The Missed Opportunity: Guaranteed Income as an Asset Class

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IMPACT POINTS

- Forty-eight percent of all U.S. households indicate having an interest in products that provide guaranteed income for life, and investors are willing to accept a low rate of return in exchange for such a product's protection. In 2010, that 48% of households represented $10 trillion in total financial assets—37% of total U.S. households' financial assets.[1]
- Consumer respondents to a 2007 survey from Alliance Bernstein and the Insured Retirement Institute (IRI) "said they were willing to pay between 4% and 6% of assets to guarantee that they wouldn't run out of money in retirement."[2]
- Of independent financial advisors surveyed by Aite Group, 65% recommend guaranteed income solutions to pre-retiree clients facing longevity risks.
    - Independent financial advisors affiliated with an insurance broker/dealer recommended guarantees 80% of the time.
    - Independent financial advisors affiliated with an independent broker/dealer recommend guarantees 69% of the time.
    - Financial Advisors affiliated with an independent registered investment advisor (RIA) recommend guarantees 49% of the time.
- Aite Group research finds that among independent financial advisors asked whether they regard guaranteed income as its own asset class, 55% do. Of independent financial advisors affiliated with an insurance broker/dealer, 62% regard guaranteed income as its own asset class, followed by 54% of financial advisors affiliated with an RIA and 52% of financial advisors affiliated with an independent broker/dealer.
- The foundational academic research of Peng Chen, Moshe Milevsky, and others indicates that income guarantees have delivered higher returns and reduced shortfall income risk levels while addressing sequence-of-return, investment, and longevity risk factors for clients.
- Given a 30-year horizon, Ibbotson research shows that adding a guaranteed income component to conservative, moderately conservative, and moderate portfolios is beneficial—it increases the average sustainable income and decreases shortfall income risk.[3]

1. Strategic Business Insights 2010-11 MacroMonitor.
2. "After the Crisis" survey, Alliance Bernstein and Insured Retirement Institute (IRI), April 2012, p. 3.
3. "Retirement Portfolio and Variable Annuity with Guaranteed Minimum Withdrawal Benefit," Ibbotson Associates, January 2010.

INTRODUCTION

For financial advisors seeking to derive better outcomes for pre-retirees planning future retirement income streams and retirees already in their distribution phase, income guarantees promise a unique contribution. Financial advisors need to deliver sustainable retirement income solutions to their clients, and income guarantees provide an income floor for withdrawal-focused clients[4] while addressing longevity, investment, sequence-of-return, and withdrawal-rate risks. Independent advisors are concerned, however; according to senior insurance industry product-development and sales executives, these concerns include control over the assets held within income guaranteed products, perceived high costs of income protection, product complexity, and worries over providers' capacity to ultimately pay the income guarantee. What is to be done about the disconnect between consumer interest in and need for income guarantees and income protection, and independent advisors' reluctance to incorporate them into their portfolio solutions?

Published by NFP Advisor Services Group and produced by Aite Group, this study assesses independent financial advisors' current position on guaranteed income as its own unique asset class and details their present and potential use of the product. It discusses expanding the existing guaranteed protection delivery model to include other potential chassis and delivery possibilities, addresses the concerns of independent advisors, and explores the gap between consumer need and advisor resistance. It also details the responses of industry senior executives, academics, and industry thought leaders who believe that income guarantees should be deemed a unique asset class, and discusses whether segmenting it as such would increase product acceptance and lead to greater adoption.

METHODOLOGY

To research income guarantees as a unique asset class, Aite Group utilized a 360-degree approach, including perspectives from investors, independent advisors, and leading insurance carrier senior executives (product development and sales). Leading academics and industry thought-leaders were also consulted. The analysis also leverages publicly available information.

This white paper is also based on a March 2012 Aite Group online survey of 248 independent financial advisors. The sample is a composite of three groups of financial advisors: financial advisors affiliated with an insurance broker/dealer, financial advisors affiliated with an independent broker/dealer, and financial advisors affiliated with an independent RIA. These data have a 5-point margin of error at the 90% level of confidence.

Aite Group conducted a total of 21 qualitative interviews with 12 leading firms and three academic and industry thought-leaders—in all, 29 professionals.

- Eleven firm interviews were conducted with 16 senior product-development executives.

4. Taxes and penalties may apply. Withdrawals in excess of the annual allotted amount by the carrier can decrease the total amount guaranteed and the value of future annual payments. Additional withdrawal charges may apply during the surrender period, and withdrawals from a life insurance policy may cause the policy to lapse.

- Seven firm interviews were conducted with 10 senior sales and distribution executives of annuity products.
- Three interviews were conducted with leading academics and industry thought-leaders.

Aite Group interviewed some firms that sell to the independent, insurance, and RIA channels and some that do not in order to determine what attracts and deters market participation. Firms interviewed represent the largest annuity sellers in the industry, according to LIMRA's Q1 2012 sales ranking, including seven of the top 10 issuing entities.

INDUSTRY OVERVIEW

In a world where pension availability is declining and defined contribution plans are offered as a substitute, the lack of income guarantees is quite apparent. Guaranteed income protection increases in value to a future retiree if market returns are likely to be low during retirement or if the retiree has a longer life expectancy than actuarial tables predict. The protection's value increases despite its lower returns because the guarantee provides an income floor that is not available in traditional portfolios, which lack guarantees. The value of the guarantee isn't received until later in retirement—when the taxable portfolio may have run out of money—but the guarantee gains value the longer a retiree lives. Investors should keep in mind that these guarantees and benefits are subject to the claims-paying ability of the issuing entity.

Defined benefit retirement plans are becoming less common. According to the Investment Company Institute (ICI),[5] in 1975—the year after the Employee Retirement Income Security Act (ERISA) was passed into law—87% of active participants in private-sector retirement plans received primary coverage through defined benefit plans. By 1990, 43% (26.2 million) of the 61.5 million private active participants in retirement plans were engaged in defined benefit plans.[6] Fast-forward to 2008, and defined benefit plans represented just 22% of active private plan participants. Moreover, the number of defined contribution plan participants almost doubled over two decades, from 35.3 million active private plan participants in 1990 to 67.3 million participants in 2008.[7]

Declining consumer access to pension plans is resulting in a greater reliance on defined contribution and other income sources derived from investable assets. The 2008 market crisis left its mark on the wealth—and, more importantly, on the behavior—of investors. A June 2012 Federal Reserve report chronicles the impact of the crisis on wealth from 2007 through 2010, and concludes that median household net worth fell 38.8%, from $126,400 in 2007 to $77,300 in 2010. The report also notes that the accompanying collapse in housing prices mostly contributed to this overall decline in net worth.[8] Add median household income declines of 7.7% in inflation-adjusted family income before taxes (from $49,600 in 2007 to $45,800 in 2010),[9] worries about economic uncertainty and job security, longevity concerns, rising healthcare costs, and stock market volatility, and one can quickly understand why income guarantees are becoming more attractive to retail investors.

In terms of household net worth, consider the declining percentage differences as one ages from 35 to 44—the hardest-hit age group in terms of net worth—to 75 years of age or older—the least-impacted group. Overall, higher housing net worth exposure as a percentage of one's total

5. ICI Perspective, "A Look at Private-Sector Retirement Plan Income After ERISA," November 2010, p. 4.
6. U.S. Department of Census, "Private Pension Plans—Summary by Type of Plan: 1990 to 2008," sourced from U.S. Department of Labor, Employee Benefits Security Administration, Private Pension Plan Bulletin.
7. IBID
8. "Changes in U.S. Family Finances from 2007 to 2010: Evidence from the Survey of Consumer Finances," Federal Reserve Bulletin, June 2012.
9. IBID, p. 1

net worth resulted in the greatest impact during the economic downturn. Still, for pre-retiree households in the 55-to-64 age band to suffer a 33% net worth hit between 2007 and 2010 and retirees in the 65-to-74 age band to suffer an 18% decline is tough medicine indeed (Table A). Managing pre- and in-retirement income streams can be difficult, particularly for those without pensions or other income sources. Behaviorally, this can result in retirees shifting their investments to minimize risk and accept lower returns from perceived "safer" fixed income and dividend equity holdings. They may also manage liability-budgeting mechanisms as they re-evaluate their household balance sheets. Clients involved in this re-evaluation exercise express interest in guaranteed income and downside risk protection. Recalling painful losses, clients further share their willingness to pay for income guarantees. One can only guess the positive contribution that income protection would have on family net worth were it instituted as an asset class and embedded in more portfolios as part of a diversification strategy.

Table A: Family Net Worth by Age of Head of Household

All families (Age of head of household)	2007 median net worth (US$)	2010 median net worth (US$)	Percentage difference
Under 35	$12,400	$9,300	(25.0%)
35 to 44	$92,400	$42,100	(54.4%)
45 to 54	$193,700	$117,900	(39.1%)
55 to 64	$266,200	$179,400	(32.6%)
65 to 74	$250,800	$206,700	(17.6%)
75+	$223,700	$216,800	(3.1%)

Source: Federal Reserve Board

Guaranteed income must be implemented before such a contribution can be seen, however. As one academic industry thought leader shared, Harry Markowitz's modern portfolio theory, introduced in 1952, was not immediately accepted. Over time, that theory has been embraced by advisors as a fundamental part of their practices and business models. Similarly, as the industry shifts to decumulation withdrawal practices, the role of income guarantees and downside protection concepts will find a way into the business models of tomorrow.

CONSUMER DEMAND FOR SUSTAINABLE RETIREMENT INCOME

This section examines how consumer demand for guaranteed income protection translates into sustainable retirement income. In assessing consumer demand, the report utilizes Strategic Business Insights' MacroMonitor data. The data set segments the U.S. household population by life stage, as defined below:

- **Starters:** Under 35 years of age
- **Builders:** 35 to 49
- **Pre-Retired:** 50 to 64
- **Retired:** 65 or older

The data also analyze wealth tiers. Within the life stages, each segment's total financial assets are cut into four groups: the bottom 30% of life-stage respondents (Marginals), the next 50% (Mass Market), the next 15% (Affluent), and the top 5% (Wealthy). Total financial assets are defined as assets that include savings, IRAs, and employer-sponsored retirement plans—401(k), 403(b), and 457 plans—but exclude defined benefit assets, home, other real estate, businesses, vehicles, and other tangible assets.

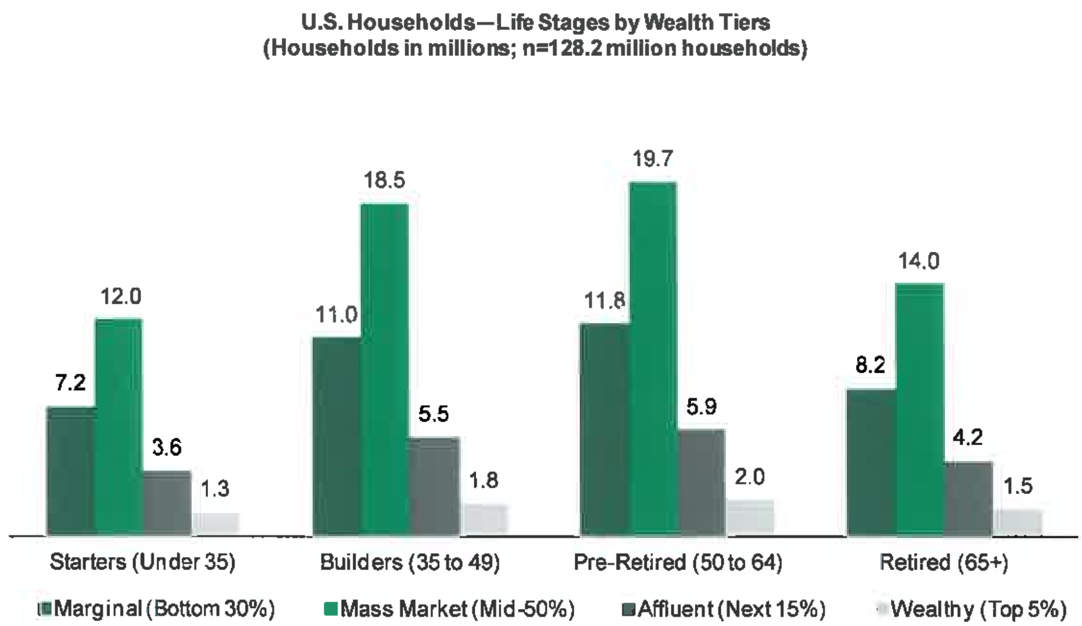
In looking at total financial assets at the aggregate level, Strategic Business Insights determined the average assets for each group as outlined below.

- **Marginal:** Less than $75,000
- **Mass Market:** $75,000 to less than $540,000
- **Affluent:** $540,000 to less than $1.2 million
- **Wealthy:** $1.2 million or more

SIZING THE POTENTIAL OPPORTUNITY FOR INCOME GUARANTEES

In sizing the opportunity for income guarantees, consider the overall U.S. household population and its current asset levels. Figure 1 represents the U.S. household marketplace and shows life stages and household financial assets.

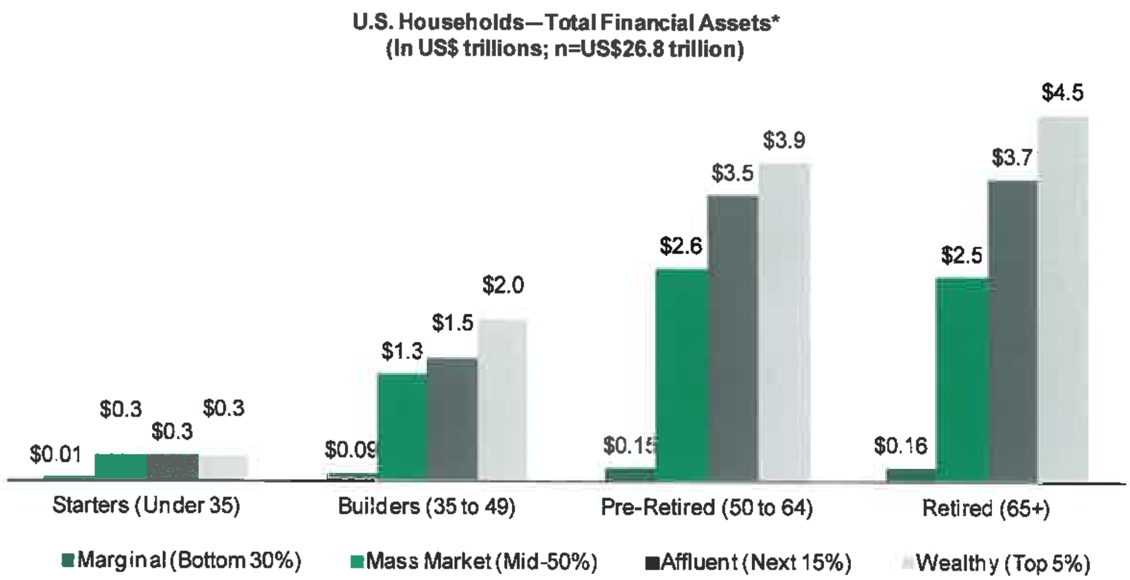
Figure 1: Composition of U.S. Household Wealth Segments by Life Stage



Source: Strategic Business Insight's 2010-11 MacroMonitor

Figure 2 illustrates total financial assets in each wealth tier by life stage. The Starters segment is unique due to its much smaller overall population, but it mirrors the other segments' total wealth patterns.

Figure 2: U.S. Household Aggregate Financial Assets by Life Stage

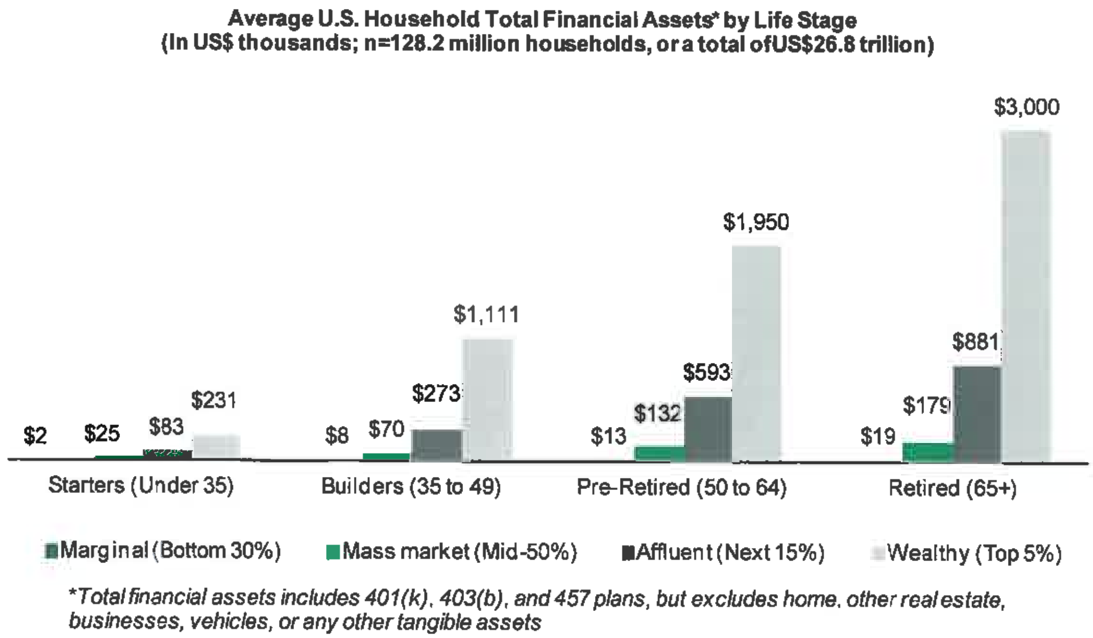


**Total financial assets includes 401(k), 403(b), and 457 plans, but excludes home, other real estate, businesses, vehicles, or any other tangible assets*

Source: Strategic Business Insight's 2010-11 MacroMonitor

Figure 3 provides the average total financial assets within each life stage. This view provides insight into asset accumulation over time across life stages and wealth tier.

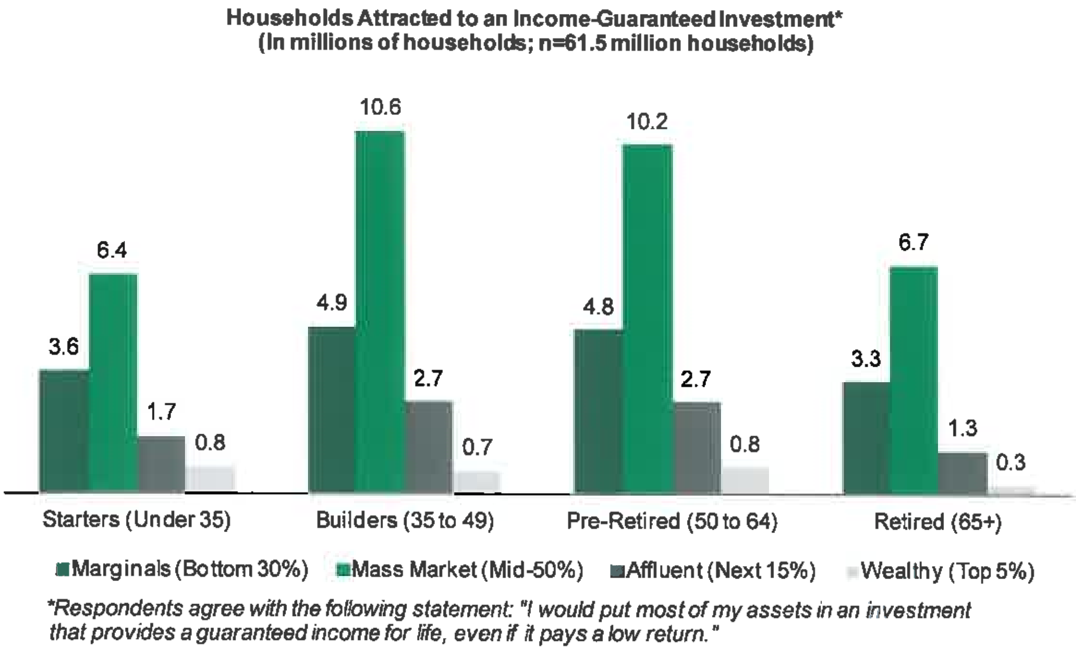
Figure 3: U.S. Household Total Financial Assets Varies by Life Stage and Wealth Band



Source: Strategic Business Insight's 2010-11 MacroMonitor

Among households asked if they agree with the statement, "I would put most of my assets in an investment providing guaranteed income," 61.5 million households (48%, or roughly half of all households) agree. While these respondent households include 16.5 million "Marginal" households that have low average financial assets (less than $75,000 each at the aggregate level, leaving little assets to devote to such a solution), a hearty 45 million households reside in the remaining wealth tiers. Further, 5.1 million households reside in the Pre-Retired and Retired Affluent and Wealthy categories that are targeted by financial advisors (Figure 4). While income guarantees may provide a low return, the raw demand for guaranteed income is thriving.

Figure 4: Households Attracted to an Investment That Provides Income Guarantees



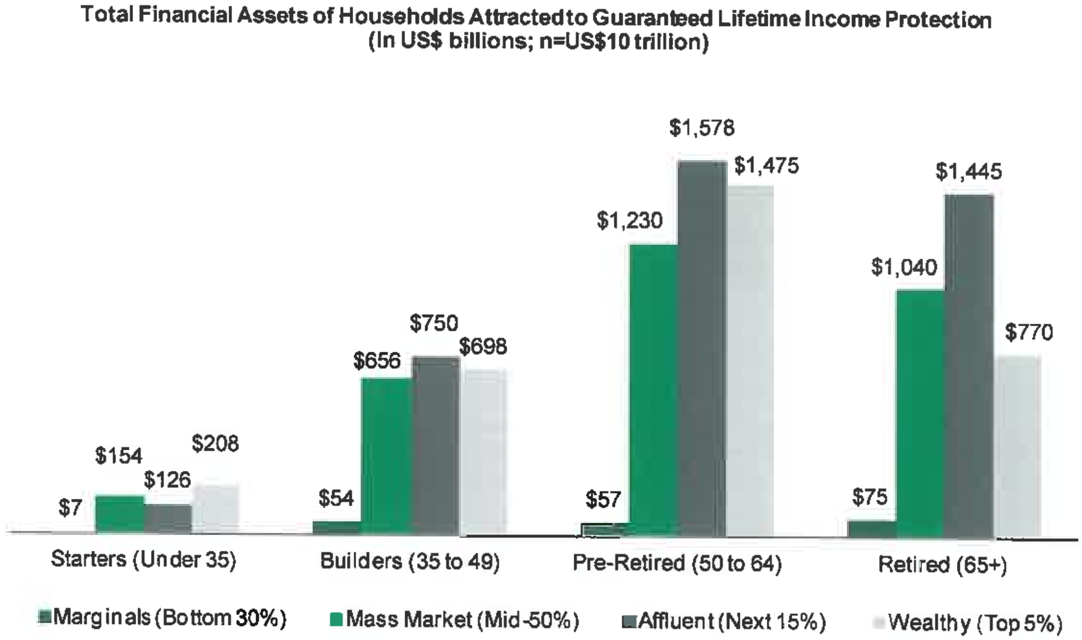
Source: Strategic Business Insight's 2010-11 MacroMonitor

These 61.5 million households control $10 trillion in total financial assets, or 37% of total U.S. households' financial assets. As one would expect, a majority of these assets resides among pre-retirees and retirees. Among the four groups, the percentage of assets controlled by respondents in the four life stages follows:

- **Starters:** $0.5 trillion (5% of respondents)
- **Builders:** $2.1 trillion (22%)
- **Pre-Retireds:** $4.3 trillion (43%)
- **Retireds:** $3.0 trillion (30%)

As illustrated in Figure 4 above, 5.1 million households comprise the Affluent and Wealthy among Pre-Retireds and Retireds attracted to an investment providing income guarantees—wealth bands and age groups that are well within the targeted range of advisors. These same households hold more than half (52%) of the $10 trillion total, at $5.3 trillion (Figure 5).

Figure 5: Total Financial Assets of Households Attracted to Guaranteed Lifetime Income



Source: Strategic Business Insight's 2010-11 MacroMonitor

CLIENT EXPECTATIONS: INCOME SURETY DURING RETIREMENT

According to the Insured Retirement Institute's (IRI) April 2012 survey, "Boomer Expectations for Retirement," clients' confidence in their retirement funds clearly declines as retirement age approaches. Among baby boomers—"Boomers"—72% of single households and 60% of married households are not confident that they will have enough money to live comfortably throughout retirement.[10] Thirty-five percent plan to retire after age 66, including the 23% who expect to work into their 70s.[11] Only 37% of Boomers expect to rely significantly on defined benefit or pension plans, while 42% expect defined contribution plans to provide a major source of their retirement income. When comparing Boomers' expected retirement security with that of their parents, 37% of Boomers feel they will be more secure than their parents, while 60% feel that they will be about the same or worse—13% regard their retirement security as significantly worse than that of their parents.

Overall, the expectation of most Boomers is that they will not be adequately prepared to cover their expenses during retirement. Almost two-thirds (64%) plan to work during retirement, and another two-thirds are not confident about having enough money to cover their medical expenses. A full 75% do not feel financially prepared for future long-term care costs. More than 85% have limited confidence in being able to provide financial assistance for their parents' long-term care needs, and 80% feel they do not have enough money to pay the costs of higher education for their children. Within the Boomer demographic, the "sandwich generation"—people who support their parents while caring for their children—experiences additional angst.

Similarly uninspiring expectations emerged from EBRI's Retirement Confidence Survey of all workers, published in April 2012: In 1991, just 11% of workers expected to retire after 65; in 2012, 37% of workers report that they expect to wait until after 65 to retire. Moreover, those expecting to retire before 65 have decreased over the last two decades, from 50% in 1991 to 24% in 2012. Seventy percent of workers today say they plan to work for pay after they retire, while only 27% of retirees report having worked for pay after retirement today. Finally, more than half of all workers (60%) report they and/or their spouses have less than $25,000 in total savings and investments (excluding their home and defined benefit plans), and 30% of those have less than $1,000.

10. "Boomer Expectations for Retirement," Insured Retirement Institute Survey, April 2012.

11. IBID

WHAT DOES INCOME PROTECTION MEAN TO A CLIENT?

According to IRI's April 2012 study of Boomer expectations, guaranteed income and principal protection rate highly among the traits Boomers seek in a retirement investment.

"Whether the 2011 survey respondents were actively saving for retirement or not, two-thirds of them ranked a steady income stream at the top of their retirement wish list."[12]

This same preference for guarantees was shown in a 2010 study conducted for Allianz Life.

"An overwhelming 80% of the people surveyed preferred a product with 4% return and a guarantee against losing value over a product with 8% return and a vulnerability to market downturns."[13]

The study also indicates that investors seek stability.

"As advisors can attest, their clients' biggest priority is to avoid a repeat of 2008's catastrophic losses at all costs. Investors crave stability above everything else—even return potential. And they want downside protection that works when they need it most, not just in theory."[14]

A May 2010 study conducted from Allianz perhaps best sums up the fear of outliving one's assets. It notes that, of 3,257 U.S. adult respondents aged 44 to 75, 61% said they, "were more afraid of outliving their assets than they were of death."[15] What does income protection mean to a client? In short, it means a great deal.

WHAT DOES INCOME PROTECTION COST A CLIENT IN ACTUAL DOLLARS?

The previous section shows that income protection is important to investors—but how much are they willing to actually pay for it? Costs for income protection vary, but, according to industry experts, the cost for the guarantee alone runs roughly 60 to 100 basis points. Other product costs—administration, distribution, and investment management—are not included in the cost of the guarantee, but must be factored in and viewed relative to the potential price investors may pay for lacking such protection. All investors must do to conjure such a situation is recall their memories of 2008's dramatic portfolio-value losses, when family households suffered a median 38.8% decline in household net worth between 2008 and 2010. Such recent memories remind investors that it takes time to make up these losses, and pre-retirees and investors already in retirement know well that making up for lost investments may mean cutting back and/or going back to work for some period of time.

12. "After the Crisis" survey, Alliance Bernstein and Insured Retirement Institute (IRI), November 2011, p. 3.
13. "Reclaiming the Future," Allianz Life Insurance Company, conducted May 2010, p. 10.
14. "After the Crisis" survey, Alliance Bernstein and Insured Retirement Institute (IRI), November 2011, p. 2.
15. "Reclaiming the Future," Allianz Life Insurance Company, conducted May 2010, p. 10.

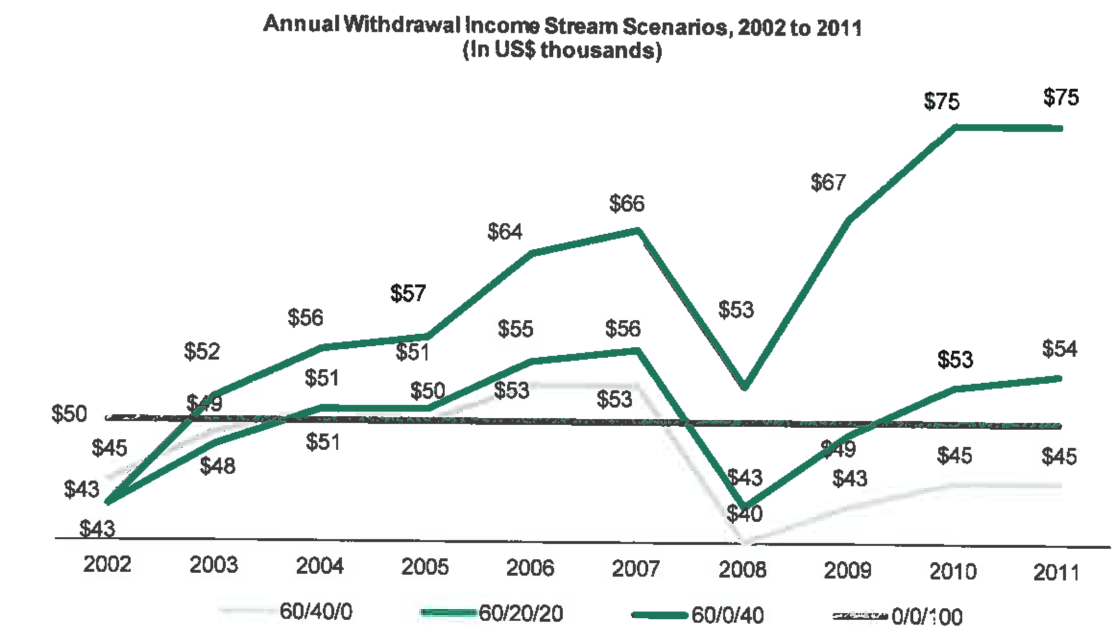
Figure 6 shows the raw return effects of four annual-withdrawal portfolios between 2002
2011, all beginning with $1 million in assets and assuming a 5% withdrawal amount. The S
500 index was used as the proxy for the equity portion of portfolios, while Barclay's Capit
Aggregate Bond index performance was used as a proxy for fixed income performance. Pr
fees, advisory fees, and inflation were not considered for this simple exercise. The portfoli
structured as follows:

- 60/40/0: A traditional 60% equity and 40% fixed income portfolio
- 60/20/20: A 60% equity, 20% fixed income, and 20% guaranteed portfolio
- 60/0/40: A 60% equity and 40% guaranteed portfolio
- 0/0/100: A 100% guaranteed portfolio with a flat 5% payout

compare this to PFM's research

While income variability certainly exists in the traditional 60/40/0 portfolio, its first three years surpass income generated from the 60/20/20 portfolio. From 2005 onward, however, the trend reverses. The 60/0/40 portfolio, apart from the first year, surpasses the traditional portfolio every year and generates the most income from 2002 to 2011.

Figure 6: Guarantees and Their Impacts on Annual Withdrawal Income Portfolios



Source: Aite Group estimates.
Past performance does not guarantee future results. You cannot invest directly in an index.

IS THAT AMOUNT WORTH THE PROTECTION?

Given the numbers above and recent memories of financial downturn, is the protection worth its price? According to a 2007 survey from Alliance Bernstein, consumers "said they were willing to pay between 4% and 6% of assets to guarantee that they wouldn't run out of money in retirement."[16] While this figure is indeed high and costly, note that this survey was conducted before the 2008 market decline. Post-2008 decline, the protection value alone for those in income mode, particularly those brand-new retirees concerned with sequence-of-return risk and those facing longevity risk, would have fared well with such protection.

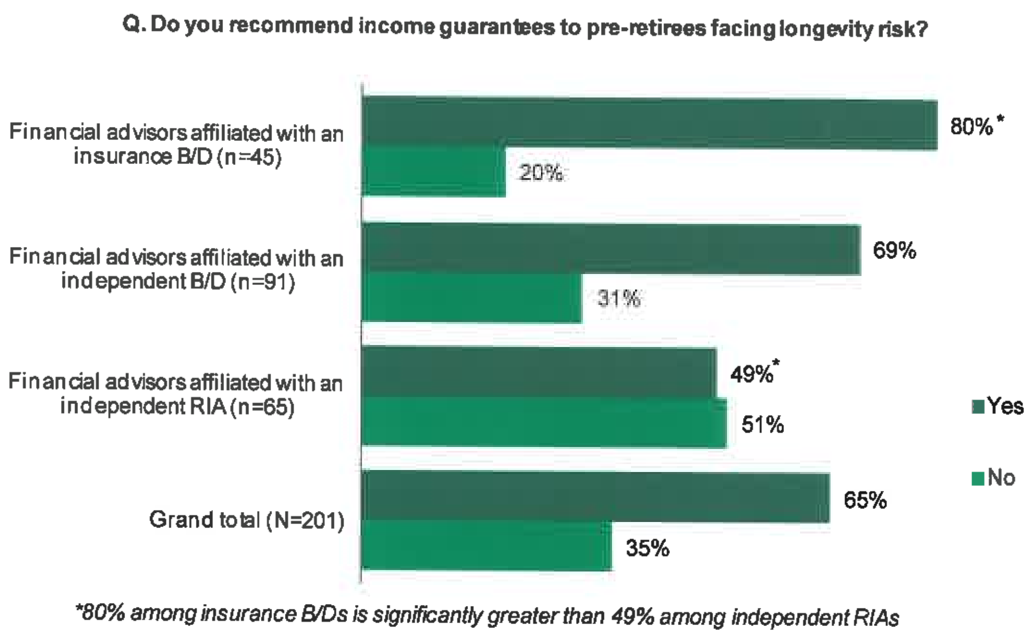
16. "After the Crisis" survey, Alliance Bernstein and Insured Retirement Institute (IRI), November 2011, p. 3.

INDEPENDENT FINANCIAL ADVISORS AND GUARANTEED INCOME

To gauge an overall willingness of advisors to offer guaranteed income solutions, Aite Group asked these advisors whether they recommend guaranteed income solutions to pre-retiree clients who face longevity risk. Aite Group aggregated and assessed the following groups independently of one another: financial advisors that are affiliated with an independent broker/dealer, financial advisors that are affiliated with an insurance broker/dealer, and financial advisors affiliated with an independent RIA.

Overall, respondents indicate a pragmatic willingness to recommend guaranteed income solutions to such pre-retiree clients (Figure 7). The insurance broker/dealer group largely embraces guaranteed income solutions, as do more than two-thirds of financial advisors affiliated with independent broker/dealers. Financial advisors that are affiliated with an insurance broker/dealer recommend guaranteed solutions at a significantly greater rate (80%) than do financial advisors affiliated with an independent RIA (49%). There is no significant difference among financial advisors affiliated with an insurance broker/dealer versus those affiliated with an independent broker/dealer. About half of financial advisors affiliated with an independent RIA show a reluctance to recommend income guarantees to pre-retiree clients facing longevity risk.

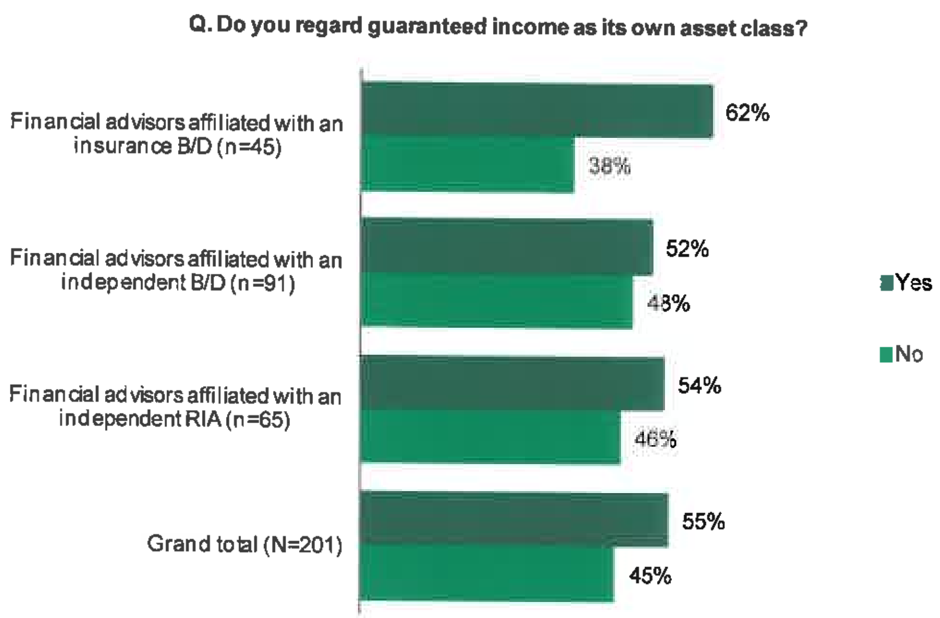
Figure 7: Guaranteed Income Solutions Face Resistance



Source: Aite Group survey of 248 independent financial advisors, March 2012

After taking this behavioral read of guaranteed protection, we shifted to an attitudinal question on the same theme, asking whether respondents regard guaranteed income as its own asset class. Overall, no significant statistical difference exists among the three groups. The insurance broker/dealer and independent broker/dealer advisors' percentages declined in contrast to their answers about using the solution for pre-retirees facing longevity risk; despite their high usage of guaranteed income, neither will yet embrace guaranteed income solutions as an asset class. Financial advisors affiliated with an independent RIA, on the other hand, remain roughly true to their usage rate.

Figure 8: Income Solutions as an Asset Class



Source: Aite Group survey of 248 independent financial advisors, March 2012

Given that these baseline levels are in place and that a majority of financial advisors affiliated with an independent RIA embrace the concept, additional inroads may be on the horizon. An advisor considering guaranteed income protection is likely concerned with tail-risk market factors that could result in clients outliving their assets, and plenty of that exists today. But steps will need to be taken in order for widespread adoption to occur. Educating advisors about the merits of income solutions as an asset class may be one of those steps: According to the numbers, insurance broker/dealer and independent broker/dealer advisors will require some education, and financial advisors affiliated with an independent RIA will require the most education and support.

GUARANTEED INCOME: ASSET CLASS AND PORTFOLIO IMPACT

Guaranteed income as its own asset class and the portfolio impact it provides is where the real value of this unique offering surfaces. But what does it do, and how? Additional education on this front, incorporating all aspects of the data discussed in this section, would provide additional insights to independent advisors.

WHAT DOES GUARANTEED INCOME DO TO A DISTRIBUTION-BASED PORTFOLIO?

Several studies have touted the rationale behind and benefits of an income guarantee, which is unique in how it interacts with portfolio construction. "Merging Asset Allocation and Longevity Insurance: An Optimal Perspective on Payout Annuities," the 2003 work of Peng Chen and Moshe Milevsky, speaks to the role the guarantee plays within the portfolio:

> Our main qualitative insight is as follows. The natural asset allocation[17] spectrum consists of investments that go from safe (fixed) to risky (variable). In contrast, the product allocation spectrum ranges from conventional savings vehicles to annuitized payout (pension) instruments. The asset and product spaces are separate dimensions of a well-balanced financial portfolio; yet the product/asset allocation must be analyzed jointly ... the numerical results confirm that the optimal allocations across assets are influenced by many factors, including age, risk aversion, subjective probability of survival, utility of bequest, and the expected risk and return tradeoffs of different investments. We claim that the first step of a well-balanced retirement plan is to locate a suitable global mix of risk and risk-free assets independently of their mortality-contingent status. Then, once a comfortable balance has been struck between risk and return, the guaranteed income component should be viewed as a second-step "overlay" that is placed on top of the existing mix. And depending on the strength of bequest motives and subjective health assessments, the optimal annuitization fraction will follow.[18]

Taking these ideas further is a 2007 Ibbotson white paper, completed for Nationwide Insurance and updated in January 2010. The 2007 white paper hypothesized (expanded upon in its 2010 study) that guaranteed income protection within a portfolio helps improve retirement income levels without causing income risk levels to rise. The study assessed the guaranteed income solution against (1) a traditional, diversified mutual fund portfolio that lacked guaranteed income protection and (2) a combination of income protection with a traditional, diversified mutual fund portfolio. The analysis assumed a fixed 5% withdrawal rate for both the traditional, diversified mutual fund portfolio and the guaranteed income protection.

17. Asset allocation or diversification does not protect against loss of principal due to market fluctuations. It is a method used to help manage investment risk.

18. "Merging Asset Allocation and Longevity Insurance: An Optimal Perspective on Payout Annuities," Peng Chen, Moshe Milevsky, February, 20, 2003, p. 9

After assessing empirical results and Monte Carlo simulations,[19] the study found that combined portfolios—those with income protection and traditional diversified mutual funds—experienced lower average negative income returns and higher total income withdrawals. As the equity portion of the traditional mutual funds segment of the portfolio increased, the portfolio provided higher total income and higher income risk. The addition of the guaranteed income protection (by replacing cash or fixed income allocations) resulted in increased total retirement income and decreased income risk. Since the guaranteed income protection component of the portfolio lacked income risk, the combined portfolio experienced overall lower income risk, while the combined portfolios' higher equity allocation contributed to higher total retirement income.

The study next analyzed shortfall income risk and median sustainable income levels for the three scenarios over a 30-year horizon. The result? All combined portfolios experienced higher median income and lower shortfall income risk compared with traditional, diversified mutual-fund-only portfolios."[20]

> For a 30-year horizon, adding a guaranteed income component "to the conservative, moderate conservative and moderate portfolios was beneficial in that it increases the average sustainable income and decreases the shortfall income risk."[21]

In short, adding a guarantee component to a portfolio works under these conditions. It increases average sustainable income while decreasing shortfall income risk, resulting in better client outcomes. Providing a guaranteed income component offers protection in market downturns and, more importantly, in reducing retirement income risk. This portfolio asset-allocation strategy may increase the amount of income generated from the entire portfolio (especially during declining long, fat-tailed market periods) and reduce the amount of income risk.

19. The projections or other information generated by Monte Carlo regarding the likelihood of various investment outcomes are hypothetical in nature, do not reflect actual investment results and are not guarantees of future results. Monte Carlo presents only one possible outcome out of a range of various outcomes.
20. "Retirement Portfolio and Variable Annuity with Guaranteed Minimum Withdrawal Benefit," Ibbotson Associates, January 2010.
21. IBID

OTHER WORK SUPPORTS GUARANTEED BENEFITS

Other work, too, supports adding a guaranteed income allocation to reduce overall portfolio while generating potentially greater income. Leading firms focusing on guaranteed income protection; David Babbel of Wharton; Peng Chen, formerly of Ibbotson and now with Dimensional Fund Advisors; Moshe Milevsky of York University; and the work of leading firms that provide guaranteed income products have discovered the benefits of guarantees and generally come to the same conclusion: The inclusion of an income guarantee for the portfolio's fixed income component improves overall portfolio sustainability over time, reduces income shortfall risk, increases income, and reduces the portfolio's overall riskiness. Regardless of the product chassis, the overarching story—that income protection/guarantees provide value to the end consumer by contributing to portfolio sustainability to the underlying portfolio—is what matters.

In "Rational Decumulation,"[22] a 2007 study, David Babbel and Craig Merrill, professors at the Wharton Financial Services Center, found that annuitizing a large portion of one's wealth at retirement—a larger portion than many financial advisors have recommended—was optimal. They also found that annuitizing a substantial portion of one's wealth, contrary to conventional wisdom, actually assists a retiree in providing a bequest for his or her heirs. Of course, the portion one should annuitize depends upon the total accumulated wealth at retirement, the profit margins embedded in pricing, the age and risk tolerance of the investor, and the returns on the bond and stock market alternatives. Key findings of the Wharton study include the following:

- **Income guarantees enable income protection with 25% to 40% less financial assets.** The study found that, because insurers can share the risk of outliving one's savings across a large group of policyholders, income guarantees can offer financial security throughout retirement *using 25% to 40% less* in financial assets than would be required to provide an equivalent level of financial security through a retirement portfolio that does not incorporate income annuities—a benefit that no other financial product can provide.

- **Equities, fixed income, and other investment products are not substitutes for income guarantees.** Babbel and Merrill demonstrate in their study that, unlike income annuities, other asset classes fail to address the risk of living a long life. In addition, the study shows that consumers who place their retirement wealth in investment products (e.g., mutual funds) are subject not only to greater risk, but also to returns that are unlikely to keep pace with annuity returns when investment risk is taken into account.

- **Covering basic living expenses with income guarantees can enable significantly greater flexibility in other areas of a retirement plan**. The study suggests that individuals whose basic expenses are covered by guaranteed income can keep their discretionary funds invested in equities for a longer period of time, providing the benefits of historically higher returns. This approach can also enable retirees to delay taking Social Security benefits until they are fully vested, providing higher

22. "Rational Decumulation," David F. Babbel and Craig B. Merrill, May 2007.

payments. Guaranteed income protection provides portfolios with additional sustainability and durability by leveraging the risk of outliving one's savings across a large group of policyholders. Presence of an income guarantee provides greater flexibility elsewhere within the plan. This added flexibility can take on additional risk, if desired, or simply allow invested equity positions to remain invested longer and (it is hoped) avoid drawdowns at inopportune market moments.

The real benefit of guaranteed income protection is reducing investment risk by providing independent financial advisors with additional flexibility as they manage retirement income streams. This role—managing retirement income streams—is really what responsible decumulation requires as financial advisors shift from investment management to planning for, and ultimately managing, retirement income streams for those planning for and in the midst of retirement.

KEY TAKEAWAYS FOR SENIOR INSURANCE EXECUTIVES, PRODUCT DEVELOPMENT

Several key guaranteed income protection themes emerged from Aite Group's interviews with 16 product-development senior insurance executives at 11 leading firms in the industry. These themes are discussed below.

GUARANTEED INCOME AS ITS OWN ASSET CLASS

Active guaranteed-income participants universally agreed that recognizing guaranteed income as its own asset class would help increase adoption rates. They also think that addressing other factors would further increase its adoption. Among them:

- **Independent advisors, particularly RIAs, want a solution that fits within their business model, investment, and allocation process.** Educating advisors as to how this solution will fit in their quiver will help overcome these issues.
- **Today's financial planning tools do not integrate well with guaranteed income protection frameworks.** This is changing, thanks to the help of Ibbotson and other firms, but more, better-integrated planning tools—complete with investor questionnaires that allow for distinct client demand differences and enable advisors to recommend varied amounts of guaranteed income protection designed to meet varied client needs—are required.
- **Failure of back-office clearing system to integrate with guaranteed income protection makes the process difficult.** Consequently, some independent advisors lose interest, given the additional complexity and oftentimes manual process.
- **That not all managed account platforms incorporate guaranteed income protection makes advisor control challenging.** But for those that do (e.g., Envestnet), the sales and operations process can be streamlined.

COMMITMENT TO GUARANTEES

All interviewed firms that provide income guarantees remain committed to the space, despite some firms exiting the business entirely. Regardless of how long they have been providing guaranteed protection, most participating firms see in them a strong opportunity for independent advisors, particularly those affiliated with an independent RIA.

OVERCOMING BIASES REGARDING FINANCIAL ADVISORS AFFILIATED WITH A RIA

Firms that are newer to the RIA space have discovered their own internal biases concerning guarantees. Some firms, for example, suspected that RIA clients, given their higher levels of wealth, would not be interested in guarantees. Instead, they have discovered that wealthy RIA clients were actually more concerned with wealth preservation than growth and were, consequently, interested in guaranteed income protection.

CONTINUING EDUCATION

Universally, all firms recognized that a great deal of time and education will be required to fully communicate the benefits of guaranteed income protection. Financial advisors affiliated with an Independent RIA, particularly those with a "money manager" orientation, require more attention and education to address internal biases.

FUTURE PRODUCT EVOLUTION

Overall, all firms agreed that product-development innovation, focusing on the guaranteed income protection space, would continue. Specific areas commonly heard as being of prime interest are:

- **The stand-alone living benefit approach:** New entrants are certainly raising industry interest in seeing if this latest iteration can succeed where past entrants have not.
- **Making operational issues easier for independent advisors:** Financial-planning modeling and proposal-generation systems were mentioned frequently as sore spots for which enhancements to allocation modeling would make a real difference to clients. Back-office processing, including clearing processes that enable this business, was also mentioned frequently.
- **Product innovation for 401(k)s:** Outside of the independent advisor market, new product innovations with guarantees in the 401(k) marketplace are ripe.

KEY TAKEAWAYS FOR SENIOR INSURANCE EXECUTIVES, SALES AND DISTRIBUTION

In our seven firm interviews with 10 senior sales and distribution executives of leading firms in the industry, several key themes emerged from discussions about guaranteed income protection. These themes are discussed below.

GUARANTEED INCOME AS ITS OWN ASSET CLASS

There is a widespread belief that recognizing guaranteed income as its own asset class would greatly help to increase product adoption. Still, to truly help, it would need to be broadly integrated within the independent advisor's proposal generation/financial planning framework. Enabling advisors to customize guaranteed income solutions to fit the needs of their clients is required, according to these executives. In times of down markets, such solutions would allow advisors to share with their clients just how these products have protected their retirement income stream in the short term and long term. Availability of this message to end-clients checking their account values online is another important element, and would result in greater client loyalty and potential referrals.

SUCCESS STORIES TO DATE

Platform providers that have partnered with product manufacturers to develop guaranteed income solutions excel in working with independent advisors. These partnerships benefit by leveraging these relationships to co-present to advisors via wholesaler product sessions.

MORE INDUSTRY EDUCATION ON INCOME PROTECTION NEEDED

On the guaranteed protection front, the critical issue is education. Generally, there was concern that the guaranteed protection story is not receiving the amount of attention it deserves and that much more industry focus is required. Respondents are also concerned the financial media still fails to fully capture the real value these products provide and instead portrays them through the "old lens."

CONCLUSION

Fear of running out of money is a real concern for many consumers. More than 60% of investors fear running out of money more than death. Combine that fear with longevity risk and sequence-of-return risks, where sequential bad market years early in retirement can devastate portfolios, and the need for more than just non-correlated assets emerges. Regardless of the investment wrapper, strong consumer demand exists for income guarantees. Roughly half of all U.S. households that control more than a third of total U.S. financial assets are attracted to lifetime-guaranteed income—even if it pays a low return. Further, these consumers have indicated that they are willing to pay 4% to 6% of their assets for guaranteed income protection.

Academics and firms have shown, through numerous studies and for many compelling reasons, that income guarantees make sense as part of an overall portfolio. The primary benefit of adding an income guarantee to portfolios is the added income protection provided. Retirement entails risks, and suffering a negative sequence of return risks or suffering losses during the early years of one's retirement can pose very difficult challenges to generating income over time. As evidence, just refer back to the Federal Reserve study and look at the losses endured by pre-retirees and retirees.

The collective response to income guarantees, particularly among independent advisors and in the RIA community, does not align with consumer demand. One resounding message heard from every senior insurance executive interview, whether in product development or sales, is that a great deal of education continues to be required. While today's resistance remains high, client demand for downside protection and guarantees also remains high, creating an ongoing opportunity. One can only imagine the difficult conversations ahead for some independent advisors ignoring their clients' wishes for guaranteed income protection after the next market downturn. Advisors must recognize that their clients have just one crack at managing their retirement income, and independent advisors would be well advised to learn more about these products and the benefits they provide.

While the product solution space can be debated *ad infinitum* as to what particular firm or firms' products are best suited to meet client needs, it is clear that many firms remain committed to the guaranteed protection space. Firms seeking to innovate in the guaranteed protection space stand to make a difference not only for themselves, but for their clients' long-term sustainable success as well. As these products evolve and as independent advisors evolve with them, the intention is that future client outcomes will not be jeopardized by advisors' lack of curiosity or education regarding guaranteed income.

Retirement income portfolios exist for a reason — to provide sustainable income over a lifetime, which, given increasing longevity risk, can strain many portfolios to last beyond 30 years. Living with this uncertainty amid the vagaries of rising medical costs, sequence-of-return risks, and all the rest requires from advisors an openness to explore solutions in the best interests of their clients. Guaranteed income solutions certainly represent a missed opportunity and deserve ample consideration from independent advisors.

RELATED RESEARCH

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Wealth Management on the Move: The Moment of Truth, June 2011.

CRM for Wealth Management: Approaching Total Practice Management, April 2011.

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