

Multiplying investment and retirement knowledge

PROJECT M

MICRO

A radically altered age structure will profoundly affect everything, from healthcare to pensions to the economy

MACRO

Restore long-term horizons so that insurance companies no longer measure solvency on a one-year basis

META

Esther Béjarano first sang at the camp gates in Auschwitz. Now she's enjoying a late career as a hip-hop artist

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GOODBYE, DORIAN GRAY

THE
BABY-BOOMER GENERATION
WILL TRANSFORM
AGING – AND THE
MARKETPLACE

FOCUS

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STOP WORRYING ABOUT ASSET VALUE

Volatility and valuations are the wrong measures for retirement saving, says Robert Merton. Income stream is what the industry and regulators should look to as a benchmark

Although aged 72, Nobel laureate Robert Merton is far from retiring. The professor of finance (MIT Sloan School) provides a personal example when he argues that people should retire when ready, not at a pre-set age.

"Some people can't wait to reach retirement, but I'm not one of them," says Merton in a recent interview with PROJECT M, brushing aside the notion he should slow down. "When one reaches retirement age, one needs greater opportunities to make intelligent choices."

Meanwhile, in the years leading up to retirement, people need savings solutions that are smarter than what is currently on offer. Retirement plans suffer from a preference for assets over income, Merton criticizes.

"Investment value and asset volatility are simply the wrong measures if your goal is to obtain a particular future income," he writes in a contribution to the *Harvard Business Review* (HBR). Yet these are the benchmarks cemented into the regulation of DC plans. In the US, disclosures highlight net asset value and its changes while "regulators in the European Union have even considered requiring minimum rates of return. But if the goal is income for life after age 65, the relevant risk is retirement income uncertainty, not portfolio value," Merton writes in HBR.

In fact, such requirements would prohibit investments into vehicles that provide a reliable income stream. "Under regulations that set a minimum floor, retirement plan managers would not be allowed to invest savers' funds in deferred annuities or long-maturity US Treasury



ROBERT C. MERTON


Robert Merton's achievements include the first continuous-time option pricing model, the Black-Scholes formula, which secured him a Nobel Prize in 1997. He is a distinguished professor at the MIT Sloan School, university professor emeritus at Harvard University and Resident Scientist at Dimensional Holdings

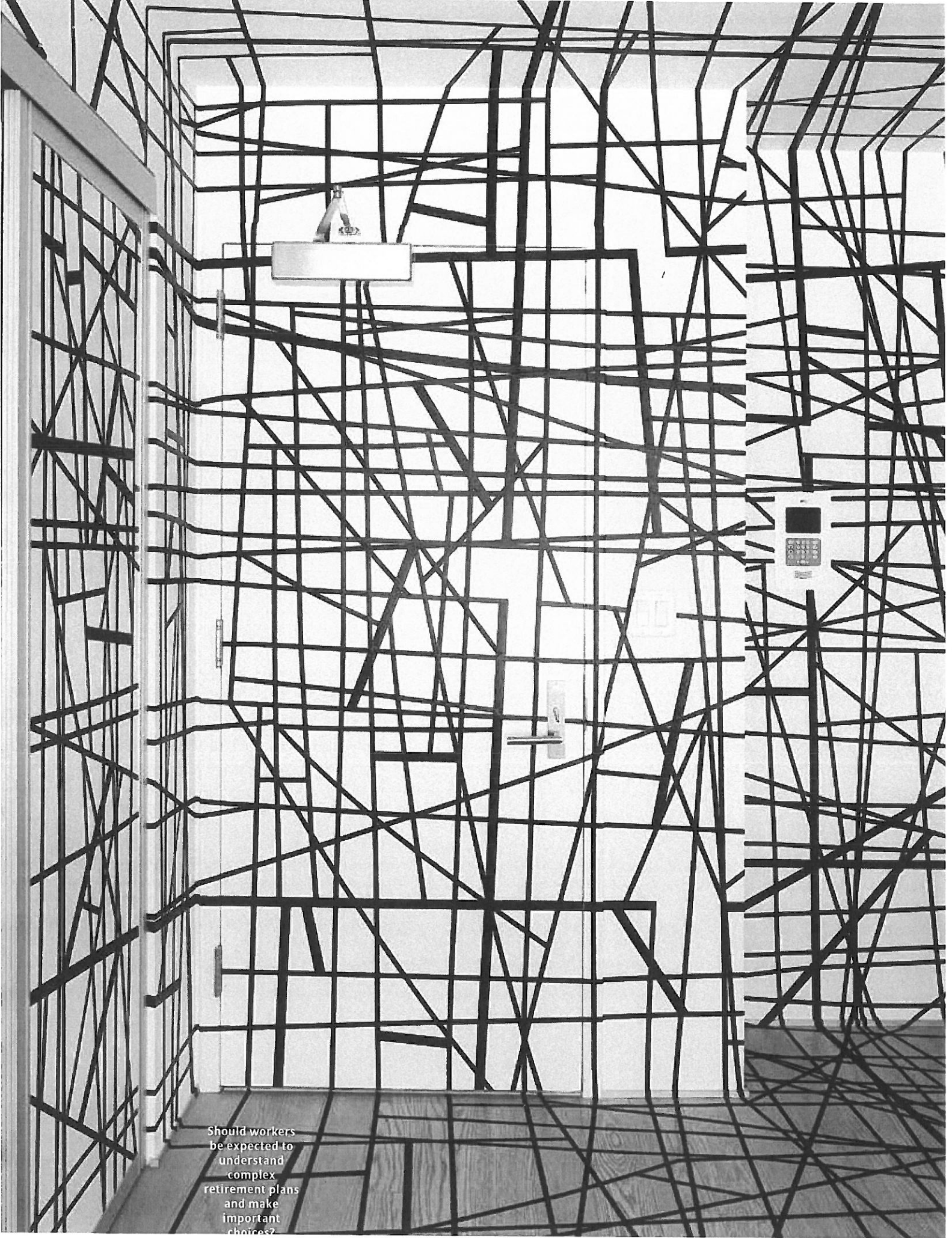
bonds – the very assets that are the safest from a retirement income perspective." In short: for retirees, risk should be defined from an income perspective and the risk-free assets should be deferred inflation-indexed annuities.

MAKE IT PLAIN


Managers do not necessarily need to buy annuities. "They should match the risk-free part of the portfolio in such a way that, on retirement, the employee would be able to purchase an annuity." This kind of liability-driven investment already exists for institutional investors; it simply needs to be applied on the individual level.

Despite – or because of – his deep understanding of finance's mechanics, Merton is no stranger to plain talk. When they're planning to save for retirement, individuals are too often asked complex questions such as, "How much debt versus equity do you want?" This resembles salespeople asking car buyers what engine compression ratio they would prefer when what matters to them are mileage, acceleration and reliability.

Merton bought his first stock aged 10 in General Motors, allowing him to combine finance with his other passion: cars. Throughout college and graduate school, young Bob Merton, as his late mentor Paul Samuelson called him, would rush to the brokerage houses by 6:30 a.m. and trade 



Should workers
be expected to
understand
complex
retirement plans
and make
important
choices?



stock, convertible bonds, warrants and over-the-counter options before classes. What followed is an impressive career in finance.

JOGGING OR WALKING?

What irks Merton most is that, following the shift from defined benefit (DB) to defined contribution (DC) pension schemes, workers with little financial expertise are expected to understand complex retirement investments. "With DC plans, the responsibility falls on the member. They are asked to make decisions for which they are largely unprepared," Merton explains.

In his opinion, the idea that people are able to manage their retirement funds isn't realistic. "If I'm having a knee operation, should the doctors ask me whether I want titanium pins or stainless steel ones inserted in my leg? It doesn't make sense."

Instead, savers should be presented only with decisions that are meaningful to them (see page 35). Namely, the financial equivalent of asking whether a patient wants a standard knee operation or a more complicated, expensive one that would allow him to go jogging in the future.

Secondly, retirement providers should help set sensible goals, so that a saver is left with no more than three concerns: his retirement income goals, how much he is able to contribute from his salary and how many more years he plans to work. And the only feedback he needs from his plan provider is how likely he is to achieve these goals.

The next step is to strengthen trust in the financial industry. "Before surgery, the surgeon could show me a history of the surgeries he performed, a list of all the tools he is going to use and the surgical procedures he is going to take," says Merton, adding, "But that wouldn't mean anything to me. If savers accept that retirement plans are inherently opaque to them then the only option is trust." —

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ROBERT C. MERTON

**Fear of
complexity may
be discouraging
people from
seeking vital
retirement advice**

THE BEST OF BOTH WORLDS

Combining annuities and capital market investments brings liability matching within reach of savers

Liability-driven investment should be available to clients with the flexibility to change as necessary



Robert Merton's study *The Crisis in Retirement Planning* (see pp. 38–40) didn't go unnoticed in the financial industry. Merton's argument, in conjunction with the current depressed yield environment, led Dan Krueger and Kai Wallbaum to cooperate across the Atlantic. With Krueger working for the US insurance branch of Allianz Group and his German colleague Wallbaum working for the asset management branch of Allianz Group – also the publisher of this magazine – both hope to launch a “holistic” retirement income solution in 2017.

By combining an investment approach with a deferred annuity, “we have a solution thinking in cash flows,” Wallbaum says. Based on the retiree's income needs, subdivided into must-haves and nice-to-haves, client and adviser devise an investment strategy that delivers initial retirement income based on capital market returns from the investment vehicles of Allianz Global Investors, PIMCO and selected third parties. If markets perform worse than expected, the annuity could kick in earlier; if markets do better, it kicks in later.

The idea is as much a response to Merton's study as to current low yields. While cash

deposits may have been safe and sufficient in times when returns were 4% or higher, next to no returns on safe assets have workers struggling to grow their retirement nest egg.

Combining longevity protection with a client-individual managed account allows retirees to participate in capital markets while covering the risks relevant during decumulation: market, inflation, liquidity and longevity risk. “Neither annuity nor investment product could address these risks by itself. Together, they do,” says Wallbaum. Following Merton's argument, the approach ignores volatility and short-term market valuations.

The idea is to design the product to be cheaper than a traditional variable annuity because the holistic approach should reduce the guarantee costs of the concept. “Both aspects could of course be offered separately, but the dynamic allocation between both components makes it possible to offer stable income levels at lower costs than current solutions in the market. The combination makes liability-driven investment available to retail clients with the flexibility to change as their needs evolve,” says Wallbaum.

Yet much of the success of such an approach depends on good advice, including also a regular review of assets and liabilities based on allocation and performance. With investment horizons spanning several decades, digital support tools should enable an efficient setup for customer and advisor.