The risks of generational change

Most industrial countries are in the midst of a transition away from socially mandated to individually managed retirement planning. David Rowe argues that this holds potentially huge strategic risks for buy-side firms that fail to meet the highest standards of fiduciary care while offering real opportunities to the most innovative among them

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In the 1920s, Nikolai Kondratieff documented what he called The Long Wave in economic activity, a cycle lasting 50–60 years. One somewhat flippant explanation for such a cycle is that every generation must relearn what its grandparents knew and its parents forgot. We may be experiencing just such a process of generational memory loss and relearning in the area of personal financial planning.

Most of the grandparents, and certainly the great-grandparents, of baby boomers like me came of age in a pre-social security world. Family support and personal financial resources were the cornerstones of old age financial security. Our parents' professional lives were concurrent with the rise of publicly funded old-age plans such as social security and defined-benefit pensions in the private sector. These constituted a form of forced savings with little or no individual responsibility for associated asset management decisions.[1]

In the past 10 to 15 years, we have seen a significant shift from defined-benefit to defined-contribution pensions in the private sector. Also, while social security and similar arrangements remain political sacred cows, there is growing cynicism about their long-term ability to meet people's growing expectations for sustaining their standard of living into retirement. Carol Sergeant, formerly of the UK Financial Services Authority and now chief risk officer of Lloyds TSB, has noted: "The consumer... is having to take responsibility for deciding how much to save, when to save and what savings instruments to use – in many cases for the first time in at least two generations."[2]

None of this will come as a major revelation to most financial professionals. But what is surprising is the general public's degree of ignorance surrounding basic investment principles. Sergeant cites a survey done for Invesco that "found that half of investors surveyed (and over two thirds of the public at large) do not understand the difference between equities and bonds". The FSA's own research indicates that one quarter of pension and endowment policyholders did not realise that their money was invested in the stock market.

In brief, there is a veritable chasm between the investment knowledge of financial professionals and that of the public at large. This should be a sobering realisation for money management professionals. Rapidly increasing individual responsibility for management of retirement investments coinciding with striking financial ignorance on the part of the general public is an explosive combination.

Lawsuits beckon

The next major stock market correction is likely to occur when some baby boomers have retired and others are nearing that point. This means they will either be relying on their investments for current income or have little time to recover from major losses before doing so. I fear this will provide a field day for trial lawyers mounting class action lawsuits. We have seen some of this in the recent bear market, but it could be much worse next time. It is essential for management of this serious potential risk that buy-side firms make control of selling practices and proper fiduciary care a core strategic competence. This means more than filling out forms and ticking boxes. It means a visible senior management commitment to this goal and implementation of appropriate internal procedures, incentives and sanctions to assure compliance.

This need not, however, be a purely defensive effort. Firms can gain competitive advantage from offering readily accessible training and risk self-assessment tools that encompass the basic principles of life-cycle investing. Another area for innovation is the creation of investment vehicles that directly reflect specifics of age and risk appetite. One recent example of this is the development of specific retirement year funds such as a 'Retirement 2010 Fund' and 'Retirement 2015 Fund'. The idea is that in the last 10 years prior to retirement an individual's investments should be progressively allocated more heavily towards fixed-income instruments. Investment funds such as those above would make this reallocation automatically as the designated retirement year approaches, relieving each individual from the need to make such periodic reallocations.

Such innovations could well be extended to creating funds appropriate to investors in specific age brackets with low-, medium- or high-risk tolerance and well-defined dates for requiring their funds. Thus a series of college education funds could be constructed on the basis of a specified high school graduation date and the assumption of a four-year withdrawal period. Having chosen the appropriate fund, a parent could expect it to adjust its holdings over time from growth-orientated stocks in the beginning to less volatile stocks halfway through the period, and to a significant portion of fixed-income investments as their child's graduation date approached.

Summary

Well-documented gaps in public understanding of finance combined with rapidly increasing individual responsibility for retirement planning is both a serious threat and a potential opportunity for buy-side firms. Hopefully, they will protect against the threat and capitalise on the opportunity. If not, the industry could face serious consequences in the next major bear market. ■

[1] Of course, social security schemes are not, and never were, savings plans for society as a whole. Rather, they are inter-generational transfers from the young to the old. But my point is that individuals tend to view their old-age pension contributions, and the associated expectation of benefits in retirement, as a form of savings for them as individuals

[2] Sergeant C, A strategic approach to treating customers fairly, a speech to the Retail Financial Services Forum, October 15, 2003. See www.fsa.gov.uk/pubs/speeches/sp156.html