

Investing by Seniors

Strategies for Avoiding Exploitation and Preparing for the Future



By Karl J. Ege

We are seniors. We have worked diligently for more than 40 years. We have regularly contributed to our profit-sharing, 401(k), HR-10, or similar defined contribution plan throughout our working days. We may also be fortunate to be beneficiaries of a defined benefit pension plan that provides us with an assurance of a certain level of income for the rest of our lives. We are entitled to Social Security benefits, and we may have aggregated a portfolio of assets outside of our tax

Image: iStockphoto

deferred plans from which we intend to receive financial benefit as our working days with regular income draw to a close.

At present, a large percentage of investment wealth is held by those over the age of 65. The latest data show that the median wealth (one-half above and one-half below) of those between the ages of 65 and 75 is \$206,000, and of those over 75, \$216,000; the mean (or average) wealth for those groups is \$848,000 and \$648,000, respectively, which demonstrates that many in these groups have



Karl J. Ege (kege@perkinscoie.com) is senior counsel to Perkins Coie LLP. Prior to returning to private practice in the Seattle office of Perkins Coie in 2008, Mr. Ege spent 17 years as chief legal officer of Russell Investments, a global investment advisory and management firm. At age 71, he has entered a period of “asset decumulation,” the most challenging period for developing a personal investment strategy.

This article is based in part on an ABA webinar presented July 14, 2011, entitled Financial Exploitation of Seniors: How to Protect Yourself and Your Clients. The author acknowledges AARP and the Investment Company Institute for their assistance in its preparation and participation, as well as Timothy Noonan, managing director of Capital Market Insights at Russell Investments and co-author of Someday Rich (Wiley Finance 2011), a leading text for investment advisers on sustainable investment strategies. This article represents the author's personal views and not the views or opinions of the firm of Perkins Coie LLP or of any of its clients.

significant wealth. For those seniors with above average wealth, a sizeable portion of their assets are in tax deferred pension plans or investment portfolios.

In past decades, a senior in this position would consider converting a substantial portion of his or her assets into high-quality fixed income-bearing instruments that would sustain in large part a desired standard of living. Traditionally, the rule of thumb for a retiree was that the withdrawal of four to five percent of a portfolio annually would provide reasonable assurance that a retiree would not outlive his or her assets. However, at this writing (May 28, 2013), the 30-year U.S. treasury bond is yielding 3.18 percent, the 10-year U.S. treasury bond is yielding 2.01 percent, and the 90-day U.S. treasury note is yielding 0.04 percent. Moreover, the Social Security Administration estimates that a man at age 65 can expect to live, on average, to age 83; a woman at age 65 can expect to live, on average, to age 85. One of four Americans age 65 will live past age 90, and one of 10 will live past age 95, www.socialsecurity.gov/planners/lifeexpectancy.htm. Regretfully, we now have an interest rate environment where the yields of low-risk fixed-income instruments are at historic lows, and life expectancies in retirement are longer than initially anticipated. Low-risk income-producing investment assets yielding four percent or more annually are essentially unavailable.

As will be discussed, the current low-yield fixed-income environment and the likelihood of an extended life of retirement present a troublesome dilemma for seniors. Those seeking additional yield to maintain a desired lifestyle and to ensure future income security may be tempted to invest in unproven, speculative, or excessively risky investment products or schemes that promise attractive returns but involve unacceptable risk and an increased probability of significant loss. This article sets forth some guidelines for seniors to follow when seeking investment advice, considering investment recommendations, implementing a prudent investment policy suitable to the senior's level of wealth and income expectations, and seeking to avoid exploitative investments.

The Physical and Psychological Challenges of Aging

A series of academic studies identifies two countervailing trends among seniors that, when combined, exacerbate the current low-yield, lengthy retirement period dilemma and create a “perfect storm” for exploitation.

Independent studies and objective testing have demonstrated that a person's ability to understand, absorb, and solve complex financial and mathematical problems peaks at approximately age 50 and, without exception, declines thereafter. Admittedly, mathematical and analytical acuity differs among individuals, but the decline in analytical ability is real and measurable, regardless of the level at which it rests at age 50.

Another trend supported by independent data is the increasing confidence among seniors in their decision-making ability. Perhaps this is a defense mechanism engendered by a natural desire to counter the more tangible physical effects of aging—loss of strength and agility, graying hair, arthritis, etc. Or perhaps it is mere hubris—we are older and more experienced, and we are confident we have more wisdom and better judgment. As a consequence, seniors as a group are less willing to listen to advice from those who are younger. They distrust the young, are unwilling to change their past investment and financial practices, and rely on their traditional sources of advice (often friends and advisers who are themselves aging and therefore losing the ability to understand and analyze complex financial problems and who also may have an unrealistic sense of their “wisdom” and therefore judgment).

These countervailing trends, coupled with a low-return environment from fixed-income assets, a lengthy period in retirement, and significant wealth accumulated by seniors over the years, creates a toxic mix of factors that places seniors squarely in the sights of those who wish to exploit them for personal gain. It is interesting to note that the targets for those who commit financial fraud are more often than not seniors with professional or highly skilled backgrounds—doctors, lawyers, academics, airline pilots, and, more recently, technology

professionals. All have a heightened self-confidence in their analytical and decision-making skills, are less likely to call upon investment professionals for advice, have better overall health and longer life expectancies, and have accumulated relatively substantial wealth.

Avoiding Exploitation: How to Protect Yourself and Your Clients

The foregoing factors make seniors particularly vulnerable to financial exploitation. There are steps that can be taken to lessen the likelihood that a senior will fall victim to those who seek to prey upon vulnerabilities. The key to developing a sound and practical investment plan is to minimize the impact of the psychological and physiological factors described above, namely the decline in analytical ability and the rise in decision-making self-confidence. And that key to minimizing the impact of those factors is obtaining sound advice.

Seeking Sound Advice: Broker-Dealers, Investment Advisers, or Others

There are several traditional sources of advice regarding investments. These are primarily broker-dealer representatives and investment advisers, but they also include bank or trust company trust officers, insurance professionals, accountants, and “financial planners.” Each can play an important role in advising clients with respect to investments, but few investors are fully aware of the differences in the legal obligations that these groups of professionals owe to their clients.

Broker-Dealers

Broker-dealers are regulated by both state and federal agencies and are subject to regulation by the Financial Industry Regulatory Authority (FINRA), the self-regulatory body responsible for regulating the conduct of broker-dealers through rules and guidance. Representatives of broker-dealers (the traditional “stock broker”) must be registered with both FINRA and the state or states in which they have clients. They must pass qualifying examinations administered by FINRA as a condition of their FINRA and state registrations. Broker-dealers and

their representatives who violate FINRA rules are subject to sanctions, which may include fines and/or suspension or revocation of registration.

Under current law, broker-dealers and their representatives do not have a fiduciary duty to their customers. However, under the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank), the Securities and Exchange Commission (SEC) was required to conduct a study to determine whether broker-dealers and their representatives should be held to a fiduciary duty standard with respect to their relationships with their clients. On January 21, 2011, the SEC released its study recommending that a uniform fiduciary standard be imposed on broker-dealers and investment advisers when providing personalized investment advice to their clients. SEC, *STUDY ON INVESTMENT ADVISERS AND BROKER-DEALERS* (2011), *available at* www.sec.gov/news/studies/2011/913studyfinal.pdf. On March 1, 2013, the SEC published a request for information regarding the benefits and costs that would accrue from the harmonization of standards of conduct and other obligations of broker-dealers and investment advisers. *Duties of Brokers, Dealers, and Investment Advisers*, Securities Act Release No. 34-69013 (Mar. 1, 2013), *available at* www.sec.gov/rules/other/2013/34-69013.pdf.

In any event, broker-dealers are currently subject to FINRA rules of conduct, which include a requirement to “know the customer” and to recommend investments that are “suitable” for that particular customer. Broker-dealers and their representatives are compensated generally by commissions based on the transactions executed on the customer’s behalf. Customers of broker-dealers normally are required to sign an agreement to have disputes with the broker-dealer resolved through arbitration, rather than through a civil suit. The arbitration provision does not preclude a customer of a broker-dealer from initiating a complaint with a state or federal regulatory authority. Regulatory authorities have the power to order rescission or disgorgement of profits in cases of fraud or of violations of state or federal regulations.

Investment Advisers

Investment advisers are registered either with the SEC or with the securities regulatory authority of the states in which they do business. Dodd-Frank raised the threshold for federal registration of investment advisers to \$100 million of assets under advisement. Advisers with less than \$100 million of advisory assets must register with the state or states in which they do business.

All investment advisers must provide their customers with “Form ADV,” which is also to be filed with the SEC and is available online at www.adviserinfo.sec.gov. Form ADV contains material information about the adviser’s background, experience, fee arrangements, conflicts, regulatory actions, and other information. Unlike broker-dealers, investment advisers have a fiduciary duty to their customers that requires the adviser to act in the customer’s best interests. Investment advisers most often charge a fee for services, typically an asset-based fee measured in basis points (one basis point is 0.01 percent). Basis point fees are set by a schedule, and the basis point fee normally decreases as asset levels increase.

The burden of prudence when selecting an adviser has become much more consequential.

With large portfolios, basis point advisory fees are generally negotiable. Investment advisers may also charge a commission on certain transactions on behalf of a customer if agreed to in advance in writing.

The nature of the relationship between an investment adviser and the customer is embodied in an investment advisory agreement that, unlike a customer agreement with a broker-dealer, normally does not require that disputes be resolved through arbitration. Disputes with investment advisers may be resolved through civil suits or by filing a complaint with state or federal regulatory authorities. Under the SEC’s new whistleblower rules (SEC Rules 21F-1 *et seq.*), a person filing information with the SEC that leads to a finding of wrongdoing by an investment adviser or a broker-dealer may be entitled to a bounty of 10 percent to 30 percent of the amount in excess of \$1 million collected by the SEC.

Trust Officers, Insurance Professionals, Accountants, and Others

Bank trust department or trust company officers are often called upon to advise and manage assets for individuals. They, too, owe a fiduciary duty to their clients and are regulated by either state or federal banking authorities. Insurance professionals offer financial planning services and access to insurance products such as annuities that are acceptable investment alternatives for individuals seeking a guaranteed return. Note that the “guarantee” of the annuity is only as good as the financial health of the insurance company that sponsors the annuity. Accountants and financial planners must be registered either as investment advisers or as broker-dealer representatives to offer a full array of investment advisory services to their clients.

Finding Advice: Selecting the Adviser

Whether the decision is to seek advice from a representative of a broker-dealer, an investment adviser, a trust officer, or another professional, the key is to find an adviser who is experienced and skilled and in whom the customer has trust and

confidence. Experience is clearly important, but the breadth and depth of the advisory firm is important as well. For example, if an investor wishes to invest in non-U.S. equities, in emerging market equities, or in non-U.S. debt instruments (key components of a well-constructed asset allocated portfolio), the adviser should be one who has access to sources of information that provide the basis for an appropriate recommendation of the funds or instruments to be purchased to achieve the recommended portfolio diversification.

A recommended practice for identifying an adviser is to talk to friends and colleagues who have established successful relationships with an investment professional and seek their counsel. Interview several advisers before you decide which to engage. If an adviser is a registered investment adviser, review the adviser’s Form ADV to determine the

adviser's background, experience, depth of coverage, regulatory compliance, and other key factors. If he or she is a broker-dealer, review the firm's regulatory and compliance program and the representative's background, experience, and breadth and depth of knowledge. If alternative assets (hedge funds, private equity funds, commodities pools, and other nontraditional assets) are to be included in the portfolio, conduct further investigation into the experience of the adviser in these complex and often opaque asset classes.

Essentially, the effect of longer life spans and reduced interest rates results in a need to reevaluate the conventional wisdom of what constitutes a prudent investment portfolio and which skills are needed in an adviser who will manage assets over an extended period of time. This is particularly important given the rapid changes in the capital market environment. Moreover, the increasing use of electronic transfer of private financial information places increased burdens on advisers to protect their clients from identity theft and fraud. As a consequence, the burden of prudence when selecting an adviser has become much more consequential, as the object of the advisory process rotates from product placement (i.e., the selection of a basket of appropriately rated and insured municipal bonds) to the consideration of whether an advisory practice is equipped and appropriately compensated to accompany a client through an extended period of "decumulation" (living off investments, rather than adding to them), during which the client's financial literacy will continue to decline.

Advisers as a profession have only recently recognized the need to transition their practices from "commission to fee," in other words to widen their obligation from judging that a sale of a security to a client was suitable at that moment in time, to considering whether a portfolio of assets is organized to accomplish the client's goals over an extended future. In the future, the demographic nature of the American retiree will extend this responsibility further, and advisers will be required not simply to determine that

a portfolio is appropriate, but to help an aging client maintain a portfolio strategy in the face of declining discernment and an increasing threat of predatory distractions. The best advisers understand and anticipate this change in focus.

Asset Allocation: The Key to Success

It is common knowledge that a properly constructed asset allocated portfolio that reflects the risk profile of the individual investor is essential to a successful investment strategy. A skilled adviser will encourage the investor to create a diversified portfolio that reflects the "efficient frontier," a set of securities portfolios that offers the highest expected return for a defined level of risk. (The term "efficient frontier" was first described by Harry Markowitz in a 1952 article in the *Journal of Finance*. The resulting "Markowitz theory" formed the basis for the capital asset pricing model. For his work, Harry Markowitz was awarded the Nobel Prize in Economics in 1990.) Investors who diligently invest on the efficient frontier, adjusting their portfolio for changes in risk profile and rebalancing periodically to maintain the proper position on the efficient frontier, over long periods of time outpace those who attempt to time the market and move in and out based on fear or greed, who are mesmerized by "trendy" investments, or who essentially gamble on speculative investments to seek additional returns. An adviser, whether broker-dealer representative, registered investment adviser, trust officer, or other investment professional, should be familiar with the concept of the efficient frontier and be capable of determining the proper mix of investments for a particular investor that would place the investor's portfolio on the proper position on the efficient frontier.

For seniors, the proper asset allocation will be subject to a careful analysis of a variety of factors. These include (i) the amount of assets (both tax deferred and after-tax) owned by the investor; (ii) the income needs as the investor moves into an extended period of decumulation; (iii) the life expectancy of the individual and his or her spouse or partner; (iv) the investor's tolerance for risk; (v) the financial needs (such as educational expenses

of children or grandchildren) of others who depend on the investor for support and/or financial assistance; and (vi) other factors that are deemed important to assess properly the risk tolerance and financial needs of the investor.

Once an asset allocation strategy is identified and implemented, the role of the adviser thereafter is to determine if there are changes in the client's financial, health or personal circumstances, or risk tolerance and to make appropriate adjustments to the asset allocation strategy if changes occur. As markets move and asset values change, periodic rebalancing to maintain an efficient portfolio is essential. Quarterly or more frequent meetings are important to ensure that the adviser is aware of the investor's current circumstances, tolerance for risk, and financial needs.

Cautionary Note for Seniors: Hedge Funds, Private Equity Funds, Venture Capital Funds, Commodities, Etc.

Nontraditional or "alternative" assets are often touted as offering higher rates of return than customary investments (stocks and bonds). Although there is truth to that assertion and these asset classes may be appropriate for large institutional investors or very high net worth individuals, they pose risks of volatility, illiquidity, or uncertainty that render them less than ideal for the vast majority of seniors. Hedge fund managers charge high fees and a portion of the increase in portfolio value. Private equity and venture capital funds are structured with a life of 10 or more years and are generally illiquid. Commodities are highly volatile and may present an element of unacceptable risk. Each should be examined carefully to determine whether the benefits they represent (additional portfolio diversification and the possibility of greater returns) are worth the risks they represent.

Top 10 Tips for Senior Investors

This article summarizes some of the key principles a senior should consider when moving toward a period during which one's investments are the primary source of funds for day-to-day living. The following is a "top 10" listing of tips to be considered by seniors when addressing their investments. By seeking advice from

a qualified, experienced investment professional and following the below suggestions, a senior investor should be in a position to enjoy retirement and decumulation free from exploitation by those who are not acting in the investor's best interests and from the anxiety brought about by financial uncertainty.

1. Document all existing accounts and determine how you wish to have your affairs handled before you become incapacitated or your faculties are diminished.
2. Don't *ever* invest with anyone who contacts you initially by phone or e-mail.
3. Don't *ever* invest when you are feeling pressured to do so by a specific date or time.
4. Avoid investing solely on the basis of unsolicited glossy promotional materials sent to you in the mail, delivered by e-mail, or offered through the Internet or social media.
5. Don't be too trusting of an investment adviser claiming to be a "senior specialist" or some similar special qualification (there is no accepted standard for such a designation).
6. Be careful when investing in illiquid or otherwise nonmarketable securities.
7. Be careful when investing in a financial product in which the seller either has an economic interest or is motivated by his or her own economic interest to offer it to you in lieu of another product that may be more suitable.
8. Be careful when investing in something recommended to you that appears "too good to be true." It likely is.
9. Ask if any recommended "switch" from your current investments to new ones will result in greater fees or commissions to your adviser.
10. Identify who will be responsible for your affairs when you are no longer able to do so, and determine if your adviser has a staff of professionals who will succeed to the business when the adviser on whom you are relying retires. ■