MONEY IS BETTER THAN POVERTY, IF ONLY FOR FINANCIAL REASONS

GO DEEPER INTO THE STORY
www.projectm-online.com

Join us on twitter.com/projectmonline and youtube.com/projectmonlinevideos

Allianz

PROJECT M

Multiplying investment, insurance and retirement knowledge

What exactly is happiness? Powered by seemingly equal doses of chemical reactions, financial freedom and selective memory, the elusive concept is an object of constant wonder and notoriously difficult to define

» NOW, MONEY CAN'T BUY YOU LOVE, MY FRIEND, BUT IT STILL PLAYS A CRUCIAL ROLE IN DETERMINING OLD-AGE HAPPINESS «

HAPPINESS

» YOU SHOULD BUY YOURSELF GOOD TIMES: GO ON A TRIP OR SPEND TIME WITH FAMILY OR FRIENDS. A BIKE IS A GREAT EXAMPLE. IF YOU USE IT TO BRAG ABOUT IT AT WORK, THEN IT IS A MATERIAL POSSESSION AND UNLIKELY TO MAKE YOU HAPPY. IF YOU ENJOY THE RIDES, THAT WILL LIKELY GIVE YOU SOME HAPPINESS «

» HAPPINESS REALLY IS NOTHING MORE OR LESS THAN A WORD THAT WE WORDMAKERS CAN USE TO INDICATE ANYTHING WE PLEASE «

THE YOU-KNOW-WHAT-I-MEAN FEELING

Enlightened investing for a world in transition

MICRO
The everyday life of aging baby boomers has become sexy—and Hollywood is beginning to pay attention

MACRO
Racing for a title no one wants: several countries run in the running to become the fastest-aging society on the planet

META
Adventurer and explorer Ranulph Fiennes continues to live an extraordinary life well into retirement

» #21 HAPPY FEAT
Achieving financial security is key to retirement happiness

WOODY ALLEN
Those seeking additional income in the future for retirement will have no choice but to turn to capital markets (see pages 15-17). Participation in the financial markets has become inevitable in the accumulation phase of life and desperately needs to be included in the decumulation or post-retirement phase. To create this income stream, consumers will require access to a broad range of market returns in order to keep pace with rising costs of living.

However, they also need to protect their assets from potential market downturns. Furthermore, when people hit retirement they have significantly different personal requirements, so new, innovative and individual retirement solutions are required to better meet customer needs.

GUARANTEE PRODUCTS
In the mid-1980s, unit-linked products offering participation in financial markets and guarantees were first introduced in the US. Since then, unit-linked products have overtaken traditional fixed annuities to become the primary form of protected investments.

This success has been repeated in Japan and to an extent in Europe. However, even these products are suffering from the low-interest-rate environment, as embedded guarantees are becoming more and more expensive to deliver. This makes these products less attractive to providers and clients, particularly if clients are forced to shoulder the costs of high guarantees. Some guarantee products also lack flexibility.

SMARTER APPROACHES TO GUARANTEES

Is it possible to provide a guarantee without actually guaranteeing a guarantee?
Clients’ spending patterns vary during their life, particularly in retirement. Potential health problems, changing personal situation or other factors might lead to a necessity to change to a targeted payout or even product termination. This could be costly or even impossible for classical guarantee products to meet.

That such guarantees are an issue is evident by the fact that insurance companies now offer innovative “guarantee-light” products that combine insurance benefits and asset management solutions in regulatory capital-friendly ways. In more extreme forms, guarantees are completely removed from the products.

Such an approach is attractive to insurance companies or plan sponsors as they do not have to shoulder high guarantee costs. From the client’s perspective, however, the lack of guarantees means these are little more than a drawdown product based entirely on future performance. In this sense, the customer is left alone to face the full force of market investment risks.

Is there another way to tackle income requirements in retirement? One may be through a decumulation solution that applies a risk-management strategy that mimics the guarantees found in annuities and offers a similar payoff, but without providing an expensive explicit guarantee.

**Probability-related guarantees**

This type of product could be called a “probability-related” guarantee and would be a more sophisticated way of minimizing risk compared to the “all or nothing” guarantee approaches. By incorporating dynamic risk management strategies to optimize income, individuals would have greater security to achieve a sustainable income stream in retirement even in periods of market downturns, while being able to participate more readily in performance or inflation-driven market opportunities.

The basic notion would be a trade-off where the individual accepts, say, a 98% probability that he will not lose more than he has invested into a product. The costs of providing a 100% guarantee as opposed to a 98% probability are expensive. If the individual can accept that marginal probability of 2%, then substantial protection costs of explicit guarantees can be saved.

Underlying the product would be mechanisms that replicate the payoff characteristics of the guarantee over time. So, for example, when equity prices fall and guarantees become more valuable, the strategy would shift from return-generating assets to more defensive assets, such as government bonds, cash or similar. Such a solution would be complex, as it would provide highly individualized strategies for customers based on their needs. Adjustable parameters may include the number of years that individuals want to receive payments, how much they want to withdraw and if they want to automatically ratchet up cash flows in periods of above-average performance of equity markets.

At risklab, we ran multiple scenarios and believe such a sophisticated approach to controlling risks would bring benefits to retirees (see the historic simulation graph above, for example). This approach would also allow clients to access their money at any time, should they require extra cash. In addition, contrary to many annuities, the solution would return residual savings to the customer’s family in case of death.

As sophisticated as this decumulation strategy may be, it cannot entirely cover longevity risk, as the solution would be attached to an expiry date that may fall short of the individual’s life span. For those who understand the probability that they may live longer and want to insure themselves against using all their savings, there is already a suitable, well-proven product available. It’s called a deferred annuity, and it could be integrated with such a probability-related investment approach.