

Zvi Bodie on the Future of Retirement Products

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What is the safest retirement asset for a 55-year old US resident?

That question was posed by Zvi Bodie, professor of finance and economics at Boston University, to an audience at the Managing Retirement Income conference in Boston on February 9. Bodie has written extensively on retirement planning and investments and is a leading expert in the field.

“We’ve got a really big problem with aging populations all over the world,” Bodie said. Retirement systems must be restructured, and the investment industry is searching for solutions.

Bodie insists on solving the problem of investing for retirement with the question posed above – what is the safest way to save? But his is not the question the investment industry wants to ask, Bodie said, and as a result the industry regards him as a “gadfly, if not an outright enemy.”

“If everyone takes the safest path, assets under management and turnover would be way too low,” Bodie said. “There would be no money to be made.”

Answering the question

Bodie used online financial planning tools to expose the inadequate advice offered by several major fund companies. He found they provided identical answers to his question: put 100% of your assets in a money market fund or certificate of deposit. Even TIAA-CREF did not suggest putting the money in their own funds or annuity products, instead opting for a money market account.

One member of the audience suggested annuity products as the answer, but Bodie rejected this, citing their lack of inflation protection.

Instead, for Bodie, the safest retirement asset is Treasury Inflation Protected Securities (TIPS), in which all of his personal retirement assets are invested.

As he converts his retirement assets to income, Bodie plans to use inflation-protected immediate annuity products. But he doesn’t plan to do so until he reaches age 70, in order to receive the maximum Social Security benefits.



“Saving is all about insuring and not about speculating,” Bodie said.

Investors should start with their Social Security benefits, which are already inflation-protected, and supplement those benefits with other inflation-protected income.

Bodie said this concept is not difficult to explain or understand. “The problem is that most people don’t know this is possible,” he said. Some in the investment industry do not grasp these concepts, Bodie said, noting that “there is a great deal of ignorance among professionals.”

He did not address whether this ignorance is innocent or deliberate.

Advisors are not the culprits in Bodie’s view. “There is a very good living to be made for financial advisors acting in the best interests of their clients,” he said. “But, when it comes to retirement income, it comes down to what I said about security and inflation protection.”

The role of equities in a retirement portfolio

In 1975, Bodie wrote his Ph.D. dissertation on the use of common stocks as a hedge against inflation. He considers himself an expert on the subject.

“Historically, in the US, common stocks have been a disaster in times of inflation,” he said, citing the 1974-1975 period as an example of high inflation coupled with a 50% decline in the market. “You cannot rely on the stock market to do the heavy lifting,” said Bodie.

The online financial planning tools he tested fail to heed this lesson. When Bodie instructed them that he was worried about inflation, they told him to put at least half of his money in the stock market.

Target date funds also fail in this respect, Bodie said. He criticized near-term (e.g., 2010) funds for their aggressive allocation to equities. [Ed.’s Note: see our [article](#) on this subject.]

The future for retirement products

Once an investor has secured their standard of living, through a combination of Social Security and TIPS, it may be time to put some money in the stock market. Bodie’s vehicle of choice is the Equity Participation Note (EPN).



An EPN consists of a risk-free investment (like TIPS) plus call options on a broad-based index (such as the S&P 500). The key is that the value of the account never goes below a minimum threshold. Investors participate in some of the upside when the market goes up, but never risk diminished principal.

Moreover, any realized gains are locked in. Once the market goes up, the call options are sold and used to supplement the risk-free asset base. "This creates an escalating – not a variable – payout," Bodie said.

EPNs are sold by most major brokerage firms, but they are not big sellers in the US, Bodie said. In Europe, on the other hand – especially in France – they are very popular, even more so than mutual funds. "France has never shared our optimism about the stock market," he said.

The idea is not new. In the 1500s, during the Italian Renaissance, bonds were sold with lotteries attached. The principal and interest on the bonds were safe and, if you won the lottery, you got a big payoff.

Advisors can build EPNs themselves and avoid the fees charged by brokerage firms. The critical variable is determining the number of options to buy. Bodie demonstrated a Web-based tool that does this calculation. It uses a Black-Scholes pricing model and requires users to enter variables like whether they are willing to tolerate any downside loss in their principal and how much upside participation they want when the market rises.

Increasing upside participation is achieved by buying out-of-the-money call options. In this way, the investor forfeits the initial portion of market increases (e.g., the first 10%) but gets greater participation in bigger upside moves.

"This is really simple stuff in terms of basic finance," said Bodie. "Advisors can implement this strategy themselves and expose the fees charged by brokerage firms, providing a lot of value to their clients."

"There is a business here," he said. He firmly believes advisors can implement a simple tool to give their clients what they really want: protection and upside participation.

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