Taking a closer look at SeLFIES: Added thoughts, clarifications

Robert C. Merton and Arun Muralidhar

A reaction to a recent P&I editorial about the Standard-of-Living indexed, Forward-starting, Income-only Securities) proposal.

We read your editorial, "Tackling the issue of lifetime income" (May 13) and have some additional thoughts and clarifications about our SeLFIES (Standard-of-Living indexed, Forward-starting, Income-only Securities) proposal.

People have a preference for pensions that provide retirement benefit payments for life and never outlive their assets. In contrast, globally, individuals are being called upon to take greater responsibility for their own retirement, as employer defined benefits and government pension plans are either capped at levels well below a good retirement or completely replaced by defined contribution plans. Moreover, in many countries including the United States, a significant proportion of the population do not belong to any retirement plan, but they still need to save for retirement. SeLFIES are designed specifically to address the challenges of this new responsibility faced by working- and middle-class individuals worldwide, the majority of whom are totally unprepared to do so, and do not have access to good quality financial advice.

SeLFIES are designed to mimic pension payments and can be purchased directly by anyone (to create a type of "individual DB"). To address widespread financial illiteracy, SeLFIES require only the most basic information and offer choices for buyers of any educational strata. The two required inputs are anticipated date of retirement (i.e., the SeLFIES payment start date) and target income goal for a good retirement, which determines the number of SeLFIES needed to reach this goal.
How would this work? The federal government would issue a special bond that would pay a standard-of-living-adjusted coupon of $5 per year at retirement age for a period close to the average life expectancy of the economy, currently 20 years. Workers would fund their desired retirement income by buying a target number of SeLfIES, which would be determined by dividing the desired income by $5.

A commonly accepted retirement goal for a healthy pension is to be able to sustain the standard-of-living enjoyed in the latter part of working life, during retirement. Since SeLfIES payments are indexed to per capita consumption, they protect against future inflation and standard-of-living uncertainties. The buyer must simply set their goal at the level they currently live on, a number they already know and relate to in their everyday decisions. Since SeLfIES do not make payments until the retirement date, the buyer does not need to make any further transactions or decisions to reinvest coupon or principal payments during the entire accumulation period. One transaction, one time, for each SeLfIES purchased minimizes costs, decision effort and errors.

For SeLfIES to provide the same pattern of payments as a pension, they must address the lifetime payment feature and protect against longevity risk as the editorial notes. Working- and middle-class citizens who reach retirement age (e.g., age 65) are a diverse group: Some have economic responsibilities for several people and need to bequeath money to take care of their heirs. Others have no one else for whom they are responsible and, hence, have no motive to bequeath assets. For the latter, the annuity or a life pension is ideal because they maximize the benefit payment with no risk of running out and leave no "wasted" assets when they no longer need money. When the person reaches retirement, they have the best information as to their health (such as personal life expectancy vs. the population), they will know who they are responsible for besides themselves, and what other assets and commitments they have. With this information, they are best positioned to make an informed decision on how much to annuitize or not, and thereby implement a personalized plan for decumulation. Few people would commit to a deferred annuity during their work life because they do not know what their situation and needs will actually be when they get to retirement.

SeLfIES do not directly provide an embedded annuity feature of payments for life as they offer a fixed set of payments. But they do contribute to longevity risk protection.
for those who do eventually select full or partial annuitization at retirement, while providing decision flexibility to those who do not want to annuitize.

The design calls for the number of years of payout to equal a period somewhat longer than the life expectancy for the cohort population at retirement. For example, if life expectancy at age 65 is 20 years (age 85), then the specified-payment period on the SeLFIES might be set at 22 years (age 87). A well-run insurance company should be willing to exchange a life annuity with the same $5 indexed real payment for the specified term of $5 real payments on the SeLFIES. If so, then the retiree can simply exchange their SeLFIES for a life annuity with no extra payment and no reduction of retirement income level. Those retirees in different circumstances can adjust accordingly and potentially enjoy the built-in decumulation payments in SeLFIES with no further transactions.

Why would a well-diversified insurance company be willing to exchange one SeLFIES for a life annuity that pays $5 real/year until death (ignoring profit and cost considerations)? If the insurance company has insured a large group of diverse individuals in one cohort, then its net longevity realization should be close to the economy average of that cohort, with relatively low risk. SeLFIES delivered in the exchange is the perfect hedging instrument for the insurance company's aggregate liabilities of this cohort. The somewhat longer payments on the SeLFIES than expected (22 vs. 20 years) provide compensation to the insurance company for cost and profit. It becomes more interesting if the insurance company is also diversified across multiple cohorts. Hence, SeLFIES with a maturity a touch above the economy average could facilitate a much more efficient annuity market to ensure individual longevity risk mitigation. Both insurance companies and pension funds would be natural institutional buyers of large denomination SeLFIES and create price discovery through their auction.

SeLFIES could also serve a key role in implementing Professor Richard Thaler's recent proposal for using Social Security to provide annuity-like benefits as it will offer a liquid benchmark price for any real annuity offering, including one from Social Security. Furthermore, for retirement funding strategies that engage in risk-taking, one can easily see how a well-run asset management company can use a dynamic allocation strategy between risky assets and SeLFIES, with SeLFIES as the "risk-free" asset that locks in guaranteed retirement income — a highly desirable
result. Current products today, including those with legal "safe harbor," offer no guarantee of achieving either a target wealth at retirement or a target retirement income. So, SeLFIES can greatly improve retirement funding security by completing the market. SeLFIES need to be created.

This leads to another clarification: SeLFIES can be issued by entities other than the federal government. For example, many states are launching so-called Secure Choice retirement plans for private-sector workers who don't have access to such plans through their employer — these states and municipalities could easily issue SeLFIES as part of their debt refunding or expansion, and we have discussed this with one state. SeLFIES offer synergistic cash flows to fund infrastructure — a challenge for most states — thereby allowing state and local governments to address two challenges with one innovation. The federal and state tax exemption would make their issuance for retirement funding in personal taxable accounts. We envision other (lower credit) issuers of SeLFIES, but the benefit of government issuance of SeLFIES is that credit risk is mitigated. With our aging population and "50 States of Gray," maybe this innovation emanates from one of these forward-thinking states, as opposed to "Waiting for DC." SeLFIES are designed to work in any country with a bond market.

The time to act is now — the longer the delay, the higher the cost of ensuring retirement security for future generations. SeLFIES are the new and improved "a-new-ity."

Robert C. Merton is distinguished professor of finance at MIT Sloan School of Management and resident scientist at Dimensional Fund Advisors. Arun Muralidhar is co-founder of Mcube Investment Technologies LLC and AlphaEngine Global Investment Solutions LLC.

Inline Play

Source URL: https://www.pionline.com/article/20190527/PRINT/190529910/taking-a-closer-look-at-selfies-added-thoughts-clarifications
journey from government debt silo attached to a giant pension scheme to fully-fledged investment powerhouse has involved one of the most fundamental decisions in pension investment management - whether to build internal investment capability or to buy it in.

This remains a key question for pension organisations, large and small, to this day, including Norway's GPPF. The Norwegian fund has increased its internal investment capabilities over recent years, with external managers now running about 6%. It remains overwhelmingly exposed to equity market risk, with an overall equity allocation of 82.5%.

By the time of an early IPE interview in 1998, ABP was, like hundreds of other pension funds, on the cusp of large-scale asset diversification. The launch of the Eurostar single currency the following year, AP3 then held about 20% in equities, up from 8% before privatisation, Jean-Pierre Célie, AP3's CEO, told IPE's founding editor, Perelle Petton, that the approach would be to manage Groupecon and US equities in house, for instance, with Asia-Pacific and emerging markets strategies outsourced to specialists. Recent as a pension delivery organisation in 2009 under the APG name, it now acts as a standalone fiduciary management and pension servicing company with the ABP - as its largest stakeholder.

As a sizeable institutional investor with an international profile, APG now competes with sovereign wealth funds and international pension funds across the board for talent and scarce yield-focused investment opportunities in areas like private markets. More recently it has increased internal management to around 70% of asset (as reported by APG in 2015).

Adaptable model
Goldman Sachs' 1996 acquisition of CIN Management, which ran the two British Coal pension schemes, meant it took on the right to run 80% of the schemes' assets for six years. (Cinven, another arm of the former British Coal, has become an external private equity house, while CIN Property Management was sold to LaSalle, also in 1996.)

Yet when the contracts expired the schemes adopted a more orthodox outsourcing route, informed by the core-asset approach, as advised by Watson Wyatt, Coal Pension Trustees' then CEO David Morgan told IPE in 2004. This was combined with active governance through an investment risk committee and some delegation to the management arm, but only in areas like stock lending, commission recapture, transaction costs and corporate governance. Barclays Global Investors (since merged with BlackRock) ran a small part of the assets in passive equity and bond mandates following the reshuffle while Gohlsman Sachs retained a low-risk bond mandate.

Since then the schemes have edged back towards their old model, having increased international resources with the creation of a new entity called Coal Pension Trustees Investment Services, which was authorised by the Financial Services Authority in 2011 to provide investment advice and management services to the coal schemes. New staff were subsequently hired to boost investment resources in areas like asset allocation and portfolio construction, but with investment management still outsourced to outside managers. Would the coal schemes have been better off following a different trajectory, building up in-house resources from the start? Perhaps, but they would have been swimming against the tide given the widespread faith in fully-outsourced pension investment models in the late 1990s and 2000s.

What's new?
Tony Dye's call on the PTSE, the seeding of Nor- way's Petroleum Fund, AP3's privatisation and Goldman Sachs purchase of CIN Management all took place within the same 12 months and all reflect different models of pension and investment management. The trails of Dye's FDP model are now being used, in the guise of the demise of a different model. The other three entities have had to make mission critical decisions about outsourcing since the year in question.

In common with other pension funds that outsourced much or all of their investment function in the 1990s or 2000s, including some of the early proponents of fiduciary management in the Netherlands, entities like the UK coal schemes have since sought a balanced position between the extremes of full outsourcing and extensive in-house management.

Building up internal resources, particularly in on-vogue areas like private markets is a slow and expensive game - Canada Pension Plan awarded its former CEO Mark Wiseman direct compensation of C$4.5m (€2.7m) in the fiscal year 2016, only to see him depart for BlackRock. Private markets and infrastructure portfolios take years to build and can result in heavily concentrated direct portfolios.

Dye's value management approach ironically embodies many of the characteristics of patient capitalism that are fashionable these days, even if those equity styles can underperform for years, as they have done recently. Many investment organisations and their professionals still shun Dye's dilemma - that taking a long-term view and outperforming over longer time horizons can be useless if your stakeholders or clients do not share that long-term view.

Just as with many others in real-life business situations, institutional investment professionals and pension trustees are still prone to focus on the short-term at inopportune points, while a seemingly opportune long-term strategy can easily prove itself to have been inopportune over time.

Liam Kennedy is editor of Investment & Pensions Europe.
In the current environment, a new financial instrument is needed to enable financial security for retirees.
SeLFIES Can Improve the Nation’s Retirement Security

Robert C. Merton, Ph.D., and Arun S. Muralidhar, Ph.D., discuss how Standard of Living indexed, Forward-starting, Income-only Securities can address the call for in-plan retirement income solutions.

By Robert C. Merton, Ph.D., Nobel Prize winner in Economics, and Arun S. Muralidhar, Ph.D.

Last month, the Government Accountability Office (GAO) issued a stunning report, “The Nation’s Retirement System: A Comprehensive Re-evaluation Is Needed to Better Promote Future Retirement Security” (GAO-18-11SP), on the U.S.’ retirement preparedness. In the report, it notes, “The U.S. retirement system, and the workers and retirees it was designed to help, face major challenges. … individuals are increasingly responsible for planning and managing their own retirement savings accounts … [M]any households are ill-equipped for this task and have little or no retirement savings.” The report ends with a very strong recommendation, or plea, that, “Congress should consider establishing an independent commission to comprehensively examine the U.S. retirement system and … improve how the nation promotes retirement security.”

Coincidentally, the U.S. Treasury also issued a report, “A Financial System That Creates Economic Opportunities,” that makes the case for in-pension plan retirement income options and the importance of funding infrastructure. The U.S. government can have an immediate impact on the retirement challenge, create a liquid in-plan retirement income option, and raise funding for infrastructure by issuing a new type of long-term bond, one we call SeLFIES—Standard of Living indexed, Forward-starting, Income-only Securities. SeLFIES address many of the challenges raised in the GAO and U.S. Treasury reports and are also advantageous to the U.S. Treasury.

Individuals seek a guaranteed, real income, ideally from retirement through death, and to lead a lifestyle comparable to pre-retirement. At the same time, the Treasury seeks to ensure that individuals can make independent, informed financial decisions and accumulate a retirement nest egg. The GAO notes three main challenges to achieving this goal: access to retirement plans; insufficient savings; and the complexity of investing and decumulating. Typically, low-income or part-time employees work for firms that neglect to offer retirement plans—and even if they do, many of these employees cannot participate for a host of reasons. A number of states, Oregon being the first, are stepping into the breach to create plans that offer access to uncovered private-sector workers.
Inadequate savings disproportionately affects women and some minorities and is caused by insufficient real wage growth, high debt levels and increased longevity. Further, the complexity of retirement planning leaves many confused about what constitutes adequate savings. They are overwhelmed by the information provided and the absence of a robust and uniform method to calculate income replacement rates. The attempts by Richard Thaler, Ph.D., winner of this year’s Nobel Memorial Prize in Economic Sciences, to nudge individuals into pension plans and increase savings over time, via automatic enrollment and automatic escalation, help; however, they fail to address the “how much is adequate” question.

Finally, there is uncertainty over what to invest in and how best to decumulate. Most adults can barely answer questions about compound interest, the effects of inflation or the benefit of diversification. The Department of Labor (DOL) provided safe harbor guidance about appropriate investments, but investing in existing assets is risky relative to the retirement objective, because these assets fail to provide a simple or low-cost cash-flow hedge against desired retirement income. Even a portfolio of traditional, “safe” government securities, unless heavily financially engineered—at some cost—would be risky because of the cash flow, and potential maturity, mismatch between traditional bonds and the desired retirement income stream.

The Treasury report notes, “Because annuities are the only financial services product that can provide a guaranteed lifetime income stream ... [they] are an important contributor to the Core Principle of empowering Americans to save for retirement.” However, many hesitate to buy annuities because they can be complex, opaque and illiquid; investors fear not being able to bequeath the annuities to heirs.

SeLFIES address many of these issues. Governments could issue a new, low-cost, liquid and safe ultra-long bond instrument. SeLFIES start paying investors upon retirement and pay real coupons only—say, $5—indexed to aggregate per capita consumption—for a period equal to the average life expectancy at retirement, e.g., another 20 years. Instead of current bonds that index solely to inflation, SeLFIES cover both the risk of inflation and standard-of-living improvements.

SeLFIES are designed to pay people when they need it and how they need it, and greatly simplify retirement investing. A 55-year-old today would buy the 2027 bond, which would start paying coupons when he turns 65, in 2027, and keep paying for 20 years, through 2047.

In this way, even the most financially illiterate individual can be self-reliant with respect to retirement planning. For example, if investors want to guarantee $50,000 annually, risk-free for 20 years in retirement to maintain their current standard of living, they would need to buy 10,000 SeLFIES—i.e., $50,000 divided by $5—over their working life. The complex decisions of how much to save, how to invest, and how to draw down are simply folded into an easy calculation of how many bonds to buy.

Besides being simple, liquid, easily traded at very low cost and with low credit risk, SeLFIES can be bequeathed to heirs. SeLFIES do not address all issues, including longevity, but go a long way toward improving retirement security.
These securities are a good deal for governments, too. In fact, governments are the biggest beneficiaries. SeLFIES not only improve retirement outcomes for all defined contribution (DC) plans, but also have spill-over benefits for the current administration and future ones. First, cash flows from SeLFIES reflect synergistic cash flows for infrastructure spending: namely, large cash flows upfront for capital expenditure, followed by delayed, inflation-indexed revenues, once projects are online. Financing infrastructure has been a challenge and a priority for the current administration. Second, SeLFIES give governments a natural hedge of revenues against the bonds, through value-added taxes (VATs).

The looming retirement crisis needs to be addressed by timely innovation, because the longer that governments wait, the higher the cost to the taxpayer. SeLFIES improve retirement security, fund infrastructure and can be created immediately, at low cost, without waiting for an independent commission or changing regulations!

Robert C. Merton, Ph.D., recipient of the 1997 Alfred Nobel Memorial Prize in Economic Sciences, is the School of Management Distinguished Professor of Finance at the MIT Sloan School of Management. He is also Resident Scientist at Dimensional Fund Advisors, a global asset management firm headquartered in Texas, and University Professor Emeritus at Harvard University.

Arun Muralidhar, Ph.D., is adjunct professor of finance at George Washington University. Academic Scholar Advisor at the Center for Retirement Initiatives at Georgetown University, as well as founder of Mcube Investment Technologies and AlphaEngine Global Investment Solutions. He has served as a consultant to Overture Financial (consultant to California’s Secure Choice Board) and has authored a new manuscript, “Fifty States of Grey: An Innovative Solution to the DC Retirement Crisis.” These are the personal views of the authors and do not reflect the views of any of the organizations or universities with which they are associated.

https://www.plansponsor.com/selfies-can-improve-nations-retirement-security/
SeLFIES For India

These long-term bonds can fund India's infrastructure needs and improve retirement security

Robert J Morin and Anne S Iralhalante

The Indian government mounted its Budget and recognition that the infrastructure needs investments. The government is committed to enhancing India's infrastructure. It is proposing to sell a new type of bond called SeLFIES (SeLFESS). These bonds aim to provide funds for infrastructure projects and also offer a retirement option for individuals. SeLFIES are designed to be an attractive option for retirement planning.

The complexity of retirement planning means many confused about what constitutes adequate savings for retirement. Individuals are overwhelmed by the information provided and the absence of a robust and uniform method to make these calculations. Moreover, there is uncertainty over what to invest in and how best to accumulate. Most adults can hardly answer questions such as how much will their retirement needs be covered by their investments?

SeLFIES address many of the challenges raised in the Budget. They are also an innovation in the finance ministry, especially in light of the recent implementation of a Goods and Services Tax (GST).

While life with dignity would ideally include government, social security, and access to health care, a retirement must be about a true lifestyle comparable to pre-retirement. The Indian government would likely ensure that individuals can maintain adequate financial security, and accumulate a retirement nest egg without being dependent on the government for support.

Typically, most workers lose income, or part-time employees are unable to save for retirement because of the absence of a regular retirement scheme, and even those who participate in retirement plans are often not sure about the decisions they have to make about accumulation and decumulation because their options are limited.

SeLFIES are designed to pay people when they need it and how they need it. Even the most financially illiterate individual can be self-reliant with respect to retirement planning.

In summary, markets are not sufficiently deep or developed. More importantly, the government's role in promoting savings should not be overlooked. SeLFIES offer a more robust way to promote cross-sectional risk and provide a simple, low-cost, and safe framework for retirement planning.

SeLFIES add value to many of these benefits. The Indian government could issue a new, low-cost, liquid, and safe ultra-long-term bond instrument. SeLFIES allow participants to invest in a portfolio of government bonds and the desired retirement income stream.

Other countries struggle with similar issues. Annuities are typically the only financial product that can provide a guaranteed lifetime income stream, but they are not sufficiently deep or developed.

Congress will come back to power in Rajasthan

"I have rarely seen so much anger against a government... Congress will come back to power in Rajasthan"

The Congress party's success in Rajasthan's recent by-elections is seen as a major setback for the Bharatiya Janata Party (BJP) government. The by-elections were seen as a test of the BJP's popularity in the state, and the Congress party's victory is seen as a significant blow to the government's chances in the upcoming Assembly elections.

The BJP government weakened schemes of the previous government which provided pensions, food, and medicines to the elderly. Instead, they focused on retaining the Rao-Gandhi era benefits or Atal Bihari Vajpayee's schemes. These schemes were seen as a way to get the support of the elderly population.

In conclusion, the Congress party's victory in the by-elections is a significant blow to the BJP government's chances in the upcoming Assembly elections. The Congress party is likely to continue its campaign against the government in the upcoming Assembly elections.
SeLFIES for India: These long-term bonds can fund India’s infrastructure needs and improve retirement security

February 5, 2018, 2:00 AM IST

By Robert C Merton and Arun S Muralidhar

The Indian government unveiled its Budget and recognised that the infrastructure sector needs investments of Rs 50 lakh crore to boost GDP (allocating Rs 5.9 lakh crore as a primary step). Simultaneously, certain provisions in the Budget seek to improve the lives of retirees, and Finance Minister Arun Jaitley specifically noted that, “A life with dignity is a right of every individual, in general, more so for the senior citizens.”

One of the major challenges that India will face is ensuring the income security of its senior citizens, especially in a country where financial literacy is relatively low. The government can easily fund infrastructure, especially since it has given permission to the National Highways Authority of India (NHAI) and other institutions to issue bonds, and have an immediate impact on the retirement challenge by issuing a new type of long-term bond, one we call SeLFIES - Standard of Living indexed, Forward-starting, Income-only Securities.

SeLFIES address many of the challenges raised in the Budget and are also advantageous to the ministry of finance, especially in light of the recent implementation of a Goods and Services Tax (GST).
"A life with dignity" would ideally include guaranteed, real income, from retirement through death, and the ability to lead a lifestyle comparable to pre-retirement. The Indian government would probably like to ensure that individuals can make intelligent financial decisions, and accumulate a retirement nest egg without being dependent on the government for support.

Typically, rural workers, low-income, or part-time employees are unable to save for retirement because of the absence of simple retirement schemes, and even those who participate in retirement plans are often not sure about the decisions they have to make about accumulation and decumulation because they are largely financial illiterate.

The complexity of retirement planning leaves many confused about what constitutes adequate savings for retirement. Individuals are overwhelmed by the information provided and the absence of a robust and uniform method to make these calculations. Moreover, there is uncertainty over what to invest in and how best to decumulate. Most adults can barely answer questions about compound interest, the effects of inflation or the benefit of diversification. Investing in existing assets is risky relative to the retirement objective, because these assets fail to provide a simple or low-cost cash-flow hedge against desired retirement income.

Even a portfolio of traditional, "safe" government securities, unless heavily financially engineered – at some cost – would be risky because of the cash flow, and potential maturity, mismatch between traditional bonds and the desired retirement income stream.
Other countries struggle with similar issues. Annuities are typically the only financial services product that can provide a guaranteed lifetime income stream, but annuity markets are not sufficiently deep or developed. More importantly, many hesitate to buy annuities because they can be complex, opaque and illiquid; investors fear not being able to bequeath the annuities to heirs.

Selfies address many of these issues. The Indian government could issue a new, low-cost, liquid and safe ultra-long bond instrument. Selfies start paying investors upon retirement and pay real coupons only – say, Rs 100 – indexed to aggregate per capita consumption – for a period equal to the average life expectancy at retirement, eg, another 20 years. Instead of current bonds in global markets that are either nominal or indexed solely to inflation, Selfies cover both the risk of inflation and standard-of-living improvements.

Selfies are designed to pay people when they need it and how they need it, and greatly simplify retirement investing. A 55-year-old today would buy the 2028 bond, which would start paying coupons when he turns 65, in 2028, and keep paying for 20 years, through 2048.

In this way, even the most financially illiterate individual can be self-reliant with respect to retirement planning. For example, if someone wants to guarantee Rs 50,000 annually, risk-free for 20 years in retirement to maintain their current standard of living, they would need to buy 500 Selfies – i.e., Rs 50,000 divided by Rs 100 – over their working life.

The complex decisions of how much to save, how to invest, and how to draw down are simply folded into an easy calculation of how many bonds to buy. Selfies do not address all issues, including longevity risk, but go a long way toward improving retirement security.

These securities are a good deal for governments, too. In fact, governments are the biggest beneficiaries. Selfies not only improve retirement outcomes for all citizens saving for retirement, but also have spill-over benefits.

First, cash flows from Selfies reflect synergistic cash flows for infrastructure spending: namely, large cash flows upfront for capital expenditure, followed by delayed, inflation-indexed revenues, once projects are online. Financing infrastructure has been a challenge and a priority for the current government, especially given the current Budget. Second, Selfies gives the Indian government a natural hedge of revenues against the bonds, through GST.

The looming retirement crisis needs to be addressed by timely innovation, because the longer that governments wait, the higher the cost to the taxpayer. Coincidentally, India has identified the critical importance of investing in infrastructure to improve GDP growth, but may face challenges funding these needs. Selfies fund infrastructure, improve retirement security, and can be created immediately, at low cost.

Robert Merton is a Nobel Laureate in Economics. Arun Muridhir is Adjunct Professor of Finance at George Washington University