EDHEC–Risk Days 2016

Bringing Research Insights to Institutional Investment Professionals

EDHEC-Risk Days 2016
London, March 16, 2016, 8:30 am - 10:30 am

New Frontiers in Retirement Solutions

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Outline

- On the Relevance of the Retirement Goal
- Key Requirements for a Meaningful Retirement Solution
- The Retirement Investing Products Landscape
- Enhancing Engagement Through Retirement Investing Dialogue
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From Investors’ Problems to Investment Solutions

- Stating the obvious: Investors are facing specific problems, for which they need dedicated investment solutions, as opposed to off-the-shelf investment products.

- This recognition is having a profound impact on the investment management industry, with the emergence of a whole new investment paradigm.

  - Liability-driven investing for institutional investors (LDI) – Investors’ problems can be summarized in terms of their liabilities, as well as their dollar and risk budgets.

  - Goal-based investing for individual investors (GBI) – Investors’ problems can be fully characterized in terms of their goals as well as their dollar and risk budgets.
On the Relevance of The Retirement Goal

- A variety of **meaningful goals** can be identified for most individuals and households, including among others:
  - **Target date wealth accumulation**;
  - Financing **children education**;
  - Financing **consumption in retirement**.

- In this presentation, we focus on the **retirement goal**, arguably the most important of all goals, especially with important changes impacting all 3 pillars of retirement financing: as a result of weakening state pension systems, the shift from DB to DC pension schemes in the corporate world, and the emergence of individual retirement accounts, financing consumption in retirement has become **the greatest challenge** for most individuals and households.
The US Retirement Landscape

**Figure 4**: Workers with Pension Coverage, by Pension Type, 1983, 1992, 2001 and 2013

Source: Boston College Center for Retirement Research, based on data from the Federal Reserve's Survey of Consumer Finances.

Total US retirement assets $24.8 Trillion

Source: US Total Retirement Market, Investment Company Institute 2015 (IRA data is estimated)
The UK Retirement Landscape

Around GBP 3.9 trillion in UK retirement assets

Estimated UK retirement assets, 2013
GBP billions

- Total retirement savings: 3,960
- DB – occupational: 1,100
- DC – trust-based: 632
- DC – contract-based: 199
- DC – personal pensions: 107
- ISAs: 326
- Annuity/life insurance: 470
- Other retirement savings: 871
- Workplace distributed: 887

1 2013/2014 estimates
2 Mutual funds, securities, and deposits held as retirement savings

SOURCE: McKinsey Asset Management Growth cube; Office of Fair Trading; Financial Conduct Authority; Spence Johnson

Source: McKinsey & Company: In the Eye of the Storm: Transformation in the UK Retirement Market
2013 Retail Distribution Review:
- Distinction between independent financial advisors (IFA) and restricted financial advisors.
- Upfront remuneration (flat, hourly or as portfolio percentage for ongoing advice) of advisors by customers, instead of retro-commissioning practices.

2015 Pension Act:
- As of April 2015 the UK government has nullified the compulsory annuity purchase.
- George Osborne, UK Chancellor of the Exchequer: "Let me be clear: No one will have to buy an annuity … People who have worked hard and saved hard all their lives, and done the right thing, should be trusted with their own finances. (…) Pensioners will have complete freedom to draw down as much or as little of their pension pot as they want, any time they want. No caps. No drawdown limits."
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“It is, of course, not new to say that optimal investment policy should not be “one size fits all”. In current practice, however, there is much more uniformity in advice than is necessary with existing financial thinking and technology. That is, investment managers and advisors have a much richer set of tools available to them than they traditionally use for clients. (…) I see this issue as a tough engineering problem, not one of new science. We know how to approach it in principle (…) but actually doing it is the challenge.”

Thoughts on the Future: Theory and Practice in Investment Management
Robert Merton (FAJ, 2003)
Investment management is the art and science of efficiently spending investors’ dollar and risk budgets so as to help them meet their goals or liabilities.

There are a few (very few in fact) basic requirements for an investment solution to be meaningful for a given investor, each related to one of the 3 known forms of risk management:

- **Hedging**: a “good” safe building block, that is a goal-hedging portfolio (GHP) that replicates risk factor exposures in investors’ replacement income (replicating portfolio for IL deferred annuities);
- **Diversification**: a “good” risky building block performance-seeking portfolio (PSP) that efficiently harvest risk premia;
- **Insurance**: a “good” allocation to the two building blocks that reacts to changes in market conditions and secures *minimum* replacement income levels while generating upside needed to reach *target* levels.

“*We Know How to Approach it in Principle*”
We now analyze how far this industry currently is with respect to providing individual investors with meaningful investment solutions.

We actually have reasons to believe that our industry is about to experience something that looks like an industrial revolution:

- **Production side**: Liquid & transparent and risk premia harvesting is now feasible with smart factor indices, which are cost- (and otherwise) efficient alternatives to active managers;
- **Distribution side**: Focus is on **mass-customization** and **distribution costs**, a focus that is accelerated by the trend towards disintermediation through robo-advisors and related FinTech initiatives.

“Actually Doing it is the Challenge”
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While the principles of meaningful investment solutions are unambiguous, various forms of implementation have been reported in investment practice:

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**A Brief History of Institutional & Individual Money Management**
Retirement Product I: TDFs

- The key challenge in retirement investing can be summarized as the need to generate attractive levels of replacement income in retirement given investors’ limited dollar budgets (contributions).

- Existing products such as target date funds (TDFs) embedding life-cycle allocation decisions within a one-stop decision are not adequate retirement solutions and fall short on many accounts:
  - They provide no proper hedging for the key risks faced by investors, namely interest rate, inflation and longevity risks;
  - They generate very limited upside because of their rigid glide path schedule and poorly diversified underlying building blocks;
  - They offer no proper insurance for investors’ essential goals, namely minimum replacement income level.
Retirement Product II: Annuities

- **Inflation-linked annuities** allow investors to secure purchasing power in retirement but they also suffer from severe drawbacks:
  - **They are not available in accumulation phase** since deferred annuities only exist with starting dates from 10 to 15 years out;
  - **They are irreversible investments** that leave no room for bequest motives, which partly explains their low penetration (annuity puzzle);
  - **They do not offer any upside potential** and require excessively high contributions to generate target replacement income levels.

- The dilemma that households are left with is a choice between:
  - **Certain failure** with annuities to secure target replacement income;
  - **Full uncertainty** with target date funds to achieve such target levels.

- **Variable annuities** have been insurers’ response to the dilemma.
Retirement Product III: Variable Annuities

- Variable annuities (VAs) provide a minimum lifetime payment in retirement, with an actual payment that involves an upside depending on the performance of some managed portfolio.

- Variable annuities suffer, however, from a number of fatal flaws:
  - Their unavailability at all dates in accumulation phase, which implies that retirement investing may start too late in the life-cycle;
  - Their cost-inefficiency, which results in limited upside (prohibitive cost of capital for insurers facing strict solvency requirements);
  - Their lack of transparency and flexibility, which leaves investors with no exit strategy, unless at the cost of high surrender charges.

- A meaningful retirement solution should enjoy the best-of-both-worlds benefits of VA products without the associated flaws.
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Financial engineering can and should be used to generate a new breed of meaningful mass-customized retirement solutions – a DB-like value proposal in a DC-type environment.

The biggest challenge, however, may lie elsewhere, namely in engagement and education.

From a distribution perspective, a dedicated goal-based retirement reporting process needs to be developed to enhance the dialogue with the individual investors, allowing them to analyze ex-ante and ex-post the impact of their decisions.