Give consumers fair financial deals

Retirement products must be demystified for ageing Asian populations, a professor says. JACKIE YAN ZHENG reports

LIFE-CYCLE financial products have become a significant component of many people’s investment plans. What the objectives of retirement investment products should be, what the existing system is like and where the problems lie are ever more relevant as many Asian countries now face the problem of ageing populations. Furthermore, the world has just emerged from one of the worst financial crises since the Great Depression.

These were some of the topics Zvi Bodie, Norman and Adele Barron Professor of Management at Boston University, covered in a recent lecture titled “The Next Generation of Life-Cycle Products” here in Singapore.

What life-cycle investment products should provide

In Professor Bodie’s view, the ideal products for the mass workforce should allow customers to choose from a wide range of simplified financial product features, which also sophisticated and smart beneath the product level. He used the iPhone analogy to elaborate on this issue. While consumers may not understand every piece of the iPhone’s technological details, they are able to choose the applications that fit best with what they need. In a similar way, the iPhone is a simple, yet sophisticated device for the ordinary person to use.

Current financial products do not meet the expectations of consumers, in Prof Bodie’s view. He commented that financial product developers are not using modern financial theory and technology to reduce risks involved in the products sold to consumers; rather, they are simply passing the risk from the corporate sector to individual consumers.

He gave the example of US-based target-date mutual funds, also known as life-cycle retirement funds. The combination of mutual fund assets in a dynamic asset allocation programme that is a function of one’s age, according to him, fails to provide any known schedule of payments and is often a maturity date. It is thus simply another type of risky asset.

Prof Bodie pointed out the misnomer of “target date” for such retirement mutual fund products, because consumers are not guaranteed a stable income for their retirement, which should be a deserved right of the individual (that is, the retiree) at the “target date.”

Role of modern technology

Prof Bodie believes that modern technology, together with the development of financial engineering, has made possible the objective to provide consumers “a hybrid defined contribution/defined benefit pension plan where individuals make contributions to the plan, and these contributions could vary” and “the end result when they retire is a secure lifetime income that lasts as long as they live, with full inflation protection”. Such products might involve complicated technological components, but he believes the goal is both clear and viable.

Meanwhile, modern technology also helps to make these products more affordable to middle-income populations. In the past, these retirement investment plans were mostly for high-end consumers but the “time has now come where we really can do that”, he said.

Misleading consumer education

Prof Bodie does not agree with the current practices of consumer financial education. Current complicated designs, coupling modern technology with misguided financial engineering embedded within financial products, are difficult for own professionals to comprehend, let alone the consumers. As a consequence, “consumer financial literacy is misdirected with impossible risk and return objectives”, he said. From his point of view, financial education should not be about teaching the masses to do everything on their own. He argued that financial producers are simply trying to transfer risk to the customers instead of reducing the risk, partly because the producers do not understand how to solve the problems themselves.

The transfer of risk, however, affects incentives as producers are now using higher rates of return to induce consumers to choose riskier investment plans without informing them appropriately about the increased risk. When people retire, chances are that they could either earn a higher return from the investment or end up with very little to live off for the rest of their lives. In fact, when it comes to retirement products, “safety is the primary concern for investors”, he said. 

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Conclusion

Consumers should be educated to choose from well-designed, yet simplified features of retirement products, with the end result of securing a lifetime income that lasts as long as they live and with full inflation protection. Producers should not use diversification as an excuse to transfer risk and the responsibility of providing a safe retirement income stream to consumers.

Rather, well-trained financial professionals should work with the government to reduce unwanted risk, and offer safe retirement investment plans for the mass population. Thanks to the development of modern technology and financial engineering, the joint efforts of the government and the private sector should be able to provide sophisticated financial products to meet these expectations, Prof Bodie said.

The writer is a PhD student at NUS Business School, which first published this article. Professor Zvi Bodie was here as a visiting professor at the Center for Asset Management Research and Investments (CAMRI), NUS Business School.