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Black-White differences in saving behaviors (pp. 1–16)

Patti J. Fisher, Ph.D.

This study uses the 2007 Survey of Consumer Finances to empirically explore Black-White differences in saving behavior. The impact of the explanatory variables in the model is allowed to differ between Black and White households to understand Black-White differences in saving. The results indicate that Black-White differences in saving are explained by racial differences in the individual determinants of saving, not by race in and of itself. The individual variables that significantly differ for Black and White households in their effect on saving are receiving government assistance, feeling that credit use is bad, being turned down for credit in the past 5 years, and having a saving horizon of the next few years.

Credit card debt and payment use (pp. 17–35)

Charles Sprenger, Joanna Stavins

Approximately half of credit card holders in the United States regularly carry unpaid credit card debt. These so-called "revolvers" exhibit payment behavior that differs from the behavior of those who repay their entire credit card balance every month. So far, there has been no empirical analysis exploring the relationship between revolving behavior and patterns of payment use, such as substitution away from credit cards to other payment methods. Using data from the 2005 Study of Consumer Payment Preferences, we find that credit card revolvers are significantly more likely to use debit and less likely to use credit than convenience users, that is, those who repay their balances each month. There is no difference between the two groups in their use of check or cash. Revolvers are also more likely to see debit as superior with respect to control over money and budgeting. The findings show that revolvers not only adopt, but also use, debit more frequently, as a means to control their spending and improve their financial planning. The results suggest that consumers learn from their past financial behavior and change their payment habits after experiencing financial consequences.

Social security and retirement savings accounts (pp. 37–57)

Francis E. Laatsch, Daniel P. Klein

The turmoil in financial markets has brought increased attention to the use of defined contribution and 401(k) plans. Many believe that the benefits of 401(k)s are disproportionately available to the wealthy and that 401(k)s do little to help lower income workers prepare for retirement. This paper offers a proposal tying such accounts into Social Security reform. Our proposal generates increased retirement security for workers without imposing new taxes, has little or no transition costs, does not reduce revenues currently flowing to the U.S. Treasury, but does generate nontrivial reductions in Social Security costs.

Lifecycle funds and wealth accumulation for retirement: Evidence for a more conservative asset allocation as retirement approaches (pp. 59–74)

Wade D. Pfau

A line of recent studies cast doubt on the efficacy of the lifecycle investment strategy, which calls for switching into a more conservative investment portfolio as retirement approaches, as a suitable way to provide for the retirement needs of workers with defined-contribution pensions. After comparing simulation outcomes for lifecycle and fixed asset allocation strategies, we determine that the lifecycle strategy can be justified even in a framework including only financial wealth. We find that investors with very reasonable amounts of risk aversion may prefer the lifecycle approach, despite the tendency for aggressive fixed allocation strategies to produce larger expected wealth.

Modeling withdrawals from a taxable account (pp. 75–93)

Andrei Shynkevich

This paper demonstrates how to correctly model withdrawals from a taxable account. The presented framework is largely generalized as it accommodates for varying rates of return, changing tax rates, different time periods, flexible withdrawal amounts, inflation, cost basis, and level of capital gains annual distribution. Closed-form solutions for special cases of constant rate of return, constant annual after-tax withdrawal, constant tax rates and constant share of distributed capital gains as well as the inflation-adjusted after-tax withdrawal are derived and supplemented by illustrative examples. The results have broad applications for the research in financial planning whenever modeling of the withdrawal phase has to be incorporated into the analysis.

Volume 19 Number 2, 2010

A Monte Carlo study of the strategies for 401(k) plans: Dollar-cost-averaging, value-averaging, and proportional rebalancing (pp. 95–109)

Haiwei Chen, PhD, Jim Estes, PhD, CFP, MBA, ChFC, CPCU, CLU

This study conducts Monte Carlo simulations to compare the performances of three popular asset allocation strategies in the financial press, that is, dollar-cost-averaging, value averaging, and proportional rebalancing, in the 401(k) plan framework. Value-averaging generates a higher terminal value for a retirement portfolio than the other two strategies. Total risk of the portfolio is lower under value averaging than under dollar cost averaging. Value averaging provides the highest reward-to-risk ratio as well as the highest likelihood of meeting the investment goal.

Based on the overall consideration of terminal value, total risk, modified Sharpe ratio, modified Sortino ratio, and dominance frequency, a targeted annual growth rate of between 9% and 11% for the equity account should be used as the target growth rate in conducting value averaging.

Quantifying the economic benefits of personal financial planning (pp. 111–127)

Sherman D. Hanna, Suzanne Lindamood

To estimate the monetary value of ideal financial planning advice, we address three types of benefits that planners provide: increasing wealth, preventing loss, and smoothing consumption. We discuss, then reject the possibility of using survey data to obtain valid estimates of the benefit of financial planning advice. We instead use theoretical examples based on comparisons of optimal decisions to naïve alternatives. We find that the value of advice varies with a client's risk aversion and the percentage of wealth that could be gained or lost. In general, the most risk averse households should place the highest value on comprehensive financial planning advice. Financial planners can use our results to better articulate the value of advice.

Willingness to pay: understanding 403(b) fees (pp. 129–144)

Brian Starr

While the private pension system relies heavily on the 401(k) construct, the public and nonprofit sectors' 403(b) plan market is of considerable magnitude but has attracted less academic research. This essay seeks to explore the theoretical underpinnings of demand for 403(b) services, estimate an average willingness to pay for these services and compare that estimation with empirically observed data. It concludes by determining that some 403(b) service providers have historically captured the bulk of the consumer surplus afforded to individual consumers in this market.

Do enhanced index funds live up to their name? (pp. 145–162)

C. Edward Chang, Ph.D., Thomas Krueger, DBA

Uninformed investors would expect enhanced index funds (EIFs) to live up to their name and enhance portfolio performance. This updated and thorough comparison of EIFs and pure index funds finds that EIFs, as a whole and in domestic stock fund categories, appear to have performed *worse* than their pure index funds counterpart with lower returns, higher risks and lower risk-adjusted returns. EIFs behaved more like actively managed funds, with higher expense ratios and turnover rates. Investors should be wary of sales pitches hyping the value of EIFs!

Expanding a U.S. portfolio internationally: ADRs, their underlying assets, and ETFs (pp. 163–185)

Axel Grossmann, Steven L. Beach

We investigate if constructed portfolios of ADRs from six countries provide a useful vehicle for international diversification in the Markowitz sense for U.S. investors and if those diversification gains differ from the results obtained from matched portfolios of the underlying assets (UAs). We analyze 280 ADRs and their matched UAs, and consider ETFs as benchmarks. We find that investors in U.S. equities benefit from allocation towards U.S. bonds and ADRs or their UAs. The best diversification benefits are obtained by directly investing in the constructed UA portfolios rather than the constructed ADR portfolios or ETFs. The results are consistent across levels of risk-aversion and do not change when considering several rebalancing strategies, sub periods, or more realistic fixed asset allocations or market capitalization weights. A discussion with respect to possible implications of transaction costs is provided. The return-to-risk benefits of the UAs over ADRs support the strategy of investing directly in foreign equities to construct an investor's globally diversified portfolio.

Volume 19 Number 3, 2010

Sustainable retirement income for the socialite, the gardener, and the uninsured (pp. 187–202)

Chris Robinson, Nabil Tahani

This paper advances the literature on the sustainability of retirement income by making consumption a stochastic variable instead of a constant real value, as previous papers have done. The paper continues to make the rate of return and date of death stochastic variables, as Milevsky and Robinson (2000, 2005) do. The sustainability of retirement income depends on the nature of the lifestyle that the retiree chooses. The difference in shortfall probabilities or risk of ruin between the variable cases and the fixed consumption case is significant, and so the adviser needs to take this into account. The difference in shortfall probabilities between making consumption a nonconstant but deterministic amount, and making it also stochastic, is not as important, because it does not reduce risk enough tomake more aggressive consumption rates secure. Finally, making consumption correlated with the rate of return, which implies the family adjusts consumption as its wealth changes, reduces shortfall probabilities to a moderate extent. In general, an initial consumption of more than 4% of initial wealth is not sustainable for any likely set of conditions. In the very best case, an initial consumption rate of 6% is sustainable, but we think that case will fit very few people.

Marital status and state of residence as determinants of the optimal withdrawal strategy (pp. 203–226)

Andrei Shynkevich

The issue of the optimal withdrawal sequence of retirement funds from a set of multiple accounts with different tax treatment is studied. Marital status and state of residence are identified as the factors that can significantly affect the optimal withdrawal strategy. Given the provision of the step-up in cost basis for a full value of the joint taxable account upon the first spouse's death available for a married couple living in a community property state, the optimal withdrawal strategy may imply holding off from withdrawing funds from the joint taxable account until the event of the step-up. Another reason to withdraw funds from the tax-deferred accounts before the taxable account is to hedge against the projected increase in income tax rates after the first spouse dies. The benefits of the postponement of the withdrawals from the joint taxable account until the event of the step-up remain robust in the presence of the required minimum distribution rules and the fact that real consumption during later years of retirement is expected to be lower than during the early years, however the presence of short-term capital gains distributions that are taxed at higher ordinary income rates reduces and in some circumstances eliminates the advantage of the postponement of the withdrawals from the joint taxable account. Statistical odds of the mortality occurrence also favor the awaiting of the step-up.

The value of credit card benefits (pp. 227–244)

Terrance Jalbert, Jonathan D. Stewart, Drew Martin

Banks offer various economic incentives to customers to pay with their credit card rather than cash. Still, many individuals either elect to pay with cash or are unable to acquire credit cards. What benefits do these people lose by paying in cash rather than credit card? This paper demonstrates two opportunity costs associated with cash payments—frequent flier miles and payment float. Under most scenarios, the opportunity cost of cash payments versus benefit accruing credit cards is large. For example, individuals or businesses charging $5,000 each month can realize a present value opportunity cost of more than $19,000 over a five-year horizon. The results help banks optimize their offerings and individuals optimize their payment patterns.

Utilization of financial advisors by affluent retirees (pp. 245–263)

John R. Salter, PhD, CFP, AIFA, Nathan Harness, PhD, CFP, Swarn Chatterjee, PhD

Approximately 78 Million baby boomers will reach traditional retirement age during the next 20 years. As the wave of baby boomers retire a shift in focus from asset accumulation to asset decumulation will occur relating to new retirement challenges. Financial advisors will continue to be an integral part of the asset decumulation phase as they are in the accumulation phase of retirement planning. The authors investigate the factors relevant to affluent retirees' utilization of financial advisors and the differences in planning activities undertaken by those utilizing an advisor using a proprietary dataset. The authors find the variables of gender, education, marital status, wealth, and debt all to be associated with the use of financial advisors. Utilization of advisors was also associated with an increased level of planning activities, awareness, and confidence.

Age, income, health, and willingness to pay for health insurance in late-life (pp. 265–274)

Joy M. Jacobs-Lawson, Alicia K. Webb, Mitzi Schumacher, Christopher C. Gayer

Uninsured older adults utilize fewer health services and are at higher risk of disability and death than insured individuals. This study sought to determine the personal and demographic characteristics associated with being uninsured. Participants (aged 55–71) were asked to indicate how much they were willing to pay for Medicare B, Medigap, Long-Term Care, and private insurance. Results indicated that individuals who were poor, unhealthy, or older were willing to pay less for health insurance than more affluent, healthy, and younger participants. These findings have implications for understanding how older adults and their financial planners may consider health insurance options.

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Freedom at 55 or drudgery till 70? (pp. 275–284)

Nabil Tahani, Chris Robinson

The classic preretirement problem for the financial planner is to advise a client how much to save, how much must be saved each year to reach a specified goal, and how the investment assets should be allocated between fixed income and equity. The traditional solution is to assume a fixed rate of return for each asset class and test scenarios until the mixture of variables yields a solution that meets the stated savings goal and seems feasible for the client. This binary result (accept or reject the plan) ignores the inherent uncertainty. In this paper, we derive a stochastic model in which the rate of return and the rate of increase of annual savings are both variable and calculate the probability that a particular goal will be achieved, given any initial savings endowment, periodic additional savings amount, mixture of assets (represented by the return distribution), and time to the goal. The calculations can be done on an Excel spreadsheet. We illustrate the use and numerical results of the model with a realistic retirement planning scenario and variations on it. While this solution is particularly important for preretirement planning, it applies quite generally to meeting any financial goal, such as saving a down payment for a house.

The downside risk of postponing Social Security benefits (pp. 285–294)

Joseph Friedman, Herbert E. Phillips

The point that only live participants may initiate or receive Social Security benefits is typically overlooked. Thus, a postponement of benefits at any eligible retirement age may be likened to participation in a game of chance in which the participant is subject to a variant form of gambler's ruin at death. The typical assumption, therefore, that a participant should automatically opt for a postponement if the present value of the resulting benefits, discounted to breakeven age, higher than the present value of the opportunity costs, carries with it the implication of risk neutrality in relation to the consequence of dying before reaching breakeven death age. While this implication of risk neutrality is sometimes correct, it is more likely not. In marked contrast to conclusions reached in previous studies, this paper shows that a single Social Security participant, who is risk averse as regards the chances—and contingent consequences—of dying before reaching breakeven death age, would be well advised to initiate benefits at the earliest age at which he or she would not be subject to earned income tax penalties.

Berkshire Hathaway versus the S&P 500: 1990–2009 (pp. 295–306)

John C. Alexander, Jr., Ph.D.

We examine whether Berkshire Hathaway, one of America's premier actively managed portfolios, can outperform the S&P 500. We find that the returns of Berkshire Hathaway appear higher than the S&P 500 from 1990 to 2009. However, when adjusted for risk, we find that the return per unit of risk of Berkshire Hathaway is equivalent to the S&P 500. The relatively low correlation between the two portfolios suggests that an investor may benefit from holding both portfolios rather than either portfolio in isolation. Similar results are found when using the Vanguard 500 Index Fund to proxy the S&P 500.

To fee or not to fee: Pricing policies in financial counseling (pp. 307–322)

Camilla Mazzoli, Gianni Nicolini

Pricing represents a key variable in the financial advisory industry. For this reason we investigate the possibility of identifying the type of advisory provided by making use of the pricing policy that advisors adopt in the United States and Italy. The prevalence of 'opaque' forms of compensation leads us to identify which variables are able to predict the pricing policies (transparent vs. opaque) of a financial advisor. Results suggest that they are related to: the advisor's regulatory status (independent advisor or tied agent), the presence of certifications issued by independent authorities, the involvement in a financial products distribution process and the high or low frequency of the payments that are due for the advisory service.

Time, risk, and investment styles (pp. 323–336)

Zugang Liu, Ph.D.[a], Jia Wang, Ph.D.[b,*]

This paper investigates the changing nature of equity investment risks across time horizon, an important issue in asset allocation decisions. We extend the literature by concentrating on different investment styles and by incorporating investors' risk tolerance into the analysis. Our results show that for more risk-averse investors, the large-cap growth style is the safest style over shorter investment horizons, while a small-cap value style is the safest style over longer investment horizons. However, for more aggressive investors, the small-cap value style is always the safest style regardless of the investment horizons. In addition, the small-growth style is the most risky style across all investment horizons for both types of investors. Those results will help individual investors determine the best suited investment styles given their investment horizon and risk preferences.