10 QUESTIONS

Michael Finke on the Truth about Retirement Spending, the Annuity Puzzle, and Changing the Paradigm

by Carly Schulaka

WHO: Michael Finke, Ph.D., CFP®

WHAT: Dean and chief academic officer for The American College; researcher; educator

WHAT'S ON HIS MIND: "The ability to communicate well with clients and to help them feel at ease is important and a necessary skill for any financial adviser, but what really provides true value is knowledge."

AFTER A DECADE spent building the Ph.D. program in the Department of Personal Financial Planning at Texas Tech University into one of the most well-known programs in the country, Michael Finke moved to The American College this summer with a similar goal in mind—making sure more students are trained in financial planning as professionals.

As dean and chief academic officer for The American College, Finke will continue his research pursuits, particularly in the area of how financial advice needs to change in a low-rate environment (*Journal* readers may recall Finke's most recent Montgomery-Warschauer award-winning paper, co-authored with Wade Pfau and David Blanchett, "The 4 Percent Rule Is Not Safe in a Low-Yield World" published in the June 2013 issue).

The *Journal* recently talked with Finke to learn about his current research projects, his views on the future of education in the planning profession, his insight on effective retirement income planning, and his ideas for bridging the research-practice gap.

1. *You recently began a new chapter of your career as dean and chief academic officer of The American College. Prior to that, you directed the Ph.D. program at Texas Tech's Personal Financial Planning department. How would you describe the evolution of financial planning higher education?*

If you think about knowledge-based professions—anything from actuarial sciences to risk management to medicine to law—there is a foundation of best practices within all of these fields that is supported by objective evidence. Science is the method we use to build and refine the body of knowledge that informs best practices. The role of higher education in any knowledge profession is to identify best practices through research and then relay the current understanding of that body of knowledge to students and practitioners.

Since knowledge about best practices is always changing as scholars get access to new data, test and refine theories, and evaluate new products and strategies, there needs to be an ongoing dialogue between academics and practice to ensure that advisers are making recommendations that are in the best interest of their client. In this way, science and education serve as the foundation of the profession. They create the knowledge that is then used to provide value. There is no value without the knowledge in a knowledge-based profession.

Financial advising is a relatively new profession that generally didn't evolve from an academic base. This has created a disconnect between the academic community and the profession. Academics largely ignored personal financial planning despite the importance and size of the industry. And many planners have become distrustful of academics who don't seem to understand or value what they do to help clients.

This disconnect is one of the reasons I came to Texas Tech. I was in a Ph.D. program in finance at the University of Missouri while also teaching in a financial planning department. I saw that many of the graduates from finance doctoral programs ended up at universities teaching undergraduate students who went to work at banks and brokerages providing advice to individuals. But the standard finance curriculum teaches students institutional investing and corporate finance. I saw that this was only going to change if finance produced Ph.D. students who could then go into a finance department and teach classes in personal financial planning.

In many cases, finance professors feel like they "get" financial planning. I made that mistake as well before I got more deeply involved in understanding the profession. The reality is that this is a highly complex occupation that requires a lot of specialized knowledge that is not traditionally taught in business schools.

One of my goals coming to Texas Tech was to work within a program that had the resources to develop a high-quality doctoral program focused on financial planning education that produced graduates who could compete for academic jobs within business schools. I wanted to build a curriculum that resembled a traditional finance Ph.D. but focused on financial planning, while also giving the students the skills they needed to teach applied financial planning coursework. So at Texas Tech we graduated—now in the range of 25 to 30—Ph.D. students who have populated many of the major financial planning programs in the United States like Kansas State, Missouri, Texas A&M, Georgia, Utah Valley, Winthrop University, and William Paterson University as well as The American College.

So that was my goal at Texas Tech—to be able to push academic programs toward providing high-quality financial planning education in a classroom as a first step to making sure that more students were actually trained in financial planning as professionals. This is also my goal at the American College. In addition to traditional classrooms, there needs to be a platform for online, cutting-edge specialized knowledge that serves the financial planning profession.

2. *What is the future of financial planning education?*

A realization that I came to while at Texas Tech is the importance of online applied education in general. To me, that is going to be how professional education is provided in the 21st century—through high-quality and innovative online delivery. We're seeing it already in a number of similar types of professions like medicine, business, and law. You can deliver courses to remote students using methods that develop a student's ability to solve complex applied problems through advances in online learning. Our challenge at The American College is to keep on top of this online education technology as well as maintaining our knowledge of best practices.

In many ways, this is a perfect time for The American College. It is the educational institution that has the greatest reach within the financial planning profession right now. The College has educated one in five financial advisers in the United States; we have over 200,000 alumni. It is positioned at a time when online education has never been more important, nor has there been more potential in creative online delivery. Online learning—especially financial education—done right, can be as good as education delivered in a classroom if not better.

3. *What new research are you working on now?*

I'm doing a number of different studies, but what really interests me right now is how advising is going to change in a low-return environment. That's a subject that I've addressed in past research, but I continue to work on studies that address different aspects of how a low-return environment changes the way we give advice. It affects every aspect of planning from selecting the right savings and decumulation rates to the cost of insuring long-term risks and sheltering assets from taxes.

In some ways, we've become a little complacent having lived through a relatively high-return environment in the 1990s. But the reality is that stocks are very expensive right now and bond yields are very low. That means it's difficult to sell one's value proposition net of fees through simply providing a higher rate of return on assets than you could achieve without the help of a financial adviser. Especially with asset-based fees. In 1990, if you charged 1 percent of fees and recommended an investment in, for example, 10-year T-bills, your fees would've been 12 percent of every dollar that your client earned in yield. Today, at the same 1 percent AUM, your fees take up 64 percent of the yield that investors are getting on 10-year T-bills. Moving from charging 12 to 64 percent of bond yields, from charging 20 percent to 50 percent of stock dividends, is a game-changer when it comes to forcing advisers to show their value above basic portfolio management.

Knowledge has always been essential to financial professionals. The ability to communicate well with clients and to help them feel at ease is important and a necessary skill for any financial adviser, but what really provides true value is knowledge. This is a knowledge-based profession, ultimately, and you trust an adviser who has made that investment in knowledge. That's another reason why it's so interesting to be at a place like The American College now. Education has never been more central to demonstrating value to clients.

4. *Your 2012 award-winning* Journal *paper "The Impact of the Broker-Dealer Fiduciary Standard on Financial Advice," co-authored by Tom Langdon, found no evidence that the broker-dealer industry was significantly affected by the imposition of a stricter fiduciary standard on the conduct of registered reps. We now have the final DOL fiduciary ruling. Knowing what we do about the DOL rule, do you think the findings of your original 2012 research will persist?*

First, it's important to understand why being a fiduciary is historically a part of how advice-based professions are regulated. There would be no marketplace if the adviser did not know more than the client. That gives the adviser an informational advantage, and it's necessary for the profession to exist. But the informational advantage also means that the adviser can make recommendations that are not in the best interest of the client, especially if they're compensated to recommend products that pay more revenue but are inferior.

If you went to a doctor and she recommended a specific type of hip replacement and you found out later that the artificial hip you received was inferior, maybe it only lasted 10 years and she could've recommended one that lasted 30 years but received a financial incentive to recommend the inferior product, you would want some kind of legal recourse.

> "This is a knowledge-based profession, ultimately, and you trust an adviser who has made that investment in knowledge."

Likewise, in financial services, we all know of people who are making recommendations that are self-serving. There isn't a financial adviser alive who hasn't seen it done wrong. If there are limits to recourse in the event of bad recommendations, a segment of the profession will be able to make a living off of making unsound recommendations. There needs to be some kind of fiduciary standard if financial advising is to be a serious advice profession. There is plenty of evidence that markets with an information imbalance are much healthier when investor protections exist.

The real concern comes when you have to actually implement the fiduciary standard. The standard changes incentives. You want the standard to change incentives in a way that is going to lead to better-quality recommendations by advisers. When they're weighing whether to recommend a good or substandard financial product or strategy, they will have a disincentive to recommend the wrong strategy, even if it's in their own best interest.

There are some things that have happened with the new legislation that are a little concerning to me. There are always unintended consequences. You never quite know how it's going to turn out until after the rules take effect. Essentially, lawsuits will help guide practice as it does in medicine. In many cases, the tests that you receive when you go to the doctor are a function of the end result of lawsuits. This is both good and bad for the customer. It increases costs and sometimes leads to overly cautious recommendations that aren't really best for clients.

Lawsuits are permanently changing employer-sponsored contribution plans right now in some ways we hadn't anticipated 10 years ago. It's pushing the industry in a more efficient direction in general, but there have been inefficiencies along the way and significant headaches for advisers. The impact of fiduciary risk may also affect employee access to retirement plans. One of the big fears is that some clients will not receive the same level of service because some of these legal costs are too high. But that remains to be seen.

Another issue is that the level fee exemption will probably push more and more advisers to asset-based fees. That, in itself, creates a disincentive to recommend some products and strategies that may be in the client's best interest but may traditionally have a different form of compensation.

5. *Your 2016 co-authored* Journal *paper "Spending in Retirement: Determining the Consumption Gap," challenged the common assumption that retirees continually spend down their retirement savings. What did your analysis reveal about how retirees are actually spending money?*

When you enter retirement, there are three important unknowns. You have no idea what investment returns are going to be in retirement. You also don't know how long you're going to live. And you don't know how much you're going to have to spend.

What a lot of financial advisers have done is look at your preretirement income and take some sort of percentage of that, but one replacement rate can't be appropriate for all retirees. The better way to do it is to actually figure out how much a client spends over the course of a year. Chances are, the year after you retire you're going to be doing the same things you were doing the year before you retired. You'll go to the grocery store and buy the same things, live in the same house and pay the same utilities, drive the same car. You may be going on a few more vacations, but you'll also have other work-related expenses that are going to be different. In many cases, you may end up spending less on health care after you retire than you did before you retired out of pocket. Medicare is reasonably generous.

In reality, you have two types of people in retirement. One is the retiree who has spent less than their income their entire life. In retirement, they continue to spend less than their income and very often, especially in that top wealth quintile, the majority of retirees don't even spend down assets at all.

This whole concept of spending down assets that forms the foundation of the 4 percent rule isn't even a thing for the majority of the kind of people who tend to be clients of financial advisers. In that case, they're not running out of money; they're building money. So we follow them between 2000 and 2012 and we see that a lot of these wealthy retirees, even during a period where markets were pretty much flat, ended up with more money than they had before they started.

That makes a lot of sense if you think of spending as a habit. If the amount of money you're spending after retirement really isn't that big of a percentage of what you were making before you retired (for example, in the top wealth quintile, the average retiree was spending about 40 percent of their gross income the year before retirement), that makes sense because you've got taxes, saving for retirement, and general saving overall. You may have a mortgage before retirement but not after retirement.

So that means that if they maintain that level of spending, they may be spending much less than the 70 to 80 percent that advisers assume people are going to spend of their preretirement income, in which case they don't need as much to be able to fund that specific income goal. So understanding the real income goal that will maintain a lifestyle requires paying a little bit more attention to how much people spent before retirement. This becomes especially important in a low-return environment that increases the costs of funding a given level of income.

The one big unknown is health care. In another study that a graduate student and I did recently, we tried to look at that distribution of health care expenditure. You may have heard in the news that a retiree has to save up $250,000 to cover health expenses in retirement. That's true on average, and actually that's not a huge amount of money spread over the number of years you're going to be living in retirement. Oftentimes, this is money that simply comes out of your Social Security check to pay for Medicare and is often less than what you paid for health insurance and co-payments before retirement.

But at the very end of the tail, there are a small minority of retirees who are going to have huge health care expenses. You can either set aside $1 million to $2 million at the beginning of retirement to cover that 2 to 3 percent risk that you're going to have huge medical expenses in retirement, or you can somehow try to pool that risk among retirees. Long-term care is a product that has had a lot of problems recently. Variable premiums make it difficult to plan for the cost of insurance, and companies are abandoning coverage of extreme tail risk.

I think the industry needs to work with insurance companies to develop better products that cover the tail risk but allow the individual retiree to absorb moderate health care risk. A retiree who experiences long-term care costs at the tenth percentile may be better off retaining most of this risk, but the extreme expenses of the first or second percentile should be transferred to the insurer.

6. *Do you feel there is a product that is misunderstood or underutilized by financial planners in general?*

There is such a thing in economics as the annuity puzzle. If your primary goal in retirement is income, there's no argument that an annuity is the way to get a higher, safer income relative to investments. You don't know how long you're going to live; that is an idiosyncratic risk. The way we deal efficiently with this risk is to pool it with other retirees. Just as an adviser would recommend that a client who has half their wealth in a single company stock reduce their idiosyncratic risk, in a retirement income plan an adviser should be recommending some kind of strategy for reducing the idiosyncratic risk of longevity.

Probably the one product that is most underutilized is a qualified longevity annuity contract, or QLAC. Insurance companies aren't very excited about it because it's such a small product, and financial advisers are not necessarily interested in recommending it because annuities have a bad reputation, they're not aware of the product, or because it takes money off the table. This is the kind of product that provides longevity pooling during the years when it has the greatest economic advantage. So if you ask an economist what is the best type of annuity for retirement, they would say an annuity that allows retirees to share later-life risk.

Economists have been arguing this for a while, and the Treasury department has agreed to provide up to 15 years of RMD deferral as an incentive for retirees to go ahead and buy one of these annuities in a qualified longevity annuity contract. It increases the expected return you get from your annuitization investment.

For insurance companies, it's only $125,000; it's not a particularly profitable product, and it is not being heavily marketed. It's also not that well known among advisers, but you can essentially cut your risk of running out of money in half in retirement by substituting a $125,000 longevity annuity for bonds, because you get so much more income per dollar from the annuity later in life. And if you do run out, you have a higher income than Social Security alone.

7. *What role are financial planning professionals playing in the annuity puzzle?*

I frequently talk with advisers who are primarily AUM compensated, but also have the ability to obtain compensation from the sale of annuities. They lose money when they recommend an annuity because the commission they make from an annuity doesn't match the amount of money they can be expected to make from applying a 1 percent AUM fee to the premium dollars over time. Especially with the more competitively priced fixed annuities, the commissions are relatively modest. And a fee-only adviser only loses money by recommending a guaranteed income product to a retiree.

This brings up a very real argument about whether a fee-only compensation structure has fewer conflicts of interest in retirement planning. Clearly, AUM compensation during the accumulation phase aligns incentives with clients in ways that commission compensation does not. But when it comes to building a retirement income plan, where there is such a clear income benefit from pooling safe investments, clients may be better served by advisers who have the flexibility to earn compensation on either pooling or investment strategies. The research shows that even an adviser who is convinced they have the best interest of a client in mind will subconsciously bend their recommendations to fit their compensation incentives.

> "We've created this framework for building a retirement income strategy through the 4 percent rule and that model is incomplete."

A client can gain significant theoretical and behavioral benefit from transferring safe investments to risk-pooling products that reduce the anxiety of running out of money in retirement. When you give people a slider and ask them what percentage of their retirement savings they want in guaranteed income, you might be surprised what the answer is. In my own recent experiments, it is apparent that unknown longevity and health expenses weigh heavily on retirees. Almost nobody would prefer an investment-only strategy. A well-trained adviser knows which pooling products make sense and can build a plan that allows a retiree to maintain a desired lifestyle without the fear of outliving assets.

8. *Is there a common misperception you feel financial planners have when it comes to retirement income planning?*

A decumulation strategy is more complex because of the added uncertainties and the specialized knowledge that is involved in efficiently pulling money out of investment accounts. That means a true retirement income plan requires information that doesn't necessarily exist in the traditional CFP® education. That's one of the reasons I think the RICP™, the Retirement Income Certified Professional designation from The American College, has been so popular. It supplements that base of traditional knowledge investment advisers have. You have to understand the different products, different strategies, different tax laws, and even different behavioral elements of retirement income planning that don't exist in the accumulation stage.

We've created this framework for building a retirement income strategy through the 4 percent rule and that model is incomplete. It was an important concept when it was written, but the retirement income process is so much more multifaceted than the assumptions of the 4 percent rule.

9. *Why do you think the 4 percent rule is still embraced by many planners?*

There is this theory in economics known as the first-mover advantage. You establish the rules if you're the first game in town. In this case, the 4 percent rule fit well with the business model and was conservative and made a lot of sense. Historically it's worked fine, so for many financial planners if it's not broke why fix it? It's the lens through which we've traditionally viewed retirement. Why do we need to change that lens?

The bottom line is that many of the assumptions of the 4 percent rule don't match up that well with current reality. As people are living longer in a low-return environment, that 4 percent rule that used to be safe isn't as safe as we might've been led to believe, especially if you add asset management fees on top of the lower expected returns.

As I present at conferences, I see that people are changing how they think about strategies they use to create a retirement income for clients. But once a paradigm has been established, it's a little difficult to change it. There are going to be people who have practiced a certain way who are going to resist, especially if there's no evidence sitting in front of them that there's anything wrong with their current approach. Why change? I think you change because it's what the client wants. When you look at what affects satisfaction in retirement, that fear of insecurity is a big barrier to getting the most out of retirement.

If you look at the differences in satisfaction between those who have a pension and those who don't, even if you back out the present value of that pension and add it to wealth, having that regular paycheck does seem to make people happier. They know exactly how much they can safely spend each month. That's a powerful tool. The 4 percent rule doesn't give people that same level of security. They fear that in a down market—especially if that down market occurs early in retirement—that their lifestyle could be jeopardized. And they're right.

10. *Some people say that academic research in the financial planning profession is not always relevant to a planners' work with clients. Do you agree? If so, what strides can the profession take to remedy that?*

I completely agree that academics don't spend enough time talking with practitioners to identify the most important questions they want answered by researchers. We need to develop better ways for academics and practitioners to work together to figure out how to best serve clients.

Some of the research can come across as being incomplete or naïve or not aware of the kinds of challenges that advisers face when they're making recommendations to clients. The most satisfaction that people like Wade Pfau and I get by focusing on some of these topics is that advisers tell us that it has changed how they work with clients. I want to see more academics have the ability to get that satisfaction from their research.

I feel that as I get closer to the profession, it becomes easier for me to identify where the real knowledge gaps are. My hope is that, for example through the CFP Board's new Center for Financial Planning, we can begin a closer dialogue between academics and financial planners.

I'm sympathetic to both sides. Academics can become discouraged when their work is criticized as being impractical despite making an important contribution to theory. At the same time, I understand that a lot of academic research that I read isn't really that relevant for financial planners. When I read through the *Journal of Financial Planning,* there are some months where I look at an article and I think, "This doesn't really matter to anybody who's actually doing financial planning." It frustrates me because, even as an academic, I feel like we need to be doing a better job of identifying those topics that we need to be filling if this is going to be a knowledge-based profession. And that's our job as academics, to work hand-in-hand with practitioners to answer important questions about how to do the job better. ■

Carly Schulaka is editor of the Journal. *Contact her at CSchulaka@OneFPA.org.*