

The Market for Retirement Financial Advice

The Market for Retirement Financial Advice

EDITED BY

Olivia S. Mitchell
and Kent Smetters

OXFORD
UNIVERSITY PRESS

OXFORD

UNIVERSITY PRESS

Great Clarendon Street, Oxford, OX2 6DP,
United Kingdom

Oxford University Press is a department of the University of Oxford.
It furthers the University's objective of excellence in research, scholarship,
and education by publishing worldwide. Oxford is a registered trade mark of
Oxford University Press in the UK and in certain other countries

© Pension Research Council, The Wharton School, University of Pennsylvania 2013

The moral rights of the authors have been asserted

First Edition published in 2013

Impression: 1

All rights reserved. No part of this publication may be reproduced, stored in
a retrieval system, or transmitted, in any form or by any means, without the
prior permission in writing of Oxford University Press, or as expressly permitted
by law, by licence or under terms agreed with the appropriate reprographics
rights organization. Enquiries concerning reproduction outside the scope of the
above should be sent to the Rights Department, Oxford University Press, at the
address above

You must not circulate this work in any other form
and you must impose this same condition on any acquirer

Published in the United States of America by Oxford University Press
198 Madison Avenue, New York, NY 10016, United States of America

British Library Cataloguing in Publication Data

Data available

Library of Congress Cataloging in Publication Data

Data available

ISBN 978-0-19-968377-2

Printed in Great Britain by
CPI Group (UK) Ltd, Croydon, CR0 4YY

Preface

The long-term shift away from traditional defined benefit pensions toward defined contribution personal accounts requires that people saving for retirement must become more sophisticated than ever before. Yet the landscape for financial advice is changing, with new rules and regulations transforming the financial advice profession. This volume offers new insights into the marketplace for retirement financial advice, seeking to illuminate market and regulatory challenges so as to enhance consumer, plan sponsor, and regulator outcomes. We inform this discussion by exploring what financial advisors do, how they are compensated, how one might measure performance and impact, and how clients can be protected from bad advice and steered toward good advice.

The volume, an invaluable addition to the Pension Research Council/Oxford University Press series, should interest a wide range of readers including consumers, researchers, and employers seeking to design better retirement plan offerings, and policymakers charged with oversight and enhancement of the financial system.

In the process of preparing this book, many people and institutions played essential roles. My co-editor and Wharton School colleague, Kent Smetters, contributed ideas and suggestions. We thank him, along with our Advisory Board, Senior Partners, and Institutional Members of the Pension Research Council for intellectual and financial sustenance. Additional support was received from the Pension Research Council, the Boettner Center for Pensions and Retirement Research, and the Ralph H. Blanchard Memorial Endowment at the Wharton School of the University of Pennsylvania. We also offer our appreciation to Oxford University Press which hosts the Pension Research Council series of books on retirement security. This manuscript was expertly prepared and carefully edited by Andrew Gallagher and Donna St. Louis.

Our work at the Pension Research Council and the Boettner Center for Pensions and Retirement Security of the Wharton School of the University of Pennsylvania has focused on aspects of pensions and retirement well-being for over half a century. This volume contributes to the fulfillment of our mission, which is to generate research and debate on policy issues affecting pensions and retirement security.

Olivia S. Mitchell
Executive Director, Pension Research Council
Director, Boettner Center for Pensions and Retirement Research
The Wharton School, University of Pennsylvania

Contents

<i>List of Figures</i>	ix
<i>List of Tables</i>	x
<i>List of Abbreviations</i>	xiii
<i>Notes on Contributors</i>	xv
1. The Market for Retirement Financial Advice: An Introduction <i>Olivia S. Mitchell and Kent Smetters</i>	1
Part I. What Do Financial Advisers Do?	
2. The Market for Financial Advisers <i>John A. Turner and Dana M. Muir</i>	13
3. Explaining Risk to Clients: An Advisory Perspective <i>Paula H. Hogan and Frederick H. Miller</i>	46
4. How Financial Advisers and Defined Contribution Plan Providers Educate Clients and Participants about Social Security <i>Mathew Greenwald, Andrew G. Biggs, and Lisa Schneider</i>	70
5. How Important is Asset Allocation to Americans' Financial Retirement Security? <i>Alicia H. Munnell, Natalia Orlova, and Anthony Webb</i>	89
6. The Evolution of Workplace Advice <i>Christopher L. Jones and Jason S. Scott</i>	107
7. The Role of Guidance in the Annuity Decision-Making Process <i>Kelli Hueler and Anna Rappaport</i>	125
Part II. Measuring Performance and Impact	
8. Evaluating the Impact of Financial Planners <i>Cathleen D. Zick and Robert N. Mayer</i>	153

viii Contents

9. Asking for Help: Survey and Experimental Evidence on Financial Advice and Behavior Change <i>Angela A. Hung and Joanne K. Yoong</i>	182
10. How to Make the Market for Financial Advice Work <i>Andreas Hackethal and Roman Inderst</i>	213
11. Financial Advice: Does It Make a Difference? <i>Michael Finke</i>	229
12. When, Why, and How Do Mutual Fund Investors Use Financial Advisers? <i>Sarah A. Holden</i>	249
Part III. Market and Regulatory Considerations	
13. Harmonizing the Regulation of Financial Advisers <i>Arthur B. Laby</i>	275
14. Regulating Financial Planners: Assessing the Current System and Some Alternatives <i>Jason Bromberg and Alicia P. Cackley</i>	305
<i>End Pages</i>	321
<i>Index</i>	325

List of Figures

6.1	Online advice usage	113
6.2	Aggregate usage (online and management)	118
6.3	Net new managed account members	120
6.4	Aggregate usage with defaults	121
7.1	Annuity quotes for a \$100,000 deposit over one year	140
8.1	Randomized field experiment to assess the impact of consulting a professional financial planner	159
8.2	Estimated incremental effect of consulting a financial planner on total financial wealth	174
8.3	Estimated incremental effect of consulting a financial planner on proportion of total financial wealth held in stocks	175
8.4	Estimated incremental effect of consulting a financial planner on the number of different types of financial assets held	176
9.1	Survey questions of ALP modules: Panel A. Screen shot of task description: high returns + affirmative decision advice treatment; Panel B. Screen shot of task: rules treatment. Panel C. Screen shot of task: portfolio checkup treatment	196
9.2	Experimental design schematic	199
10.1	Comparison of stated risk preferences and average actual portfolio risk. Panel A: Risk categories for target portfolio risk (Financial Institution 1); Panel B: Risk categories for target portfolio risk (Financial Institution 2)	223
12.1	Majority of mutual fund investors initially seek professional investment advice during their peak earning and saving years	251
12.2	Mutual fund investors and help with asset allocation	254
12.3	Mutual fund investors and help with financial planning	255
12.4	Sources used by mutual fund investors to purchase mutual funds	259
12.5	Nearly half of mutual fund-owning households held shares through multiple sources	260
13.1	Broker-dealers' profit margins from 1975 to 2005	280
14.1	Summary of key statutes and regulations that can apply to financial planners	309
14.2	Differences in the standards of care required of financial planners	311

List of Tables

3.1	The current financial planning mosaic	48
3.2	How it all plays out	64
4.1	Financial advisers' role in advising clients on Social Security	75
4.2	Adviser input on the timing of claiming Social Security benefits	77
4.3	Adviser framing of the decision of when to claim Social Security benefits	79
4.4	Adviser evaluation of Break-Even Analysis	80
4.5	Adviser recommendations on when to claim benefits in different scenarios	81
5.1	Percent of pre-retirement salary required to maintain living standards, 2008	90
5.2	Current law Social Security replacement rates, 2030 and later	91
5.3	Saving rates required for a medium earner to attain an 80 percent replacement rate with a 4 percent rate of return	92
5.4	Saving rate required for a medium earner to attain an 80 percent replacement rate with a starting age for saving of 35, by rate of return	92
5.5	Households falling short of target	96
5.6	Wealth levels by wealth deciles	96
5.7	Amount required as compensation for retaining typical portfolio allocation	98
5.8	Typical and optimal portfolio allocations	99
5.A1	Comparison of workers with all HRS households under age 65	102
6.1	Demographic comparison of online advice users	114
6.2	Demographic comparison of managed account users	117
7.1	Types of retirement guidance or education provided by companies to their employees	129
7.2	Comparison of structural and active guidance in institutional platform delivery models through different channels	132

List of Tables xi

7.3	Obtaining annuity income through retail purchase, institutional purchase, and/or DB payout	134
7.4	Characteristics of annuity purchasers and what they purchased through different channels	135
7.5	Characteristics of single premium immediate annuities purchased: amounts of income purchased and annuity features chosen	138
8.1	Weighted means and <i>t</i> -tests for financial outcome variables	166
8A.1	Weighted means for ordinary least squares regression covariates	167
8.2	Ordinary least squares parameter estimates of total financial wealth	168
8.3	Ordinary least squares parameter estimates of proportion stock equity	169
8.4	Ordinary least squares parameter estimates of the number of asset categories	170
8A.2	Logistic regression parameter estimates of the first stage of the propensity score analysis: dependent variable is ‘consults a financial planner’	172
9.1	Summary statistics: American Life Panel (ALP) data	186
9.2	Ordinary least squares estimates of the determinants of the propensity to seek advice	187
9.3	Portfolio allocation patterns of current defined contribution (DC) planholders	188
	Panel A. Portfolio characteristics	188
	Panel B. ‘Mistakes’ in reported portfolio allocations	188
9.4	Ordinary least squares parameter estimates	190
	Panel A. Empirical determinants of portfolio allocations by DC planholders	190
	Panel B. ‘Mistakes’ in reported portfolio allocations	190
9.5	Portfolio allocations and financial literacy: ordinary least squares estimates for current DC planholders	192
	Panel A. Reported portfolio allocations and financial literacy (current DC planholders)	192
	Panel B. ‘Mistakes’ in reported portfolio allocations and financial literacy	192
9.6	Summary statistics on the ALP experimental sample	198
9.7	Determinants of the propensity to seek advice: affirmative decision treatment	200
9.8	Experimental results: comparisons of means	201

xii List of Tables

9.9	Intent-to-treat effects on portfolio quality: all choice treatments	202
9.10	Portfolio quality, advice, and financial literacy: affirmative decision treatment	205
9.11	Estimates of the average effect of treatment on those treated on portfolio quality and financial literacy: affirmative decision treatment vs. controls	206
10.1	Four possible configurations in the market for financial advice	218
11.1	Household characteristics and retirement planning	232
11.2	Financial planner regressions	236
12.1	Achieving specific financial goals often prompts mutual fund investors to seek professional investment advice	252
12.2	Mutual fund investors and research and investment advice	256
12.3	Investor/adviser split of decision-making	257
12.4	Mutual fund investor head of household characteristics	262
12.5	Variables used in probit regression model	264
12.6	Probability mutual fund investor has ongoing advisory relationship	265
13.1	Financial information for broker-dealers (1969–2010)	297

List of Abbreviations

AICPA	American Institute of Certified Public Accountants
AIME	Average Indexed Monthly Earnings
ALP	American Life Panel
AUM	Assets Under Management
BLP	best linear predictors
BLS	Bureau of Labor Statistics
BMELV	German Ministry of Consumer Affairs
CE	Continuing Education
CFA	Chartered Financial Analyst
CFP	Certified Financial Planner
CFS	Certified Fund Specialist
ChFC	Chartered Financial Consultant
CIC	Chartered Investment Counselor
CIMA	Certified Investment Management Analyst
CLU	Chartered Life Underwriter
CPA	Certified Public Accountant
CRRA	coefficient of relative risk aversion
DB	defined benefit
DC	defined contribution
DOL	Department of Labor
EBRI	Employee Benefit Research Institute
EBSA	Employee Benefits Security Administration
EC	European Commission
ERISA	Employee Retirement Income Security Act
ESOP	Employee Stock Ownership Plan
FINRA	Financial Industry Regulation Authority
FPA	Financial Planning Association
FSA	Financial Services Authority
FSA	Fellow of the Society of Actuaries

xiv List of Abbreviations

FSB	Financial Stability Board
FTC	Federal Trade Commission
GAO	Government Accountability Office
HRS	Health and Retirement Survey
IAA	Investment Adviser Association
ICI	Investment Company Institute
IFIC	Investment Funds Institute of Canada
IPO	Initial Public Offering
IRA	Individual Retirement Account
IRS	Internal Revenue Service
LP	linear probability
MiFID II	markets in financial instruments directive II
NAIFA	National Association of Insurance and Financial Advisors
NASD	National Association of Securities Dealers
NIA	National Institute on Aging
NLSY	National Longitudinal Survey of Youth
NYSE	New York Stock Exchange
OLS	ordinary least squares
OMO	open market option
PACFL	President's Advisory Council on Financial Literacy
PFS	Personal Financial Specialist
PPA	Pension Protection Act
QDIAs	qualified default investment alternatives
RFE	randomized field experiment
RIA	Registered Investment Adviser
RMD	required minimum distribution
SANCO	European Commission Directorate—General Health and Consumers
SCF	Survey of Consumer Finances
SEC	US Securities and Exchange Commission
SRO	self-regulatory organization
SSA	Social Security Administration
TPAS	Pensions Advisory Service
US	United States

Notes on Contributors

Andrew G. Biggs is Resident Scholar at the American Enterprise Institute, where he focuses on Social Security reform, fiscal consolidation, state and local government pensions, public/private compensation comparisons, and financial literacy. Previously, he was the Principal Deputy Commissioner of the Social Security Administration; he also worked on Social Security reform at the National Economic Council and staffed the President's Commission to Strengthen Social Security. He holds a Bachelor's degree from the Queen's University of Belfast, Northern Ireland; Master's degrees from Cambridge University and the University of London; and a Ph.D. from the London School of Economics and Political Science.

Jason Bromberg is Assistant Director of Financial Markets and Community Investment with the U.S. Government Accountability Office (GAO). He has overseen several GAO studies on financial literacy and education, consumer protection, financial regulation, bankruptcy reform, identity theft, and consumer privacy. He received his Bachelor's degree in Philosophy from Vassar College and the Master's degree in Public Policy from Harvard University.

Alicia P. Cackley is Director in the Financial Markets and Community Investment team at the U.S. Government Accountability Office. She manages projects on program evaluation and policy research in consumer protection, housing, and finance issues; her areas include financial literacy, consumer product safety, bankruptcy, and homelessness. She earned her Ph.D. in Economics from the University of Michigan.

Michael Finke is Associate Professor and Director of Ph.D. studies in Personal Financial Planning at Texas Tech University. His research interests focus on financial planning, including household financial decision-making, individual investment performance, the value of financial planning advice, and the importance of contracts among financial service agents. He earned his Ph.D. in Family Resource Management from The Ohio State University and in Finance from the University of Missouri.

Mathew Greenwald is President of Mathew Greenwald & Associates, Inc., a market research company that focuses on retirement matters. He previously worked at the American Council of Life Insurance. He is an elected member of the Market Research Council, and he was nominated by Congress to serve on two National Summits on Retirement Saving. He received

xvi Notes on Contributors

his Bachelor's degree from Binghamton University and his M.A., M.Phil., and Ph.D. degrees in Sociology from Rutgers University.

Andreas Hackethal is Professor of Finance at Goethe University Frankfurt, where he is also Dean of the Faculty of Economics and Business Administration. He is a member of the advisory council to the German Financial Supervisory Authority and of the Exchange Experts Commission advising the German Ministry of Finance. He earned his degrees in Business Administration from Goethe University and the University of Iowa.

Paula H. Hogan is the founder of Paula Hogan, a fee-only financial advisory firm (formerly known as Hogan Financial Management) in Milwaukee, Wisconsin. She is a nationally recognized leader in the financial advisory field and her firm has been selected as one of the nation's top advisory firms. She also serves on the advisory boards for Money Quotient and Veritat. She earned her B.A. degree in Economics from Princeton University and an M.S. degree from the Harvard School of Public Health.

Sarah A. Holden is Senior Director of Retirement and Investor Research at the Investment Company Institute (ICI), where she researches the US retirement market, retirement and tax policy, and investor demographics and behavior. She has conducted analysis of 401(k) plan participant activity using data collected in a collaborative effort with the Employee Benefit Research Institute (EBRI), and she also oversees The IRA Investor Database™. Previously, she was a staff economist in the Flow of Funds Section of the Research Division at the Federal Reserve Board. She graduated from Smith College and earned her Ph.D. in Economics from the University of Michigan.

Kelli Hueler is CEO and founder of Hueler Companies, an independent data and research firm providing reporting and systems designed for the annuity and stable value marketplace. Her work focuses on stable value investments and guaranteed investment contracts. She received her Bachelor's degree from St. Olaf College.

Angela A. Hung is Senior Economist at RAND, where she is Director of the Center for Financial and Economic Decision Making, and Associate Director for the RAND Roybal Center on Financial Decisionmaking. Her research examines on how people collect and use financial information; how they match their financial decisions to their interests and goals; conflicts of interest in financial advising; and testing materials for financial statements. Previously, she taught at the H. John Heinz III School of Public Policy and Management at Carnegie Mellon University. She received her Ph.D. in Social Science from the California Institute of Technology.

Notes on Contributors xvii

Roman Inderst is Finance Professor at Goethe University Frankfurt, where his work focuses on corporate finance, banking, competition policy, and information economics. He is a member of the academic advisory board to the German Federal Ministry of Economics and Technology. He received a B.A. in Business Administration from Reutlingen University, a Magister Artium in Sociology from Fernuniversität Hagen, and a Diploma in Economics from Humboldt University of Berlin. His Ph.D. in Economics was earned at the Free University of Berlin, and his Habilitation was conducted under the supervision of Benny Moldovanu at the University of Mannheim.

Christopher L. Jones is Chief Investment Officer and Executive Vice President of investment management for Financial Engines. He leads a team responsible for investment analysis, financial research and development, and portfolio management. Additionally, his group has pioneered the technology for online advice and professional management services. He earned his Master's degrees in Business Technology and Engineering Economic Systems, and his Bachelor's degree in Quantitative Economics, from Stanford University.

Arthur B. Laby is Professor of Law at Rutgers University School of Law in Camden, New Jersey, and former Assistant General Counsel of the US Securities and Exchange Commission in Washington, DC. His interests are securities regulation, business organizations, investment management regulation, and fiduciary law, as well as the regulation of investment advisers and broker-dealers, conflicts of interest, and the fiduciary relationship. He earned his Law degree from Boston University School of Law.

Robert N. Mayer is Professor in the Department of Family and Consumer Studies at the University of Utah, where he focuses on consumer problems and policy, global consumer movements, and currently, retirement planning in the aftermath of the Great Recession and the role of consumer advocates in creating the Consumer Financial Protection Bureau. He received his Bachelor's degree from Columbia University and the Ph.D. in Sociology from the University of California-Berkeley.

Frederick H. Miller has worked in financial services as Management Consultant—in product and business development at Scudder Investments, and now at Sensible Financial, which he founded. His firm is one of the fastest growing registered independent advisory firms. He is a CFPR Certificant and a member of both the National Association of Personal Financial Advisors and the Financial Planning Association. He recently served on the Trends in Financial Planning and Job Analysis Task Forces of the CFPR Board. He earned his A.B., A.M., and Ph.D. degrees in Economics from the University of Chicago.

xviii Notes on Contributors

Olivia S. Mitchell is the International Foundation of Employee Benefit Plans Professor of Insurance/Risk Management and Business Economics/Public Policy at the Wharton School of the University of Pennsylvania. Her main areas of interest are private and public insurance, risk management, public finance, labor markets, compensation, and pensions with both a US and an international focus. She is also the Executive Director of the Pension Research Council and the Director of the Boettner Center on Pensions and Retirement Research at Wharton, Faculty Research Fellow at the National Bureau of Economic Research, and Associate Director of the Financial Literacy Center. She received her B.A. in Economics from Harvard University, and her M.S. and Ph.D. degrees in Economics from the University of Wisconsin-Madison.

Dana M. Muir is Arthur F. Thurnau Professor of Business Law at the Stephen M. Ross School of Business at the University of Michigan. Her research interests focus on fiduciary, remedial, and international issues pertinent to investments, pension plans, and retirement saving plans. She earned her M.B.A. at the University of Detroit and her J.D. from the University of Michigan.

Alicia H. Munnell is the Peter F. Drucker Professor of Management Sciences at Boston College's Carroll School of Management. She also serves as the Director of the Center for Retirement Research at Boston College. Previously, she served on the President's Council of Economic Advisers, was Assistant Secretary of the Treasury for Economic Policy, and co-founded the National Academy of Social Insurance. She earned her B. A. at Wellesley College, she received her M.A. from Boston University, and Ph.D. from Harvard University.

Natalia Orlova is a Research Associate at the Center for Retirement Research at Boston College, where she conducts research on retirement issues. She earned her BA in Mathematics and Economics from Boston University and her M.A. in Economics from the University of San Francisco.

Anna Rappaport is an actuary, consultant, author, and speaker with Anna Rappaport Consulting; her interests focus on the impact of change on retirement systems and workforce issues. Previously, she was at Mercer Consulting. She is an FSA and MAAA, she also chairs the Society of Actuaries Committee on Post-Retirement Needs and Risks, and she has served as President of the Society of Actuaries. She is on the ERISA Advisory Council and serves on the Board of the Women's Institute for a Secure Retirement (WISER), and the Advisory Board of Wharton's Pension Research Council. She received her M.B.A. from the University of Chicago.

Notes on Contributors xix

Lisa Schneider is Research Director at Greenwald & Associates, where her work focuses on financial services and opinion research. Previously, she was Marketing Coordinator for the American Council of Life Insurers' Membership and Development Department. She received her Bachelor's degree in Sociology from George Washington University.

Jason S. Scott is Managing Director of the Financial Engines Retiree Research Center, where he works on projects to help retirees maximize their standards of living given uncertain investment performance, uncertain longevity, and uncertain health care costs. His research has focused on longevity annuities, efficient retirement spending, investment strategies, and investor behavior. Previously, he directed the research and development group at Financial Engines. He earned his Bachelor's degree in Economics from Texas A&M University and his Ph.D. in Economics from Stanford University.

Kent Smetters is the Boettner Chair Professor at the University of Pennsylvania's Wharton School and Faculty Research Fellow at the National Bureau of Economic Research. His research examines incomplete markets, investment risk management, and the interaction of risk management and public policy. Previously, he worked at the Congressional Budget Office and served as Economics Policy Coordinator for the US Treasury. He received his Bachelor's degrees in Economics and Computer Science from The Ohio State University and his Ph.D. in Economics from Harvard University.

John A. Turner is Director of the Pension Policy Center, where he provides pension policy analysis for various US and international organizations. Previously, he conducted research at the US Social Security Administration, the US Department of Labor, the AARP Public Policy Institute, and the International Labor Office. He has also taught economics at the George Washington University and Georgetown University, and he was a Fulbright Scholar in France at the Institut de Recherches Economiques et Sociales. He earned his Ph.D. in Economics from the University of Chicago.

Anthony Webb is Research Economist at the Center for Retirement Research at Boston College. His research examines the impact of pensions on retirement ages, the financing of long-term care, the process of asset decumulation, and the impact of bargaining within the household on asset allocation and drawdown. Previously, he worked at the International Longevity Center—USA and served as economic adviser to the British government. His Bachelor's degree in Industrial Economics is from the University of Nottingham, he also earned a Master's degree in Economics from the University of Manchester, and a Ph.D. in Economics from the University of California, San Diego.

xx Notes on Contributors

Joanne K. Yoong is Economist at RAND and Professor at the Pardee RAND Graduate School. Her work explores individual decision-making with an emphasis on finance and health in vulnerable populations. Previously, she was a credit derivatives research analyst in the Fixed Income, Commodities and Currencies Division of Goldman Sachs. She earned her Bachelor's degree in Economics at Princeton University and her Ph.D. in Economics from Stanford University.

Cathleen D. Zick is Professor in the Department of Family and Consumer Studies, and Director of the Master of Public Policy program, at the University of Utah. Her research examines how public policies alter the choices that families make about allocating their money and time resources, as well as the role of familial health histories and retirement planning. She has served as President and on the Board of Directors for the American Council on Consumer Interests. She earned her Bachelor's degree from the University of California, Davis, and her Master's and Ph.D. degrees in Consumer Economics and Housing from Cornell University.