CHAPTER 6

Building Retirement Income Portfolios

Objectives

- Create floor and upside portfolios
- Building over time

By definition change is disruptive. Too often the planning for retirement income really begins in earnest on the date of retirement or at the time of the 401(k) rollover distribution. As a general rule, proposing large changes always faces more resistance than proposing small changes. Annuitization, which is essentially a transformation of a large part of most portfolios, is a big change. In retirement, the portfolio change is also linked to a profoundly personal acceptance of mortality. This helps to explain those who ultimately annuitize only after experiencing some period of retirement and becoming comfortable with the idea. Any steps taken prior to that point will be helpful. Structuring retirement income portfolios to look and feel like accumulation portfolios minimizes disruption and maximizes flexibility.

We always want to keep in mind the cognitive dissonance associated with change. Questions like "Why now?" and "Was the old way wrong?" are questions that can be avoided by letting the client know what changes are to be expected as accumulation gives way to retirement income planning.

The trick, the subtlety, and the art lies in making the change both expected and seamless—both for the client and the adviser. Portfolio proposal tools can easily be enhanced to facilitate both accumulation and retirement portfolios; the approach and sleeving of products should be enhanced so that it is backward compatible with traditional portfolio construction.

Along with the theme of retirement income, there need to be concrete methods or approaches for both setting and meeting goals. To that end, we offer three generic templates that can be used to motivate anything from an informal to a pitch-book approach. Three generic templates for creating retirement income accumulation plans are described. Here they are labeled as "Brick Layer," "Track Layer," and "Surge Maker." Their dual purpose is to provide the client with a plan of action and you with a backstory for marketing.

Within this chapter, we also cover some of the advantageous ways to build accounts from a tax perspective as well as some of the taxation pitfalls associated with retirement portfolios. Our objective is to use the tax shields most advantageously for creating a retirement portfolio. Taxes act as a friction in the machinery of retirement. Tax laws have a habit of changing over time, so our focus is on the nature of the rules rather than the specific rates.

What is true of the client is also true of the financial professional. Extensions or tweaks to a business model, which offer incremental upside with no downside, are more likely to gain acceptance than major shifts that create risks along with the opportunities. Much of what we show in this chapter is that a major gain to retirement practice works out to being analogous to a slight change in the sleeving of products. Until the market catches up with more dedicated fund offerings for retirement income, the retirement income sleeve will be filled with more individual securities, but to the professional it should feel as before. For managing multiple clients, it is as simple as starting the Smiths' retirement income in 2018 and Joneses' in 2021.

Traditional intuition about the trade-off between risk and return works quite well in this framework. To motivate a visual interpretation we can think of the familiar construct of the *capital market line* (CML) shown in Figure 6.1. The CML links a risk-free asset and the efficient frontier[1] of risky assets by showing the best ways to combine the risk-free asset with portfolios on the efficient frontier. The efficient frontier gets its name from the idea that if we take all risky assets and consider all possible combinations of those assets, the efficient frontier will represent the portfolios of risky assets with lowest possible risk for a particular expected return (or conversely the highest expected return for a given level of risk).

PORTFOLIO SLEEVES FOR RETIREMENT INCOME

In Chapter 2, we saw that the top-down view of the retirement problem allowed us to write the consumption solution as the following:

$$\begin{aligned}\text{Optimal consumption} &= \text{Consumption floor} + \\ &\quad x\%\cdot[\text{Current wealth} - \text{PV(Future floors)}] \\ &= \text{Lifestyle floor} + x\%\cdot(\text{Discretionary wealth})\end{aligned}$$

This framing provides us with a natural way to create product sleeves that take the optimal from the hypothetical to the practical. *Sleeving* is a common way to build a portfolio composed of modules that allow the adviser to stay within a disciplined framework while offering clients a customized portfolio.[2] For advisers, whether on a single-fee or transaction-based model, the commonality between the sleeving presented here and the sleeving that sits in their proposal-generating tool will help create a natural bridge to cross from pure accumulation to accumulation for retirement income. The basic construct for retirement income, shown in Figure 6.2, involves two sets of sleeves—one for flooring and the other for the excess portfolio, which shows one of the main distinctions of retirement income portfolios: assets committed to lifestyle security and assets that represent discretionary wealth or funds intended for but not yet committed to flooring. The roles change a little, but, in spirit, this should feel no different than a sleeving of fixed-income and equity. The excess portfolio sleeving will, at first glance, be entirely familiar. The difference here is that the excess portfolio is only part of the total retirement income portfolio, so the familiar can be interpreted as a subset of a broader view.

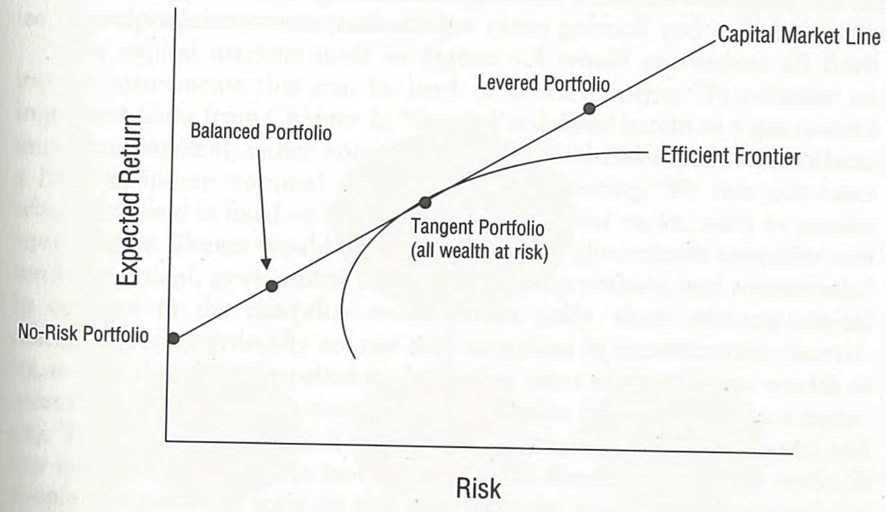

FIGURE 6.1 Allocation along the Capital Markets Line (CML)

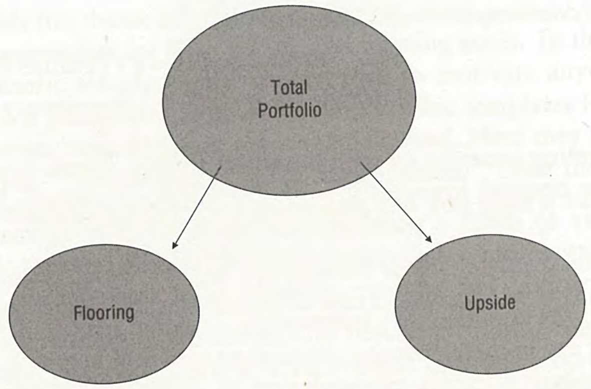

FIGURE 6.2 Creating Initial Allocations

The mechanical view of how the sleeving works is best illustrated by thinking of a two-track process. Along the first track we move to flooring. We will break this down further at a later point, but for now flooring includes longevity protection—lifetime flooring. The second track takes us to the sleeves for the management of discretionary wealth shown in Figure 6.3. Later on this will also be broken down to be more inclusive of liquidity balances. You'll notice that the bottom right of Figure 6.3 has a placeholder for discretionary wealth. If the funds are in risky assets, they may be potential flooring, but they are not in-place flooring. Not everyone with the wherewithal to buy flooring today will be ready to commit; we keep it as

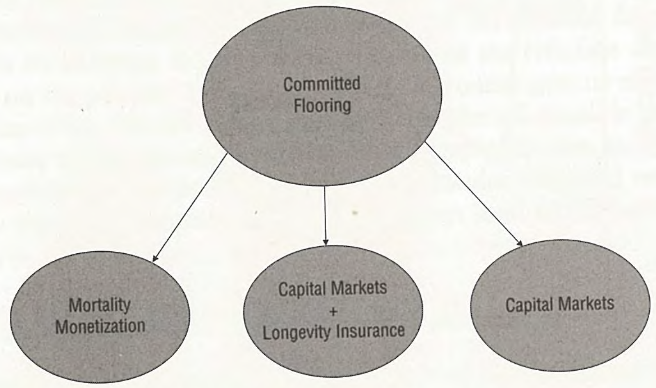

FIGURE 6.3 Flooring Sleeves

a placeholder for now.[3] We treat this segment in great detail in Part Three, where we discuss techniques for managing portfolios in the presence of flooring risk.

Moving down a level first to the committed flooring node, we see in Figure 6.3 that there are three groupings of sleeves for products: annuities, hybrid, and capital markets. Of the roughly 20,000 financial advisers at Bank of America/Merrill Lynch, a significant majority are registered to be able to sell both capital markets and insurance products. For retirement income products, having both registrations is desirable. Note that the different nodes are the natural flooring solutions for different levels of relative wealth (Wealth/PV/Lifestyle needs).

Annuities sit within the first grouping in Figure 6.3, sleeves for mortality monetization; this includes variable annuities.[4] As its name implies, the sleeves should contain all products for which there is a sizeable component of mortality monetization: fixed annuities and variable annuities. Folks choosing flooring via mortality monetization fall into two camps: (1) those who choose it as a way to provide a tax-advantaged floor outside of the constraints of their retirement accounts; and (2) those who feel that monetizing mortality is the best way to maintain lifestyle. These are two very different constituencies.

Not all products that are placed in an insurance wrapper constitute flooring. Many financial products are placed in an insurance wrapper to confer tax deferral, even though the insurance component is essentially secondary; such products would best be described and sleeved as discretionary wealth products; not all insurance products monetize mortality; not all insurance products constitute flooring.

The capital markets node in Figure 6.3 would encompass all fixed income instruments that can be used to create flooring. To reiterate an important point from Chapter 2, "flooring is defined herein as a guaranteed minimum payment, either nominal or real." Yield-based products without a fixed minimum notional do not constitute flooring. We rule out cases where the yield is fixed or floored, but the notional varies, such as certain equity funds. Sleeves would contain options for government securities and funds—nominal, government securities, real, corporates, and municipals.[5] In contrast to the mortality monetization node, those desiring capital markets flooring generally are not only unwilling to monetize their mortality, nor do they feel compelled to do so. For those with sufficient wealth to meet their lifestyle needs, mortality monetization is an option, not a necessity. This means that there is a greater opportunity for both high-end and low-end flooring products to be created and sleeved within this node. A simple but powerful start on this sleeve can be made by listing available strips by maturity.

The central node in Figure 6.3, capital markets plus longevity insurance, would not simply copy and add to the capital markets sleeving. It is important to remember that the typical hybrid flooring purchaser is motivated by a desire to maintain lifestyle in the face of longevity risk. Without longevity insurance, they only have enough to maintain lifestyle for a finite period of time. Flooring choices located off of this node should be of the more basic and most secure types; kept straightforward, secure, and affordable. For those in this category, separating flooring and discretionary wealth, securing the flooring, and concentrating efforts on the discretionary wealth provides the best opportunity for incrementing lifestyle at a later date.

The sleeve contents for discretionary wealth are the same as those for ordinary accumulation portfolios. The difference here lies not in the content, but in the construction. If we have taken care to set up a floor for the client, then they have more freedom to take risk in the discretionary wealth subportfolio to move the portfolio as a whole to a desired risk-return structure. I am not advocating using the discretionary wealth subportfolio to gamble, but pointing out that the flooring subportfolio has the volatility dampening characteristics of the fixed-income portion of an accumulation portfolio. In a simple sense then, the discretionary wealth subportfolio would be expected to have a higher weight in equity than the equity sleeves of an accumulation portfolio.

PORTFOLIO INTUITION

Once again we refer to the concept of the capital market line. In Figure 6.4, we show the retirement income analog to the ordinary accumulation view of the CML. We use the notion of the CML to illustrate retirement income allocations between lifestyle security (flooring) and risky assets (the discretionary wealth portfolio). We want our discretionary wealth to be in an efficient portfolio and we wouldn't knowingly construct our portfolio to be inefficient. Professionals may differ in the construction of portfolios, but they all aim for maximum reward per unit of risk.

One main difference in Figure 6.4 is that we now have the concept of lifestyle risk replacing the concept of risk merely for return distributions as in the accumulation CML. Here the risk-free end of the spectrum refers to allocations that correspond to a 100 percent fixed lifestyle (insurance or capital markets). For this case, there is no allocation to discretionary wealth whether bundled into a variable annuity or in an unbundled fashion comprised of risky capital markets products. For practical purposes, the other

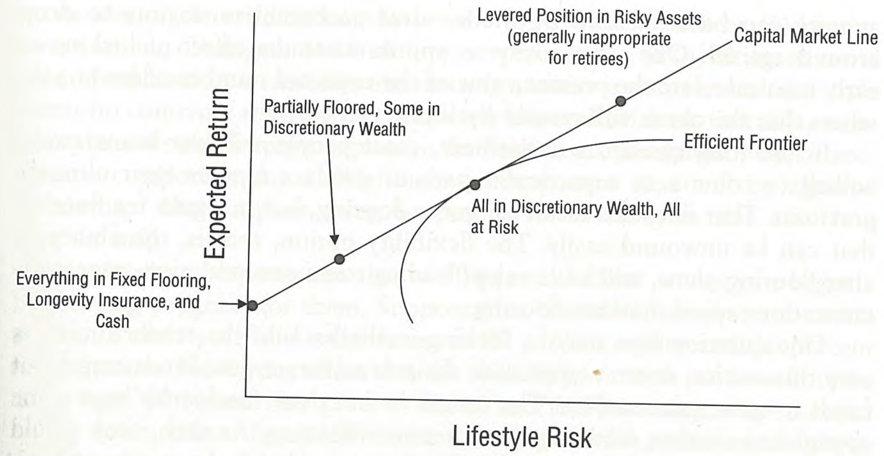

FIGURE 6.4 CML Analog for Retirement Income

end of the spectrum that we consider would be a portfolio with no allocation to lifestyle security and 100 percent in at-risk assets. Except for the very young, or those actively engaged in risk managing portfolios, this would not be recommended. In between those two endpoints would be all shades of balanced approaches that are more or less appropriate depending on age and degree of activity allowed for risk management.

BASIC PORTFOLIO CONSTRUCTS

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