Retirees: Do They Face An Advice Gap?

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At some point in our lives, we retire. The biggest risk that retirees face is running out of money before they run out of life. The amount withdrawn each year impacts the longevity of your portfolio. It is essential to understand that there are two very distinct phases of our investing lives – accumulation and after retirement, we begin withdrawing money from the portfolio.-this is known as the de-accumulation stage. (a.k.a. distribution). In the de-accumulation phase the primary goal typically is the ongoing cash flow required to fund living expenses and other spending desires. A secondary goal may be to grow, or perhaps preserve, wealth to use for gifts or bequests.

It's important to understand the two phases because the strategy and issues are distinctly different and the financial advisor skill set is also different (if one is used). There is a concern that retirees will live longer yet fewer and fewer of them will be able to rely on traditional corporate pension plans to fund their retirement. The financial decisions made by those who are at or nearing retirement are more important than ever before. Seniors are a fast growing segment of the population and they will need professional retirement planning advice.

As investors age, their investment time horizons, goals, loss capacity and tax status change. Liquidity often takes on added importance. And, depending on their particular circumstances, seniors and retirees may have less tolerance for certain types of risk than other investors. For example, retirees living solely on fixed incomes may be more vulnerable to inflation risk than those who are still in the workforce, depending on the number of years those retirees are likely to rely on fixed incomes. Likewise, investors whose investment time horizons afford less time to recover investment losses may be disproportionately affected by market fluctuations.

During retirement we need to consider things like our cash flow needs, healthcare costs, income taxes, longevity of our retirement account(s), insurance needs such as critical care, Government social benefit programs, costs for a retirement residence, our will and an estate plan. For many, this may be overwhelming task, so a financial advisor may be needed .The question is, is the Canadian advice industry geared up to provide professional advice for de-accumulators? Most advisors are "OK" maybe at the accumulation stage but proficiency and other questions take on added importance at the de-accumulation stage. Note that until the CSA national registration project a few years ago, mutual fund registrants were classified as "salespersons" - after the project, they are now registered as "dealer representatives" , a more investor-friendly registration title, but one less descriptive of reality.

So, is there an advice gap? There are five key issues to consider.

Issue One:

Most dealer representatives (a.k.a. "Advisors") work on a commission/fee basis. As client account size declines (if you're lucky it may not), the Rep may find the account less attractive. More importantly, the method of compensation skews recommendations. Would a Rep advise a client to close his investment account and purchase and annuity or cut down non-deductible debt if it meant a reduction in fees? It's not obvious that the current compensation model is a good fit for de-accumulation phase investors.

A recent Forbes article, *Retirement Crisis Enabled By Financial Services Fibs* **http://www.forbes.com/sites/johnwasik/2013/08/05/retirement-crisis-enabled-by-financial-services-fibs/** stated "There's no question that Americans are under saving for retirement. Depending upon the source, they are far behind where they should be. According to Helaine Olen, Forbes blogger, financial journalist and author of *"Pound Foolish: Exposing the Dark Side of the Personal Finance Industry"*, it's the purveyors of mutual funds, annuities and money management who are aiding and abetting the crisis: For the first time in living memory, it seems likely that living standards for those over the age of 65 will begin to decline as compared to those who came before them -and that's without taking into account the possibility that Social Security benefits will be cut at some point in the future. The culprit?…the 401(k), along with the other instruments of do-it-yourself retirement."

In Canada, the situation is not much different. Conflicted advice and high fees do take a huge toll on our savings. In fact, according to a recent Morningstar research report, Canada has the highest mutual fund fees in the world. And fees are a major cause for erosion of a retirement portfolio. Reps with a conflict-of-interest may not recommend economical alternatives.

While much of the Canadian retail financial services industry is still considered a brokerage/transaction orientated industry, it has become much more involved in promoting itself as a provider of wealth management solutions, and is developing more sophisticated retirement income planning solutions. In other words, its legacy framework is one structured around transactions.Anyone who has read the transcripts of recent Ontario Securities Commission Roundtables on Mutual Fund Fees or Best interests can clearly see that the industry, with few exceptions, is against removing embedded trailer commissions or implementing a Best interest standard for advice. This means that they want to retain an advisory relationship with a built-in conflict –of-interest and retain the weak suitability standard for making recommendations.

A professional advisor should consider a retiree's age, life stage and liquidity needs. He/she should also consider a customer's primary expenses (for example, a mortgage), sources of income (and whether it is fixed), amount of retirement savings (and how they are invested), extent of health insurance coverage, and whether the customer will be relying on investment assets to pay for anticipated and unanticipated health costs. Does the current Know-Your-Client /suitability approach really get at these issues? Based on our observations and experience, we believe the current system is broken and needs to be repaired. (see our report on the suitability system at http://www.canadianfundwatch.com/2012/09/suitability-system-needs-overhaul.html)

Here's a quote from the Canadian Securities Administrator's (CSA) Consultation Paper on Best interests duty:

- There may be an inadequate principled foundation for the standard of conduct owed to clients.
- The current standard of conduct may not fully account for the information and financial literacy asymmetry between advisers and dealers and their retail clients.
- There is an expectation gap because investors incorrectly assume that their adviser/dealer must always give advice that is in their best interests.
- Advisers/dealers must recommend suitable investments but not necessarily investments that are in the client's best interests.
- The application in practice of the current conflicts- of- interest rules might be less effective than intended.

Any one of these concerns should raise RED flags for retirees. Taken together, they paint a clear picture. The current client – adviser (dealer) relationship works against the retiree investor in a material way. Yet, Canadian regulators are not moving fast to introduce real investor protection reforms as have occurred in the UK, Australia and in other jurisdictions.

Issue Two:

This issue refers to complaint handling. When something goes wrong, retirees expect a fair system to resolve complaints. A complaint from a retiree can be more significant than one from an investor in the accumulation phase. It may mean a major change in the standard of living as there is inadequate time to recover from losses. Clients are not being treated fairly – responses are dismissive- the process is adversarial. OBSI reports that over 4 in 10 investment dealer complaint decisions are overturned. Who knows how many valid complaints never reach OBSI www.obsi.ca because the dealer's rejection was taken at face value? [The 2012 OBSI Annual Report states that 38.6 % of complainants are retirees which is higher than the percentage of the general population; 48 % of complainants are 60 years of age or older (8.7 % are 80 or older!).]

Issue Three:

Bad behavior is our third issue Why are so many client account statements so uninformative?- few provide personalized rates of return Why are misleading titles like "Seniors Specialist" used to deceive elderly clients into believing the Rep has special qualifications. Why does the industry promote "Free lunch" seminars as educational events when in fact they are often nothing more than an opportunity to pitch product sales at unsuspecting seniors? Why is leveraging so actively pushed? Why are some major dealers calling for the destruction of OBSI- could it be that OBSI is exposing the deficiencies in the KYC and suitability systems? Why is it so difficult to transfer an account? Why are some dealers starting to impose minimum account sizes just as the number of RRIF account holders is increasing? Why are some firms starting to charge for hard copy account statements unless eServices are used? (older employees are much more comfortable with paper copies of statements). Some firms are even beginning to charge $2.00 for the delivery of trade confirmation slips, a regulated POS document! (investors, particularly retirees, don't consider having to log in as actually delivering a confirmation). These kinds of behaviors are not indicators of an advice industry that should be trusted.

Issue Four:

The fourth issue concern revolves around product mis-selling. Why is there a chronic issue with misleading sales communications and marketing materials? Why is there so much undifferentiated promotion of RRSP's? Have Target date funds met the promises made? Should reverse and leveraged ETF's really be foisted on pensioners? Why have T class funds caused so many investors heartburn? Did LSIF's add to seniors wealth or to advisors? Who can forget the non-bank ABCP fiasco? Remember the Portus nightmare where "advisors" collected referral fees for recommending this toxic product without effecting due diligence? And of course there's the nasty practices of off-book selling, borrowing from clients, churning, unauthorized trading and outright fraud. The industry clearly has to do better if it is to earn the trust of retirees.

Issue Five:

Lastly, issue five involves proficiency and expertise in retirement planning.

"During the accumulation stage the most important thing is the volatility of returns. Assets allocation can manage the volatility of returns reasonably well. On the other hand, during the de-accumulation stage, the most important thing is the sequence of returns. Asset allocation does not manage well the bad effects of sequence of returns. Therefore, it has little impact on portfolio longevity except in borderline cases. This is also why a new fad on the block, called Target date funds, cannot provide much protection for you as you get closer to retirement. It is the wrong fix for the sequence of returns." - Jim Otar, *"Unveiling The Retirement Myth"*

[In the above quote, the term "sequence of returns "is used. It is an important idea for retirees to understand. It refers to the importance of the order in which returns occur in a de-accumulating account. You can think of it as reverse dollar cost averaging. William Bengen's seminal study in the October 1994 *Journal of Financial Planning, "Determining Withdrawal Rates Using Historical Data"* helped usher in the modern area of retirement withdrawal rate research by codifying the importance of sequence of returns risk.York University Professor, Moshe Milevsky provides an excellent plain language explanation *Retirement Ruin and the Sequencing of Returns:* http://www.ifid.ca/pdf_newsletters/PFA_2006FEB_sequencing.pdf]

What quality of advice is available to deal with an account that functions as a pension with monthly withdrawals to meet living expenses? —an account that must last for the lifetime of the client. During the accumulation phase advice, such as "start early" and asset allocation is reasonably effective. In the de-accumulation phase, however, clients need individually tailored advice because each individual is facing specific issues with their health, finances, taxes, lifestyle, family and estate situation, so the advice must be holistic- it may also include insurance products. The de-accumulation phase is in many ways much more critical/challenging from the retires/advisor perspective, given that if something goes wrong in the market early in retirement and the withdrawal strategy is inflexible, the portfolio may never recover. The de-accumulation phase presents significant planning challenges in dealing with multiple variables. Does the industry have a cadre of specially trained/certified financial planners available? Are they fiduciaries? We all know the answer.

Given the prevailing scenario, it's probably a good idea to get a little educated on retirement investing. Read books and learn to get ideas and think outside the box as much as you can as you will get little help here from most advisors. Here are three books worth reading:

"Winning the Loser's Game- Timeless Strategies for Successful Investing", by Charles Ellis: *"Portfolio Design"* by Richard Marston; and purely Canadian, MacKenzie and Hawkins' *"New Rules of Retirement - What your financial advisor isn't telling you"* . There are also a number of blogs catering to retirement issues. My favourites are RetirementAction.com and Retirehappy.ca (read blog, *RRIF: The Complete Online Guide*).

Retirement planning is the process of designing and following a strategy that will provide a lifelong income stream for the retiree. This is where a robust portfolio design is critical. It's not about making assumptions, hoping for the best and it's not about wishful thinking. It is about facing the reality of a situation. Such a retirement plan requires a pension plan mindset. Can the financial services industry deliver? Many are unconvinced. There's a reason the old quip "Whenever I sit down with my advisor, I'm never sure whose retirement we are planning" keeps circulating around. For those who are willing and able to use a fee-only financial planner, there's hope. Unfortunately for many, it's *caveat emptor* or DIY.

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