The Quarterly Report

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Do You Feel More Secure?

INSIDE STORY

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Do You Feel More Secure?

Politics is such a strange thing. With the impeachment circus, one would think nothing could get done in Washington; I guess they understood that and did not want to earn the "did nothing but fight each other" label. Suddenly, free trade deals are getting approved and the SECURE Act has become law.

The Setting Every Community Up for Retirement Enhancement (SECURE) Act is the biggest change in retirement plan law in a long while. Has our federal government made you more secure? I'm reminded of a saying that Ronald Reagan used often: The most feared words in the English language are, "I'm from the government and I'm here to help."

The biggest change in the SECURE Act for most retirement plans will be the safe harbor for retirement plan sponsors who wish to provide annuities as options in the retirement plan. If you have a retirement plan at work then your employer is the sponsor of that plan. The plan sponsor, your employer, has a fiduciary responsibility to you as an employee and a participant in the company's retirement plan. That means all the investment options must be prudently selected keeping all the characteristics in mind, including but not limited to fees, appropriateness, and the risk-and-reward potential.

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– Ronald Reagan

As a result, annuities mostly have been eliminated from retirement plans. This new act protects plan sponsors from their fiduciary liability for putting annuities in the plan. As one can imagine, the insurance industry thinks this is awesome.

So, why is that not so great for you? I very rarely, if ever, use the word never, but an investor should never, ever, *ever* buy an annuity. Before I just let that statement settle in, I want to make a point: One of the problems in our modern discourse is that we have provided platforms that allow everyone to express their opinion. Certainly everyone is entitled to an opinion; however, all opinions are not created equal. If one has spent a lifetime studying a certain field, then her opinion should count more than someone who read a tweet.

I started my career working in the insurance industry. I am a Chartered Life Underwriter and a Fellow of the Life Management Institute ("life" here meaning life insurance, not life coach). I was at one point in my career the content editor for the Life Office Management Association's annuity textbook. When is comes to annuities, my opinion should carry some weight.

In fairness, my opinion has changed over the years. I used to believe, as many academics and consultants still do, that annuities had their place. The reason is, that annuities, in theory, could be very helpful. After all, an annuity provides the consumer a lifetime stream of income which is guaranteed by the insurance company. In theory, that is very attractive.

The problem is that we do not live our lives in theory. We live in the real world, and in the real world, annuities are outrageously priced, overly complicated traps. Several years ago I met with a client who was an attorney. He had purchased an annuity several years before our meeting and wanted us to review it for him. We went through the contract and outlined the various fees, restrictions, etc. He kept saying, "That isn't right. That is not what I was told." We kept showing him the contract. He was growing more and more frustrated and finally blurted out, "I would have never agreed to that." To which I responded, "You're a lawyer, didn't you read the contract?"

There are not enough billable hours in the world for a lawyer, or any consumer for that matter, to actually get through the average annuity contract. In the real world, annuities are just too complicated. All that complexity does two things: First, is makes it difficult to understand what you are actually paying. According to Morningstar, the average cost for an annuity is between 2.18% and 3.63%. The second reason for all that complexity is to minimize how much the word "guaranteed" could cost the insurance company.

Years ago, I reviewed an annuity contract for an institutional plan sponsor client who was considering adding it as an option to their plan. The brochure said that the participant would be guaranteed to retire with the highest balance the portfolio had seen, even if the market had dropped since that point. The contract said that was the number the insurance company would use to calculate monthly annuity payments if the participate chose to that option, which fewer than 2 percent actually do. If they took their money in any other way, they would receive the actual market value. In other words, the "guarantee' the participant paid outrageously for meant next to nothing.

The fallacy of annuities is that somehow retirement income needs to be "guaranteed." Safe? Yes. Reliable? Absolutely. But, guaranteed? Well, your income during your working years was never guaranteed. Was that a problem? Firing employees is harder in some states than others, but it can always happen. Even the best companies are not immune to business downturns. During one's working years the best she can ask for is a good job at a good company. I'm excluding entrepreneurs here because these are obviously risk takers. However, the type of person who wishes for safe and reliable is the target of the insurance company. Safe and reliable retirement income can be generated at a far higher rate and lower cost than any annuity. Never buy an annuity.

The new SECURE Act does not require anyone to buy an annuity and I doubt many will. Plan sponsors may be more willing than before to offer annuities, but even then, it is only an offer. The participant has the final say.

In return for this giant handout to insurance industry lobbyists, we got a few positives and one big negative. The positives are that the age at which one must start withdrawing funds from one's retirement account has been moved to 72 from 70.5. Remember, the government allows us to save money into the retirement plan without paying income tax on it. They allow that money to grow without us having to pay taxes on the growth. They eventually want their taxes. We are living longer, and that logically means that we will be working longer and retiring at later years. This change is frankly overdue and likely too little of a move, but it is progress nonetheless.

The act also makes it easier for companies to auto-enroll employees into the retirement plan. While employees can also opt out, many employers have moved towards enrolling employees automatically into the retirement plan. This helps with the very human trait of inertia. Many employees lose out on retirement savings due to a simple lack of action. The downside to auto-enrollment is that most companies do it at very low savings rates. We would suggest that most employees should contribute approximately 10 percent of their income to the retirement plan, and that is low compared to most in the industry (the reason for that is a newsletter in and of itself). Regardless, most employers auto-enroll at 3 percent of income and may increase it to 6 percent.

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REVIEW *of* ECONOMY

The 3rd quarter 2019 GDP growth came in at 2.1 percent. Underneath the surface, the consumer is doing fantastically well as business investment continues to be weak. It is all about tariffs. With a phase one deal with China agreed upon, we suspect we will see growth improve.

The official unemployment rate is 3.5 percent in November. We continue to be at the lowest rate in 50 years. What else can we say?

Inflation is 2.1 percent based on the latest consumer price index report. Inflation has risen but we are still near the Fed's target rate, so we doubt their will be any rate increases in the near term. +

REVIEW *of* MARKET

Markets finished the year strong. For the quarter the S&P 500 finished up 9.07 percent and small company stocks represented by the Russell 2000 index were up 9.94 percent. Growth outpaced value but all major asset classes did well.

Bonds were flat for the quarter. The Barclays U.S. Aggregate Bond index ended up 0.18 percent. High yield bonds rose 2.61 percent.

International stocks were up as well. The EAFE index finished 8.21 percent while the MSCI Emerging Markets index ended the quarter up 11.93 percent. +

MARKET *forecast*

The trade war appears to at least be in a cease fire. This is an encouraging sign. Fundamentals remain strong and should improve in the short term. However, markets do not rise in straight lines. We have come a long way fast and it would not be surprising to see a correction. If we do, we believe it will be a buying opportunity.

Small company stocks, value stocks, international and emerging market stocks, are all overdue for a period of outperformance. These cycles seem to be running in decades now and U.S. large growth stocks have outperformed for a decade. When the shift will happen is impossible to know, but every day it doesn't gets us one day closer.

Bonds remain overpriced and not likely to perform well. +

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The tradeoff in all of this comes to people who have inherited a retirement plan from anyone other than a spouse, most typically a parent or grandparent. Historically, when one inherited a retirement plan, the required distributions would begin right away, but they were calculated based on life expectancies. For a young person inheriting such a plan, the mandatory distributions could be kept small and the bulk of the investments could continue to grow tax-deferred.

Well, the government wants their money. Going forward if anyone inherits a retirement plan from someone other than one's spouse, then he will have 10 years to take all the distributions. The government will get their taxes much faster, and likely at a higher rate as beneficiaries will be taking out larger sums which will likely push them into higher tax brackets. This is a provision that makes sense in theory but will likely not go over well in practice. Time will tell if relief will be given.

As with everything that Congress does there is an endless list of other details, but these are the major points. The two biggest benefactors are the life insurance industry and the Treasury, but there is something in there for us. The obvious solution to the so-called retirement crisis (which we discussed in our 2014 Q3 Quarterly Report, "The Retirement Myth") is to work longer. Giving us another 1.5 years to let our retirement grow is not much, but it is something. I don't know if it makes us more secure, but it is a start.

> *The SECURE Act provides a safe harbor for retirement plan sponsors who offer annuities as options.*

Warm Regards,

Chuck Osborne

CHUCK OSBORNE, CFA *Managing Director*