Who Will Dominate the Retirement Advice Business?

December 7, 2015

by Joe Tomlinson

In the way Amazon dominates the book-selling business, a financial-service provider will emerge as the leading provider of retirement-income strategies. Here is how to assemble a full business model and my predictions about which companies have the best chance to take over.

The retirement advice business is fragmented, inefficient and serves only a small segment of the population. It's a business model ripe for takeover by a few major players or maybe even a single category killer like Amazon. Most of the pieces required to build a dominant business model already exist, they just haven't been appropriately combined.

The need

Mass affluent individuals and couples are shouldering more of the responsibility for retirement planning, but poorly equipped to deal with the complexity. The financial advice business has concentrated on the upscale market, where generating retirement income is simpler than for middle-income households. Upscale clients can live off portfolio income or take systematic withdrawals, whereas those with less savings need to consider annuities and the use of home equity to provide sufficient income.

There are no agreed-upon standards for generating retirement income. Wade Pfau, in this blog post, listed 34 different retirement-income strategies, and it's likely the full number is considerably higher. Service providers range from conscientious and capable planners to brokers whose recommendations are influenced by product commissions. Unlike upscale market advisors, those serving the middle market are more likely to be single-product salespeople than true advisors.

Add it all up and there's a huge market with unmet requirements and lots of questions about how to meet those needs.

Goals-based planning

Retirement advice tends to focus on specific recommendations about product mix, for example, "Invest $200,000 of savings in a 60/40 stock/bond mix and take systematic withdrawals, and use an additional $150,000 to purchase a variable annuity that will provide 5% guaranteed lifetime withdrawals."

A better approach would focus on goals first and then rely on a computer model to come up with the best product mix. Without getting into product details, the advisor and client would make decisions about goals, such as the level of income to be generated, the maximum risk of depleting funds and desired liquidity. The goals for each particular client would be reached by dialing a mix of investments and annuity products – quite different from the way it's done currently.

The good news is that there are systems that already do this, but they haven't gained much traction. This recent article in the *Retirement Income Journal*, available to subscribers or for purchase, summarized the various offerings. A system that has been around for years is QWeMA, originally developed by retirement research guru Moshe Milevsky and now offered by Cannex. A newer development is the ReLIAS system offered by economist Mark Warshawsky.

The target market for these systems has been large financial institutions to provide a marketing tool for their salespeople, but the systems have not achieved widespread use because they don't fit with the product-push culture of those sales organizations. A different target market is independent advisors, but, given their upscale focus, there's not much demand for systems that recommend mixes of annuities and regular investments.

Full optimization

Besides systems like QWeMA and RELIAS, optimization can be obtained by applying the economic concepts of life-cycle finance and consumption smoothing. Nearly 100 years of economic research has focused on this subject, including work by more than a dozen Nobel laureates. However, very little of this research has crossed over to the retirement-planning practice, partly because there is a lot of math involved, including the use techniques such as stochastic-dynamic

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programming.

But there is amazing power in these tools and techniques, if the applications can be brought “down to earth.”

One particular issue is that the optimization techniques rely on utility functions, which brings back bad memories from college economics classes. But aside from the graphs and equations, utility functions simply help us understand client preferences. Does the client prefer moderate and steady retirement income or a higher level of income that is more volatile from year to year? How important is it that the income not decline or fall below a certain level? What about liquidity needs? How important is leaving a bequest?

Answers to questions like these should feed into optimization programs that make recommendations about allocating assets and taking withdrawals from savings. Examples of optimization systems are ESPlanner and AACalc (which is free). More research needs to be done on how best to obtain client preference information to feed into the front end of such systems, but that is a manageable undertaking, not “rocket science.”

One issue for researchers and software engineers is whether to run different optimizations in sequence, for example run ReLIAS first and then AACalc, or attempt to meld everything into a big optimization model. Other optimization models could cover such matters as when to retire, Social Security-claiming strategy and use of home equity. The modeling building blocks are mostly available but in need of assembly.

Product needs

Most of the insurance and investment products needed already exist, including index funds and ETFs, various types of annuities and even reverse mortgages to generate retirement income from home equity. However, enhancements are needed to better meet the needs of retirees. A useful annuity enhancement would be a more attractively priced inflation-adjusted single-premium immediate annuity (SPIA). Inflation-adjusted SPIAs are available, but are currently overpriced compared to regular SPIAs as I discussed in this *Advisor Perspectives* article. The inflation-adjusted SPIA is the most natural product to supplement Social Security income (since Social Security itself is, in effect, an inflation-adjusted SPIA).

Another SPIA enhancement would be to add a long-term care “pop-up” benefit that would double or triple the SPIA income if the annuitant experienced mental or physical decline to a level eligible for LTC-claim status. This “Life Care Annuity” was proposed by economist Mark Warshawsky more than a decade ago and even tried by a few insurance companies, but has never caught on with their salespeople. It would have more potential in a full retirement planning context. Warshawsky described the product in detail in Chapter 6 of the 2009 CFA book, *Private Wealth – Wealth Management in Practice*. Expensive long-term care can be financially devastating, so the LTC issue needs to be addressed in any comprehensive retirement planning model.

Delaying Social Security remains a useful strategy despite the recent elimination of certain coordination strategies for couples. There are a number of software products and services that can be used to develop recommendations for Social Security claiming, but it would be useful to have a product to coordinate with the recommendations. This would be a temporary annuity that would utilize savings to generate an inflation-adjusted cash flow stream that would begin at retirement and end when delayed Social Security payments commenced. The combination of annuity payments and delayed Social Security would be calculated to produce an inflation-adjusted cash flow stream beginning at retirement.

Enhancements to managed-payout funds would be another useful addition to the retirement toolkit. In this *Advisor Perspectives* article, I remarked favorably on the current Vanguard product but advocated for an alternative design aimed at spreading payments over remaining life in line with life-cycle finance considerations. Such a product would be useful for generating systematic withdrawals for discretionary spending after basic needs had been met with guaranteed lifetime income from Social Security, pensions or annuities. It could also be used in place of annuities by those concerned about liquidity and control, although it would not provide the mortality pooling benefits of annuities.

Looking ahead

Now for predictions. Will the retirement advice business consolidate? If so, who will be the key players? Could a single category killer emerge to dominate the space?

Building the needed systems will require a lot of money and talent – researchers and software developers. Marketing and promotion, also expensive, will be necessary to achieve a critical mass of users. But once built, the marginal costs of serving clients will be greatly reduced compared to today.

These considerations point to dominance by one or a few major players.

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The amount of human guidance that clients will still require is an unknown. Obviously, this will vary by client, but regardless of client particulars, advisors will be better equipped to deliver planning services if they have access to comprehensive retirement planning software.

As for who is likely to take a lead role, possibilities include big financial institutions that already serve the public directly such as Vanguard, Fidelity or Schwab. However, these big players will have a hard time moving beyond their pure investment focus and incorporating annuity products or reverse mortgages. For example, even though Vanguard offers attractively priced annuities through partnerships, their newly launched Personal Advisory Services will not recommend annuities – no matter how compelling the need. Entrenched corporate cultures are hard to change.

There are bigger challenges for insurance giants like Prudential or Met Life aspiring to a dominant role, even though products like annuities are a core focus. They are likely to be impeded by a product-push sales culture and channel conflict with new ways of packaging and delivering products.

Financial-planning software firms like MoneyGuidePro or eMoney may step up and develop more comprehensive software. But my conversations with individuals associated with different software firms indicate that they face challenges maintaining and updating their existing systems, which are focused on the accumulation stage of investing. One owner of a software company told me, “We’d really like to get to the fun stuff, but we’re stuck in the day-to-day.”

And then there are the robos, where there is much debate about the potential to disrupt the financial advice business. Robo efforts have focused on accumulation, but there may be even more potential for the retirement phase when computer power is particularly well-suited to deal with added complexity. Of the robo players, Betterment has placed the most focus on retirement income and has developed a proprietary system for dynamic retirement-income management so that withdrawals adjust depending on investment experience. However, its focus has been limited to investment products.

Another potential dominant player is Financial Engines, which has built a significant base of 401(k) clients and offers the “Income+” program that integrates investments and annuities. This company brings a lot of research brainpower to solving the retirement income puzzle including Nobel laureate Bill Sharpe and economists John Watson and Jason Scott who have done considerable research on generating lifetime income.

Of the potential players in this race, my view is that Betterment and Financial Engines are best positioned to ascend to a dominant role. Vanguard also has potential if it overcomes its bias against non-investment products. Who ultimately succeeds will depend on the strength of its ambition to dominate, and the research, systems and marketing resources it brings to the task.

Timing is impossible to predict. The pieces are mostly in place, so the main challenges are the assembly followed by marketing and promotion. A quote from German economist Rudi Dornbusch applies: “In economics things take longer to happen than you think they will, and then they happen faster than you thought they could.” Developments, when they come, will be game-changing.

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