Embarrassment of Riches

by Harold Evensky CFP®, AIF®

Embarrassment of Riches seems to be the perfect title for this research column. I came across so many different and interesting papers that I couldn’t decide which to include and which to ignore so I made the Solomon-like decision to include them all with very brief descriptions. I’ll leave the work of following up on those that might be of interest to you, my readers.

Research on the Profession

“Retail Financial Advice: Does One Size Fit All?” by Stephen Foerster, Juhani T. Linnainmaa, Brian T. Melzer, and Alessandro Previtero (National Bureau of Economic Research Working Paper 20712, November 2014). Based on an analysis of an extensive database of Canadian households, the authors’ not very complementary conclusion is that advisers induce clients to take excess risk based on the advisers—not the clients’—risk preference and beliefs. They add that the one-size-fits-all advice costs clients more than 2.7 percent per year. A limited consolation, however, is that they do note some benefits may come from financial planning and behavioral management.

“Will ETFs replace or overshadow mutual funds eventually? Yes, I believe they will.” - Jeremy Siegel

“Investing in the Future: How Megatrends Are Reshaping the Future of the Investment Management Industry,” by KPMG International (available at www.kpmg.com/dutchcaribbean/en/Documents/Publications/Investing-In-The-Future-report-fs.pdf, 2014). KPMG sees four megatrends reshaping the future of investment management and as a consequence, the future of financial planning. These include: demographics—aging population, changing role of women, increasing industrialization, growing middle class, and working longer; environment—growth of socially responsible behavior, increasing resource insecurity, and mounting environmental risks; technology—rapid pace of change increasing connectivity, data growth, and new innovations; social values, behavior, and ethics—growth of social media, importance of trust and integrity, demand for immediacy, desire for simplicity and transparency, social political, and cultural differences, and increasing demand for personalization/customization.

“Conflicts of Interest and the Duty of Loyalty at the Securities and Exchange Commission,” by Knut A. Rostad (Institute for The Fiduciary Standard's Fiduciary Reference Analysis of Investment Fiduciary Issues, April 2015). You are certainly well aware of the heated debate regarding broker and adviser responsibilities with respect to their clients. This paper by Knut Rostad is an excellent, although depressing, summary of the SEC’s position. Rostad’s conclusion is that the “traditional views that conflicts of interest are inherently harmful and should be avoided have altered. Instead, they depict a new and benign view of conflicts. A view that holds that conflicts are routine and acceptable—not inherently inconsistent with providing objective advice.”

“Major Investor Losses Due to Conflicted Advice: Brokerage Industry Advertising Creates the Illusion of a Fiduciary Duty,” by Joseph C. Peiffer and Christine Lazaro (Public Investors Arbitration Bar Association Report, March 2015). On the same subject, emphasizing the dangers of potentially conflicted advice, this Public Investors Arbitration Bar Association (PIABA) report, based on a review of the advertising and arbitration stances of nine major...
brokerage firms, finds that “… all nine advertise in a fashion that is designed to lull investors into the belief that they are being offered the services of a fiduciary.” The report goes on to claim that “investor losses will continue to mount at the rate of nearly $20 billion per year until the SEC and DOL prescribe the long overdue remedy: a fiduciary duty standard banning conflicted advice.” PIABA is obviously biased; however that doesn’t make their conclusion wrong.

Legends of Investing

“Legends of Indexing,” by Heather Bell (Journal of Indexes, November/December 2014). This is actually a series of interviews that are all well worth reading. The legends include, among others, Rob Arnott, Jeremy Siegel, David Blitzer, David Booth, John Bogle, Robert Shiller, and Burton Malkiel. To give you a flavor of the interviews, here are a few quips:

- **Arnott:** “Investors generally have large allocations to mainstream stocks and mainstream bonds. They generally have too little allocated to liquid alternatives.”
- **Shiller,** when asked if smart-beta indexes are an improvement over cap-based indexes: “No. First of all, they are active management. … The other thing I would say about smart beta is that it has become very, very popular. What we know in investing is, when stuff becomes popular, it usually doesn’t work as well.”
- **Siegel:** “Will ETF’s replace or overshadow mutual funds eventually? Yes I believe they will.”
- **Booth,** when asked about diversification: “Over some time periods, correlations are rising, and over others they aren’t. It’s left to be seen exactly what the trends are but whatever they are, the benefit of diversification is that it’s the closest thing we have in finance to a free lunch.”

**Eugene Fama: After 40 Years, the Nobel Winner Sees the World Catching Up to His Market Theories,** by Ben Johnson (Morningstar Magazine, December/January 2015). With a Nobel prize to prove it, Eugene Fama is unquestionably an investment profession legend and his Morningstar interview is well worth the read, particularly because Fama is not one to mince his words. For example, “… so the question is, when is active management good? The answer is never.”

Planning Research

“Long-Term Care Insurance: Comparisons for Determining the Best Options for Clients,” by Christopher J. Finefrock; Suzanne M. Gradisher; and Caleb M. Nitz (Journal of Financial Planning, February 2015). Noting that the cost of annual premiums from ages 50 to 60 increases 2 to 4 percent per year, and that once clients reach their 60s, premiums jump 60 percent per year, this is an excellent update on the options for long-term care insurance.

“Two Key Concepts for Wealth Management and Beyond,” by William Reichenstein, Stephen M. Horan, and William W. Jennings (Financial Analysts Journal, January/February 2012, re-printed January/February 2015). This impressive trio of authors once again remind practitioners that asset allocation is profoundly influenced by allocations to tax-deferred accounts, and that the government shares in both the return and risk of assets in taxable accounts.

“How Old Is Old? The Story of the Three Little Quips,” by Neal Cutler (Journal of Financial Service Professionals, November 2014). Cutler, a financial gerontologist, reminds us that age is not a disease, and the...

Papers published in the Journal this year will be considered for the 2016 Montgomery-Warschauer Award.
old quip, “Are you still working?” is yesterday’s story. He reports that a government estimate indicates 93 per-
cent of growth in the U.S. labor force from 2006 to 2016 will be among workers 55 and older. Ten years ago,
only 32 percent of workers age 55 and older expected to retire at 66 or older, or never. In 2014 it was 52 percent. In
2000, baby boomers age 35 to 53 said a person became old at 62. Ten years later boomers responded that old age
begins at age 70. Old is getting older.

“Reverse Mortgages, SPIAs, and Retirement Income,” by Joe Tomlin-
son (Advisor Perspectives, April 14, 2015). This important paper looks at the efficacy of using two underutilized
strategies in tandem to provide longevity protection—a reverse mortgage and a SPIA.

**Portfolio Design/Investing Research**

“Thoughts On the Future: Life-Cycle Investing in Theory and Practice,” by Zvi Bodie (Financial
Analysts Journal, January/February 2003, re-printed January/February 2015). This is a reprint of a much
earlier publication. Although Zvi Bodie is not a big fan of practitioners’ traditional approach to retirement planning, his view of life-cycle investing is an important concept for all practitioners.

“Making Retirement Income Last a Lifetime,” by Stephen C. Sexauer, Michael W. Peskin, and Daniel Cassidy (Financial Analysts Journal, January/February 2012, re-printed January/February 2015). Consistent with Bodie’s focus on downside protection, this paper develops an interesting decumulation benchmark portfolio composed of 20 years of laddered TIPS and a deferred income annuity beginning in year 21. The authors compare this benchmark, which can be implemented as an investment, to the alternatives of a lifetime inflation-indexed annuity, a target date fund, and the nominal immediate annuity.

“The Only Spending Rule Article You Will Ever Need,” by M. Barton Waring and Laurence B. Siegel (Financial Analysts Journal, January/February 2015). This paper proposes an annually recalculated virtual annuity as the mechanism to determine what an investor should spend on an annual basis. This variation in annual spending is reminiscent of William Sharpe’s lockbox approach I’ve written about before. Although unquestionable mathematically efficient, I have serious doubts regarding its viability in practice. As the paper notes: “Risk in the investment portfolio translates directly into risk in the investor’s lifetime consumption stream: a 10 percent portfolio loss requires a 10 percent reduction in spending.” It makes you wonder how an investor in a balanced portfolio that lost 30 to 40 percent during the great recession would have felt about reducing their expenses by 30 or 40 percent.

“The Longevity Annuity: An Annuity for Everyone?” by Jason S. Scott (Financial Analysts Journal, January/February 2008, re-printed January/February 2015). Although I’m not a fan of 100 percent downside protection, I do believe that deferred income annuities will become one of the most significant investment vehicles for the next decade. This paper quantifies the potential advantage of a DIA, concluding that for a typical retiree, allocating 10 to 15 percent to a DIA is equivalent to allocating 60-plus percent to an immediate annuity. To assist practitioners in evaluating alternatives, Scott introduces the “Q ratio” that he calls the “spending improvement quotient”: Q = (self-insurance costs – insurance costs)/insurance costs.

“Revisiting the Optimal Distribution Glide Path,” by David M. Blanchett (Journal of Financial Planning, February 2015). It would be hard not to include a paper by David Blanchett, so I won’t try. In this paper, Blanchett explores four alternative glide paths—increasing equity, decreasing equity, V-shaped and A-shaped. He concludes that, in most cases, the decreasing glide path was found to be optimal, and the increasing glide path the least efficient. I’m looking forward to a debate one day by the proponents of these alternative strategies.

“Re-Examining ’To Vs. Through’: What New Research Tells Us about an Old Debate,” by Matthew O’Hara and Ted Daverman (Journal of Retirement, Spring 2015). Wrapping up with another glide path story, these authors address the question of “to” versus “through,” and conclude that an optimal investment strategy is to be fully invested in equities early in your career, gradually decrease equity exposure in the middle of your career, and maintain a constant equity allocation throughout retirement.

Well, that’s all for now. I hope you find one or more of these worth pursuing. I believe you’ll be rewarded in the effort. And, if you read something you think should be shared with other readers, please drop me a note at harold@ek-ff.com.