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Retooling Retirement

Product Insight
By Joan Warner
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The fear factor among investors scared of outliving their money multiplied exponentially in 2008, and combatting that fear usually means a flight to guaranteed products, which, most conventionally in recent years, have been variable annuities with lifetime income riders.

These products have been around since the last market crash, surfacing in 2002, and have remained a viable option for many investors. "I've been using variable annuities with income riders since they started," says Tim Kaminski, a Fintegra rep at Security State Bank in Hibbing, Minn. "They've been a godsend for peace of mind in this market."

But some advisors say the cost of variable annuities' guarantees is prohibitive. Add up a mortality and expense charge of 1.25% to 1.75% per year, investment charges of 1% or more, administrative fees of 0.15%, $25 to $50 for annual contract charges and a fee of 0.75% to 1.5% for the guaranteed income benefit rider, and your variable annuity could be bleeding 4% a year or more—and that's if you don't incur any surrender charges. Plus, rider fees are usually a percentage of the guaranteed part of the account, but with the way the market has been going, insurers may no longer be able to afford to attach a fixed price to their riders. "These riders have been underpriced in the past," says Robert Schmansky, a CFP who practices in Royal Oak, Mich. "My concern with the newer versions is that they replace a set fee with one that can increase."

The Other White Meat

Concern over annuities' cost, plus demand among consumers for guaranteed returns have, however, led providers outside the insurance field to enter the fray. Some of these alternatives to annuities are insurance hybrids—basically, managed accounts with a guaranteed income benefit that kicks in after a certain age, usually 65. Some are simply funds of mutual funds designed to provide monthly payouts until a particular target date. And the newest are structured equity products that try to limit downside risk while providing an income stream. That's good news for advisors desperate to have something other than just annuities to talk about with frightened clients, says Kathy Cody, who heads the Alternative Retirement Solutions group at Hartford, Conn.-based Phoenix. "Advisors have to be proactive with investors, and the timing is good for products that protect against volatility."

Whether these instruments will live up to their promise is anybody's guess. Skeptics point to their complexity as just one hurdle advisors face. "One of the big challenges for the industry is to come up with solutions that can be easily described to the person putting his retirement in your hands," says Stephen Mitchell, acting chief operations officer of the Retirement Income Industry Association. Then there's the issue of cost. A brutal investing environment challenges the actuarial model on which annuity underwriting is based, forcing providers to raise their fees or go out of business. Finally, the many income-generation products coming to market are difficult to compare.

Hybrid managed account/annuity products aren't cheap either—about half the cost of variable annuities-but they have a high emotional

appeal for clients because they sound simple and convenient. They wrap a lifetime income guarantee from an insurance company around an investor's managed account, creating an annuitized UMA. First out with this instrument was Phoenix, which last March launched its Guaranteed Income Edge product in partnership with Lockwood Capital Management, a subsidiary of Pershing (itself a unit of Bank of New York Mellon). The client gets a 5% annual income guarantee, layered onto Lockwood's Longevity Income Solutions Squared (LISS) asset allocation portfolio, even if the managed account falls to zero. "This product represents the convergence of the asset management market and the insurance market," says Phoenix's Cody. "Both are putting their intellectual capital to create solutions for baby boomers."

She says target clients for Guaranteed Income Edge portfolios are 55 to 70 years old, with a net worth of $1 million or more. The LISS portfolios may be allocated to 60%, 80% or 100% equity, and clients can change the mix depending on their age or on market conditions. They may start taking distributions at 65 or later, and they can terminate the guarantee feature at any time. Like variable annuities with income riders, fees on this hybrid product get more expensive as the account grows. Phoenix's charge of 1.25% comes on top of 50 basis points that go to Lockwood and an advisor fee of around 1%.

Insurers, including Allstate, Prudential, Alliance and Nationwide have registered or are working on similar hybrids, as are Envestnet Asset Management of Chicago and Genworth of Richmond, Va. Phoenix, meanwhile, is bullish enough about the product's success that it is creating additional versions of Guaranteed Income Edge with other partners, to be announced later this year. Cody says that 75% of sales are for IRA and 401(k) rollovers.

Hybrid Overkill?

Some advisors think the hybrid approach is overkill. They say that having flexible income options will be more important than anything else to retiring baby boomers, and they're reaching out to advisors with low-cost options for transitioning clients gradually from the accumulation to the distribution phase. For example, in 2004, Hueler Investment Services, a third-party provider based in Minneapolis, launched Income Solutions, a web-based system that allows individuals to buy immediate fixed annuities at institutional prices when they roll over IRA assets.

Chief executive Kelli Hueler says her company's product remedies the traditional problems that have given annuities a bad name among many consumers, especially lack of transparency in pricing. It's also less rigid. "We recognized that the way lifetime income had been delivered to transitioning employees was subpar," she says. "People had to make an all-or-nothing decision: lump sum or annuity. The first gives you a big check you control on your own. The second locks up your money. Present that to a roomful of retiring employees, and only one person in the room will pick the annuity." That's particularly true for a generation of workers who've been trained to take responsibility for their finances.

Instead, Hueler's platform allows retirees to annuitize portions of their IRA or 401(k) balances as income needs change, when they stop working and at any time thereafter. For example, a client could buy one fixed annuity with 20% of his account right away to cover basic expenses, then buy another 20% worth of a different annuity later in the interest-rate cycle. Retirees can choose annuities from a stable of nine providers (growing to 10 or 11 this year) that Hueler vets for cost-efficiency and financial soundness. These include insurance companies and financial supermarkets such as ING, which became a partner in April. And Hueler's 1% fee is factored into monthly income quotes. At that rate, she estimates retirees can make 5% more in distributions than they could with a retail annuity. Early adopters among large fiduciaries included plan administrator Hewitt, Wachovia, the United Nations Federal Credit Union, and Boston University.

Recently Hueler formed an alliance with the National Assocation of Fee-Only Advisors (NAPFA). She says fee-only planners would love to be able to recommend a pure income-generation platform at low cost. "When you start bundling competing objectives into one product, and trying to get everything under one umbrella, it gets too expensive," she insists. "You need costly distribution, it's complicated and hard to explain, and you package in a significant margin. At the end of the day, that's not in the best interests of consumers."

Fidelity Investments last fall rolled out a similarly named platform, Lifetime Income Solutions, as one distribution option for the retirement plans it administers. But for the most part, the big mutual fund families have concentrated on so-called target payout funds. These are not the same as target-date funds, which automatically reallocate assets to create a portfolio that becomes gradually more conservative and income-oriented as a specified retirement date approaches. Rather, a target payout mutual fund returns investors' money via monthly payouts. Some are designed to be depleted by a particular date; others seek to preserve or grow principal. The investor picks a

rate, usually between 3% and 7%, but sometimes higher, at which distributions are calculated.

For instance, Vanguard launched three payout funds of funds in May 2008: a growth fund that distributes 3%, a growth and distribution fund that pays 5% (which has proved the most popular), and a distribution-only option that pays 7%. The three products have gathered about $300 million in assets since they launched. "We view these as mini-endowments for the individual investor," says Vanguard spokeswoman Rebecca Cohen. "A lot of financial advisors like to do complex drawdown strategies for their clients. But for a smaller-asset client who needs an income strategy and doesn't want to put a lot of effort into customizing it, these could be a good solution."

Fidelity's family of 11 Income Replacement Funds (soon to be 14) are combination target-date funds, with horizon dates in two-year increments from 2016 to 2036, and payout funds. Depending on the size of the account and the "horizon date," the company determines a payment schedule designed to keep pace with inflation. And Charles Schwab in March debuted three Monthly Income Funds, structured a bit like Vanguard's (a 3% to 4% "moderate" payout model, a 4% to 5% "enhanced" version, and a 5% to 6% "maximum" payout fund, in descending order of equity exposure).

Payout funds are relatively low cost, usually between 50 and 60 basis points, and are often marketed as an alternative to annuities. Of course, the biggest difference is that principal isn't guaranteed with a mutual fund, and the income stream will fluctuate depending on how the funds perform. That uncertainty—and the one-size-fits-all approach—leaves some advisors cold. "This seems like a lazy way to go about creating an income strategy," says Schmansky. "We can manage client portfolios more prudently than that."

First-of-Breed

Perhaps the most complex of the new breed of retirement income generators is a structured product that purports to address longevity risk, pay for inflation, and offer withdrawal flexibility. Called Alphacycle retirement income solutions, it's due to hit the market early this year. Its creator, Wellesley, mass.-based portfolio and index manager F-Squared investments, will offer the product through Smartleaf, a provider of overlay technology and distribution services for SMAs and UMAs based in nearby Cambridge, mass. Alphacycle portfolios are actively managed to limit downside volatility, yet the delivery model allows F-Squared to price the product competitively, at a cost of less than 1% to the investor. The withdrawal rate begins at 5.9%, with an embedded annual increase to offset inflation, and ideally is meant to rise as the retiree ages, performance permitting.

The key, according to F-Squared co-founder and CEO Howard Present, is a proprietary technique that essentially recalculates the efficient frontier as the investor draws down principal. It also readjusts for each client's changing distribution rate, time horizon and risk tolerance. "This is definitely a first-of- breed," says Present. "There are still a lot of people who don't appreciate the risk profile issue of systematic withdrawals."

While the low minimum of $25,000 and affordability of an AlphaCycle Retirement portfolio are attractive for a mass-customized UMA solution, managing volatility in the year 2009 is likely to be easier said than done. F-Squared is sending around illustrative materials that show a 98% probability of success—that is, its sample portfolios don't run out of principal—but there are those who feel that today's environment will put a lot of investors in that 2% failure range. "The market we're going through highlights that you can do all the Monte Carlo analysis and time-tested allocation principles you want when you're accumulating," says the RIAA's Mitchell. "But in worst-case scenarios, they can still fail you in delivering retirement income. And you may not have years to recoup your losses."

The smartest and safest approach an advisor can take in a market like this may be to manage clients' expectations. Without working and saving longer, many investors will simply have to forgo the opulent retirement fantasies they dreamed up when stocks were soaring. For those approaching their sunset years in light of the last five quarters, a steady 5% is starting to look like a beautiful thing.

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