From the Editor

As baby boomers gradually replace their parents as members of the retired population, the ratio of retired to working persons will increase. And when we add to this ever increasing longevity, something has to give. Americans must either retire later, or retire with a diminished proportion of aggregate personal income, or both.

Changes in both real after-tax Social Security benefits and qualified pension plans reflect this new reality. The net value of Social Security retirement benefits has been diminished by gradual increases in the age needed for full benefits, increased taxation of payments, and increased premiums on workers. The institution of two-tier systems by many employers has affected qualified pension plans by lowering future benefits for today's younger workers. In addition, there has been a trend to replace generous defined benefit plans with less generous defined contribution plans, which also shifts investment risk from the employer to the employee.

The net impact of these changes is to increase the burden on the individual to supplement his or her retirement income with personal savings and investments. The burden is twofold: To achieve a comfortable retirement, most people must begin voluntary retirement savings at an early age and continue to fund them throughout the life cycle. This is not easy for those with young families or children in college. The second part of the burden is to invest the funds intelligently. While much of the advertising aimed at retirement dollars focuses on tactical decisions relating to things such as asset timing or sector rotation, the more basic and more difficult strategic decisions are often ignored. Yet it is only the strategic decisions that can be supported by accepted methods of financial analysis.

In this issue of *Financial Services Review*, we present four sophisticated papers which give sound advice to those who will make retirement investment decisions. The first, "An Optimization Model for Scheduling Withdrawals from Tax-deferred Retirement Accounts" by Cliff Ragsdale, Andrew Seila, and Philip Little, addresses the very real problems faced by those who have saved for their retirements through tax-deferred accounts. While some professional advisors use various "rules of thumb" for making withdrawals, the problems are complicated by five important variables. 1) If you begin withdrawal too early, you must pay a premature distributions tax; 2) if you take out too little (after age 70 ½) you must pay a minimum distribution tax; 3) if you take out too much in any year (over $150,000), you are subject to the excess distributions tax; and 4) if you leave a gross estate of more than $600,000, it is subject to estate taxes. To further complicate the matter, 5) you may have two or more tax-deferred retirement accounts from multiple jobs or from a combination of 401(K)s, 403(b)s, IRAs and other qualified plans. "Rules of thumb" will just not cut it in an analysis of this complexity.

To help retirees and their advisors make these complex decisions, the authors present a mathematical programming model. While the model itself is necessarily complex, it can

be used with the ubiquitous personal computer and its complexity is transparent to the user who needs only answer a few simple questions.

The second paper addresses the basic question of asset allocation between risk and risk-free assets for the retiree. Entitled "Asset Allocation, Life Expectancy and Shortfall," by Kwok Ho, Moshe Arye Milevsky, and Chris Robinson, this Academy of Financial Services award-winning paper shows the asset allocation that will minimize the probability that a retired person will be unable to consume at a certain desired level over his or her expected lifetime. The paper exemplifies the financial tools that are available to assist in true strategic asset allocation.

The third paper, entitled "The Impact of Mutual Fund Distributions on After-Tax Returns" by William Randolph was particularly interesting to me. The paper focuses on the often-large effect of mutual fund portfolio turnover on after-tax returns. Since realized capital gains of mutual funds are distributed to fund owners, if funds are held in non-tax-sheltered form, funds with high turnover rates impose a high tax burden on owners. This becomes particularly significant in the case of growth funds which have a huge proportion of expected return in the form of capital gains. It implies that growth funds held in non-tax-sheltered form may be selected on the basis of low turnover to minimize the effect of taxation.

The paper was especially significant to me since I was about to publish a basic financial planning textbook in which I implied that non-deductible IRAs offered few advantages to the investor. Clearly I had focused my analysis on fixed income assets and ignored the beneficial effects of holding growth funds with high turnover rates in non-deductible but tax-deferred form. This error was cleared up before shipping the manuscript to the publisher thanks to the author of this timely (for me) piece.

The final paper deals with a somewhat different problem of retirement investing, the complex new provisions found in many corporate bonds. As investors approach retirement, many find that their degree of risk aversion increases with respect to their investment portfolio since they are becoming more dependent on their non-human capital. One common response is to increase the proportion of fixed income assets held in the portfolio. Corporate bonds of well-known companies are often used for this purpose because they generally have good credit ratings and yields which are higher than those from the government, and generally good credit ratings.

However, as Joseph Fields, David Kidwell, and Linda Klein discuss in the paper entitled "Coupon Resets versus Poison Puts: A Valuation of Event Risk Provisions in Corporate Debt," corporate bonds are subject to event risk or loss in value due to corporate restructurings such as taking on huge amounts of new debt. To protect themselves from these potentially harmful events, bondholders have insisted on "covenants" or provisions that will protect them from the financial effect of restructurings or other actions of management that may adversely affect bond values. One such provision is the "poison put" which forces the company to repurchase the bonds at face value if management engages in specific activities that are harmful to bondholders. A second provision is the "coupon reset" which mandates that the bond's coupon payment be increased if the rating falls.

The authors find that investors value coupon resets but not poison puts. However, the overall value of this article is greater than just this empirical finding in that it points out and explains the increasing complexity in formulating a retirement investment portfolio. This places additional responsibility on the shoulders of the investor and his or her advisor or broker to read and understand the indenture provisions carefully to insure that particular bonds are suitable vehicles for a particular retirement investment portfolio.

In this issue, we add a regular feature, "A Practitioner's Perspective". The objective of this column is to discuss one of our academic papers and the implications that the research has for the individual and the financial practitioner. In addition to her academic work, our Managing Editor, Barbara S. Poole, has a financial planning practice and has earned the Certified Financial Planner (CFP), Chartered Financial Consultant (ChFC), and other professional designations.

As the *Financial Services Review* finishes its third year of publication, Managing Editor Barbara Poole and I wish to extend our sincere thanks to our editorial board and reviewers for the help that they have provided in launching this journal. When you publish the first journal in an emerging field, you have the added responsibility of "developing" your authors and their papers. For this reason, Barb and I welcome telephone calls or drafts from prospective authors and will often take a promising but unsuitable piece and give detailed suggestions of how it could be reworked into a paper suitable for publication. Further on in the process, our editors (who are often the reviewers) also contribute to this process of development.

In a letter that accompanied the final draft of a paper in this issue, the authors wrote:

> "I would like to thank you and the reviewer for your help on the paper. The review was the most comprehensive and perceptive one I have experienced. The reviewer's comments added immeasurably to the final result."