BROKER WORLD

PETER KLEIN

CFA, is director of advanced markets and underwriting at Secor Advisors Group, LLC, and IDA. With more than 25 years of experience in capital markets, securities and banking, his experience encompasses both public securities and alternative asset classes, including life settlements.

Klein started his career with Travelers Insurance Company in investment management. During his tenure at Travelers, he attended life insurance school, receiving extensive training in life insurance products. He has advised corporations on keyman policies, performance bonds, corporate COLI plans and non-qualified pension plans.

For the last several years, Klein has provided consulting services to life insurance general agencies and independent marketing organizations. He holds two graduate degrees, an MS in science and an MBA from the University of Connecticut.

Klein can be reached by telephone at 317-414-1205.

The Fourth Estate

Increasingly I hear the following refrain from clients and friends alike: After watching their 401(k) accounts go up and down—an experience equivalent to a white-knuckled roller coaster ride—most wish they had bought an annuity 10 years ago instead. **Fixed long term annuities can provide years of certain return and predictable growth.**

As a benefit of this post-recessionary period, most investors now have much better appreciation for Mark Twain's quote:

I am more concerned about the return of my money than a return on my money.

Before the meltdown of home mortgages and home values, a typical financial planner would have dispensed the following advice: Buy the most house you can afford, leverage the purchase as much as possible since the interest (up to $1 million in principal) on the home mortgage is tax deductible, and invest as much as possible in a 401(k) account and growth stocks, and avoid annuities, since they typically come with higher fees and offer lower returns. Unfortunately, if that advice were followed, clients would have sustained substantial losses. The illustration on this page shows a typical homeowner's dilemma with his assets in a rather precarious state.

Unfortunately, clients were vulnerable to such suggestions. After all, home values continued to climb seemingly unabated, the stock market would rise and fall, but in the end, seemed to drift inexorably upward. Prior to 2008, history was on the side of financial planners. But in fact investing is a complex game. Warren Buffet addresses the challenge of investing in his quote:

If past history was all there was to the game, the richest people would be librarians.

Clients and Investors' Proclivity

People are hard-wired to see the world as it was—not as it is or is evolving toward. As subtle accretive changes create transformative milestones, their behavioral predilections get in the way of objective thinking. Change is occurring all around us, and the cycle of progress and obsolescence is accelerating, yet people are blind to these signposts signaling change.

In the 1980s the stock market was dominated by such companies as General Motors and Kodak, long-established companies that were leaders in their respective industries. One of those firms has gone through bankruptcy, while the other is expected to declare bankruptcy shortly. Alternatively, major companies like *Google, Amazon* and *Facebook* didn't even exist at that time.

Given the fundamental and seemingly intractable worldwide economic problems, we may be facing a decade of lackluster performance for the stock market. Just as Bill Murray woke up to the same recurring events day after day in the movie *Groundhog Day,* it's likely that outlook foretells a groundhog decade for the stock market that will repeat its near-breakeven returns from the past decade!

There has never been a 30-year period for the stock market when investors have lost money; yet there have been quite a few 30-year periods that may have financially weakened some senior citizens who were relying on their stock portfolios for retirement income.

Historical averages can vary widely depending on their starting and ending points. For example, averages that started before the 1929 crash are substantially different from those that started after it.

Edward Easterling, CFA, founder of Crestmont Research, felt that choosing a single date to determine market returns was arbitrary. In response, he created the Stock Market Matrix Chart, which shows annualized returns based on thousands of possible combinations of market entry and exit. (Due to space limitations, I am unable to show the chart in this article; but I strongly urge you to spend a few minutes and review it at *www.crestmontresearch.com/stock-matrix-options.)* The significance of this matrix is that it demonstrates significantly more market volatility than most of us realize—even over periods as long as 20 years.

If you have trouble imagining a 20 percent loss in the stock market, you shouldn't be in stocks.

John (Jack) Bogle, founder
The Vanguard Group

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The Challenges of Retirement

Most financial plans are based on the premise that a client will make elections at retirement. In this recession, we're discovering this isn't always the case. In the last three years, with an information-age economy increasingly based on advancing technology, we have witnessed layoffs that target certain age groups, such as older, more senior members of the work force. Those who are more than 50 years of age are finding themselves increasingly less competitive in a technology and information dominated economy. Some in their late 50s and early 60s have been forced into retirement without adequate retirement funds or pension.

According to a 2006 survey conducted by McKinsey & Company,[1] even before the recession, four out of 10 retired workers left their jobs sooner than they had planned, usually because of health problems or loss of employment. The survey also found that 45 percent of people who were currently employed planned to keep working past age 65. However, among the retirees polled, only 13 percent said they had done so.

These findings raise concerns about Americans being able to achieve comfortable retirement. This was the perspective prior to the great recession of 2008, which has impacted older members of the work force disproportionately.

If your clients can't plan the timing of their retirement, then what control do they have in executing their retirement plan?

For older members of the work force, there may be the realization of a direct correlation between the strength of the economy, employment status and value of retirement funds. Just when they need access to their retirement savings the most, the market values are likely to be in decline.

For the first time the Federal Government Accountability Office (GAO) has acknowledged this to be a problem for retirees. Their report to the U.S. Senate in 2011—"Retirement Income, Ensuring Income throughout Retirement Requires Difficult Choices"—*recommends that future retirees without pensions allocate a portion of their savings to annuities.*[2]

Moreover, the GAO report advocates modification to tax law on minimum distributions from deeply deferred annuities to provide greater incentives for retirees to invest in a relatively new category of annuities that are designed to act as longevity insurance.

This current generation of the older workers may still be more fortunate than the next—those under 40 years of age—who will likely have only limited access to Social Security benefits. See the diagram (on page 18) compiled by the GAO of a current middle income household with someone 65 and older. Fifty-six percent of their income is derived from Social Security, while

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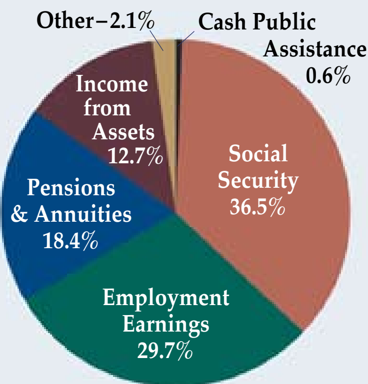
Sources of Aggregate Income for Households with Someone Age 65+



Source: U.S. Government Accountability Office

almost 20 percent is derived from pension and annuities.

The problem is exacerbated by the continued replacement of benefits such as pensions and Social Security, which minimize exposure to investment and longevity risk compared to IRAs and savings that must be managed to prevent those funds from being depleted before death. Many employers no longer provide traditional pensions with guaranteed monthly payments. Instead, they offer 401(k) saving plans, which leaves it up to the workers to salt away enough money and to make those funds last into advanced old age. Consequently, in protracted periods of low interest rates, many retirees are forced to spend an increasing proportion of their principal to sustain budgeted spending and maintain their standard of living.

What Options Should Clients Consider?

In light of these challenges, clients should consider building a "Fourth Estate" composed of non-correlating investments such as annuities and special purpose life insurance products with long term care riders, and thereby off-load longevity risk and capital market risk.

Annuities offer considerable benefits over other kinds of retirement products, especially for those who cannot deal with the risk of market volatility and the proportionate loss of their retirement savings. For example, with an immediate lifetime annuity contract, your clients are guaranteed periodic payments for as long as they live. Consequently, the risk of them living a long life is borne by the insurance company.

Social Security and pensions offer a similar form of retirement income protection—but in limited dollar amounts. Alternatively, the size of periodic annuity payment is based on the amount of money your clients have to purchase an annuity. For many retirees, the older they are, the larger their monthly payments will be for the same price.

Unlike a defined benefit plan, annuities can be tailored to provide inflation protection by ensuring that your clients' monthly paychecks will keep pace with their cost of living. For example, the GAO calculates that income of $1,000 per month in 1980 would have purchasing power closer to $385 a month 30 years later in 2009.

Life insurance carriers are regulated by the states, and they must maintain reserves to meet future beneficiary obligations. Their capitalization structure gives preference to beneficiaries if there are inadequate assets.

In the case of fixed and indexed annuities, they offer guarantees that their future balances will be at or above the amount invested. Effectively, your clients have a guarantee that they will receive back at least as much money as they invested in the annuity and, at the same time, that annuity will offer tax-efficient, tax-deferred returns.

Despite the many advantages of annuities, they do have some downsides. There are many types of annuities, and choosing the right one can be challenging.

On a risk/return spectrum, since fixed annuities are considered a safe and conservative investment, they don't offer the returns of riskier investments. In addition, annuities are typically less flexible than other retirement options—once your clients purchase an annuity contract their capital is tied up in that annuity and they no longer have access to that lump sum of money.

Some retirement financial planners recommend that clients reserve at least 40 percent of their retirement assets for unforeseen circumstances. Because most annuities are designed to provide steady income over time, they are not suited to cover large unplanned expenses.

Let me close with this one final quote from Oscar Wilde:

When I was young I thought that money was the most important thing in life; now that I am old, I know that it is.

1. McKinsey & Company report based on a national survey of 3,086 people, 40 to 75 years old, conducted March and April 2006.

2. United States Government Accountability Office (GAO) "Retirement Income, Ensuring Income throughout Retirement Requires Difficult Choices," Report to the Chairman, Special Committee on Aging, U.S. Senate, June 2011.