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Insured Retirement Institute

IRI and Cerulli Associates

2011 Portfolio Construction Dynamics

Key Findings

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For more information on *The Cerulli Report—Advisor Portfolio Construction Dynamics 2011* or *Cerulli Quantitative Update: Annuities and Insurance 2011* please contact:

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The following are key findings from The Cerulli Report: Advisor Portfolio Construction Dynamics. These findings were created exclusively for the Insured Retirement Institute (IRI). Your insight and time are greatly appreciated and we look forward to your continuing support.

Chapter 1: Firm Support: From Due Diligence to Discretion

- A majority of advisors cite using their firms' suggested model portfolios as an element of their portfolio construction process. Rather than simply implementing the home offices' recommendation, advisors use input from their home office as a leading information source across several content areas, from asset allocation to security selection.
- **An investment's placement on a platform's recommended list does not guarantee flows, but professional buyer endorsement increases advisor receptiveness to wholesaler contact and generally increases unsolicited flows.** These types of flows drive asset managers to compete aggressively forplacement on a B/D's recommended offering.
- In a recent survey, advisors named percentage drawdowns as their primary retirement income methodology. Deriving an income floor, then building up for other goals ranked second. **Broker/dealers can help to educate, either through their own materials or via distribution of insurance company training pieces, how dedicating a portion of a client's systematic withdrawal or income floor to a guaranteed income stream increases their chances of success.**
- The variable annuity industry **must reestablish the positioning of the variable annuity as a retirement income solution.** While much of recent product development has focused on income guarantees, the positioning of the product has centered on comparing competitive products rather than how to solve client needs. **Second, the industry must find a way to broaden its producer base.** The industry's more sophisticated (and more productive) advisors have moved away from annuities. These advisors have largely shifted their practices to ones that are more solutions-based and consultative in nature. **Changing these two factors are, in fact, intertwined if the variable annuity industry wishes to reinvent itself.**

Chapter 2: The Retail Advisor Landscape

- **The overall number of advisors has remained relatively stable, but their allotment among distribution channels has changed a bit as independent channels (IBD, RIA, and dually registered) have grown at the expense of the historically employee-focused channels.** Cerulli expects independent channels to gain market share annually over coming years as experienced advisors continue migrate towards independence.
- **As of 2003, only 46% of advisors reported receiving a majority of their revenue from advisory fees. By 2010, just over 66% of advisors reported a majority of their revenue in the form of advisory fees.** Moves to fee-based advisory accounts generally serve to streamline an advisor's practice as technology solutions have simplified ongoing fee-account management.

- As the need for retirement income continues, advisors are using a variety of products to achieve their clients income needs. **The RIA channel represents a significant drop in advisor use of variable annuities, largely due to the fee-based revenue structure these advisors have.**
- VAs remain a transactional product, largely priced on a commission basis. The positioning of this product will have to significantly evolve if insurance companies wish to have success selling into RIAs. Even asset managers that have had success in the RIA channel report that traditional wholesaling techniques are ineffective with RIAs. Success with RIAs requires a softer, more consultative sale and strong sales personalities can be a turnoff for these advisors. **Successful discussions with RIAs often revolve around using various products to create a better client solution or outcome.**

Chapter 3: Managed Account Programs and Platforms

- **Advisors anticipate significant increases in their discretionary business over the next several years.** Discretionary portfolios ultimately allow advisors to focus their efforts on value-added services, creating greater client satisfaction rather than tracking down clients to obtain approval for trades.
- From the broker/dealers' perspective, this flexibility makes open programs an ongoing challenge with regard to compliance oversight. However, open programs are critical to recruitment and retention of top-producing advisor teams that believe their internal processes create beneficial outcomes for clients.
- While wirehouse share of managed account assets has decreased, this is in fact, a positive for the managed accounts industry. Wirehouse managed account assets have actually risen over the decade, but less-established channels have grown faster. Fee-based pricing is expanding to other channels as advisors recognize the advantages of this business model. As noted above, **independent broker/dealers (which include insurance broker/dealers) have doubled their share of the managed account industry. Independent and insurance broker/dealers are the strongest sales channels for variable annuities, meaning variable annuity manufacturers must take the growth of fee-based pricing seriously.**

Chapter 4: Client Risk Tolerance

- **While industry standard risk questionnaires result in a suggested level of appropriate risk, seldom does the discussion veer off into what that actually means and how it will affect client portfolios on a year-to-year basis**. In the wake of the markets of 2008-2009, many B/Ds considered their client risk profiling process, but very few actually made a change, based on a combination of several factors: potential costs of implementation, advisor resistance to any change, and the perceived potential for increased advisor liability were the most frequently cited.
- **A more nuanced approach to identifying an investor's actual capacity and appetite for risk would require taking an approach that more fully encompasses financial planning or behavioral finance**. While advisors often discuss an investor's goals, few are willing to delve into the difference between wants and needs, as these are difficult conversations that consume time and effort without short-term rewards.
- As a generational shift is in the air, advisors anticipate changes to their practice as a result of the increased need to aid clients in generating retirement income. **The challenge of generating income throughout retirement can be overwhelming and difficult. As a result of this intricacy, advisors expect an increase in the number of clients and revenue as well as the need to use a broader range of investment vehicles to meet retirement income goals.** With the different phases of retirement and needs associated with them arises an opportunity for other products, such as annuities to be used as part of a retirement income plan.
- Investors who have less net worth are concerned with generating enough income for retirement and not outliving their money. **As client**

net worth increases, retirement income plays less of a role for advisors as client needs are more centered on protecting wealth and deferring taxes. Education for advisors on the varying roles annuities can play in client portfolios is essential to a greater understanding and use of the product.

Chapter 5: Asset Allocation Strategies

- **Advisors cite the highest level of confidence in their own research when making asset allocation decisions**. While each individual bias differs, advisors' decisions generally replicate a consensus of qualitative and quantitative input data from sources including home office, third-party technology platforms, asset managers, and media outlets.
- Insurance companies have deemphasized investment options in recent years, focusing more on their ability to hedge the investments, rather than identifying creative solutions. This inherent conservatism has driven a gap between annuity investments and how the industry's more sophisticated advisors are investing. Although the importance of investments is likely slightly overstated here, **CA does believe room exists for insurance companies to revisit how advisors can invest in variable annuities, and more closely align it with how they operate their practices.**
- Despite being the feature that defines annuities, annuitization has not see widespread adoption from advisors as they fear the lack of control and low returns associated with this method. While much of variable annuities' retirement income value proposition revolved around guaranteed withdrawal benefits, annuitization bears revisiting as it may be able to generate more income for clients than a GMWB or GLWB. **Insurers should consider revisiting the benefits and advantages of annuitization. This tactic may be appealing, in particular for clients who find themselves underprepared for retirement.**

Chapter 6: Portfolio Risk Assessment and Management

- **Portfolio construction methods are often misconstrued as self-standing; advisors typically utilize a number of techniques in concert to create client portfolios**. Advisors widely felt modern portfolio theory alone did not adequately manage risk as a standalone solution. Although advisors have not jettisoned modern portfolio theory and the values of diversification, they have responded by taking a more active stance towards short-term market movements to protect client assets from downturns and capitalize on upswings.
- Insurance companies have shied away from alternative investments in their products for risk control reasons—essentially, the flexible and creative strategies of alternatives make them extremely difficult for insurance companies to hedge. The counterargument for alter**natives is that they are non-correlated investments and, thus, can be used to reduce risk in client portfolios. While insurance company risk management is of utmost importance, insurance companies do need to think more creatively about the investments they offer on their platforms.**
- **The two phases of variable annuities are accumulation and payout. Advisors looking to choose a variable annuity provider want to ensure that both of these phases are reached to their full advantage. During the accumulation phase, advisors are looking to gain significant return for their clients.** In order to achieve this goal, advisors will look for a variety of investment options with strong performance. The payout phase of an annuity contract requires the provider to have the ability to provide the amount guaranteed to their clients. Advisors, therefore, also look for a company that is stable financially and has the ability to cover the risk they assumed.

Chapter 7: Product Selection

- Despite the ongoing proliferation of new products and providers, over the last several years Cerulli has documented an ongoing trend of advisors using fewer asset managers.
- **Advisors are continuing to move to more widespread use of managed products, mutual funds, and ETFs rather than individual**

securities. Advisors are generally more comfortable positioning themselves as a manager of managers rather than a stock-picker.

- The GLWB has become the guarantee of choice for the annuity industry. While one can see the appeal of this product, it locks the annuity industry's positioning in as a retirement income provider. With only one type of benefit being offered, insurance company conversations with advisors will continue to revolve around the differences in competitive benefits. **Although an industry shift to a single guarantee of choice serves to simplify the product, it also continues to force the annuity industry into niche positioning.**
- There has been a great deal of industry froth around the theme of retirement income. Manufacturers of all types have rushed to develop products to solve this client need. However, for many advisors, they do not look to solve for a client's income need with a single product, but rather see income planning as a process, with the products as secondary. **Narrow guarantee choices in an annuity makes positioning that much more challenging, thus having an array of benefits would make it easier to fit the annuity product into a variety of advisor methodologies.**