Employees Warned Of Early Retirement Investment Pitches That Promise Too Much

A securities regulator, the National Association of Securities Dealers (NASD) has issued an Investor Alert to employees contemplating early retirement in reliance upon early retirement investment pitches. These pitches have been "flawed, even fraudulent", and have caused retirees great financial harm.

Let's examine the NASD's Investor Alert. The NASD outlines the typical scenario. Investment advisers provide free seminars to employees of major corporations. The advisers pitch a strategy that recommends one of more of the following actions:

- Retire earlier than expected
- Opt out of the company's retirement plan (which means cashing out of a 401(k) plan and/or taking a lump-sum cash value payment from a pension plan)
- Open a traditional Individual Retirement Account (IRA) at the financial adviser's firm
- Invest

Although the NASD cites as investments variable annuities, Class B and Class C mutual fund shares and exchange traded funds (ETFs), other investments (like stocks) and investment strategies (like concentrating investments in certain sectors such as technology and telecommunications companies) may be equally problematic.

The free seminars typically misrepresent two critical planning assumptions, which are the expected returns of the investments and the recommended annual withdrawal rates. NASD reports that, in one disciplinary case it prosecuted, the financial adviser represented that he would be able to generate annual returns as high as 18 percent and, for planning purposes, assumed annual returns of 11 to 14 percent. Likewise, the NASD reports that the financial adviser in that case recommended annual withdrawal rates starting at 7 1/2 percent to 9 percent of the investor's initial investment, with increases at five-year intervals. To avoid early withdrawal penalties (before age 59 ½), under Section 72(t) of the Internal Revenue Code the IRS requires such retirement plan distributions to be "part of a series of substantially equal periodic payments."

Critically, the NASD warns investors that many experts recommend much lower annual withdrawal rates, along the lines of 3-5% per year, not 7-9% per year. The NASD issues three additional warnings, regarding which employees must be "especially skeptical":

- Everyone can retire early! The NASD disagrees, observing that many employees lack sufficient resources for extended retirement and will have only limited opportunities for other employment
- You can make as much in retirement as you can by continuing to work! Not so, says

says the NASD, because such promises "usually hinge on unrealistically high returns on investments and unsustainably large yearly withdrawals"

- You can expect returns of 12% or more! This is false and the NASD cites three reasons. First, no one can predict investment performance. Second, be skeptical of any expected return greater than 10.4%, which is the historical average for the stock market (with all dividends re-invested), and is far greater than the historical return for less risky investments bonds, about 6%. Third, the stock market inherently is volatile, with many short term periods producing losses or returns well below 10.4%.

- You can withdraw 9% or more and never run out of money! To do so the NASD warns that you need "substantial retirement assets". Otherwise investors must deplete their principal and/or outlive their retirement assets.

The NASD provides 10 tips to "avoid being taken in." One of the tips reflects a situation that we faced in one of our securities arbitration cases. There our clients attended a "free lunch" seminar at their workplace. The clients were confused, thinking that their employer (a Fortune 500 company) was sponsoring the event and, indeed, endorsing the investment adviser. The NASD cautions to never assume your employer is behind the event.

Another tip relates to investing retirement assets in variable annuities. The NASD warns that most variable annuities have asset-based sales charges or surrender charges as well as a variety of fees and expenses. Variable annuities may offer "enhanced benefits" but you pay extra fees for them. The "bottom line", says the NASD, "variable annuities can be complex and expensive relative to other investments."

Finally, the NASD advises to seek a second opinion before committing to an early retirement strategy. That's good advice!

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