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Retirement Income

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For much of the 45-year history of the defined contribution ("DC") industry, plan sponsors have focused their efforts on increasing employee participation and helping them accumulate sufficient savings during working years to have adequate assets for retirement. In recent years, as more participants neared and entered retirement, a greater emphasis has been placed on what happens once workers retire (i.e., the decumulation phase). Given that the DC construct, relative to defined benefit schemes, shifts multiple risks to the participant such as sequence of returns, longevity, and investment risk, ensuring that participants' retirement dollars last for the remainder of their lives is a major concern. This increased focus has also been aided by the concern that the Social Security program is projected to run out of reserves in approximately ten years, leaving roughly 66% of recipients seeing their benefits cut by 23-25%.[1] Ensuring that participants have enough assets to last them through their retirement years is a crucial matter for plan sponsors today.

In this paper we will discuss recent legislative initiatives that focus on retirement income, the benefits and constraints of several existing retirement income solutions, and considerations that plan sponsors should evaluate as they contemplate which strategies they can and might consider offering to plan participants. Since many public DC plans contain guaranteed income solutions in their structures, we focus our analysis primarily on the private DC sector.

[1] Source: NPR.

Shifting the focus to the decumulation phase

The experience of the past fifteen years highlights several of the challenges that DC plan participants face once they reach retirement. The decade-plus bull market that followed the Global Financial Crisis ("GFC") was generally a boon for defined contribution participants' balances. The 10-year annualized return for the S&P 500 index through December 31, 2022 was 12.6%.[2]

[2] Source: Bloomberg.

While this period rewarded risk-taking, some of this return was fueled by a historically low interest rate environment that was initiated to combat the downturn beginning in 2008. Rates stayed at or near record lows for more than a decade, hampering income and return generation from lower-risk assets such as investment grade bonds. The Bloomberg Aggregate Bond Index produced a 10-year annualized rate of return of just 1.06% through the end of 2022. The low yields for traditional fixed income assets present a challenge to participants in or near retirement, as these yields may not

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produce enough income to sustain them through their remaining years. This problem is exacerbated when inflation is higher than the level of interest rates, as has been the case from the latter half of 2021 through 2022. Additionally, as yields rose quickly in 2022, participants experienced losses on their traditionally "safe" fixed income investments.

The ability of a participant to retire and have sufficient savings to last through their retirement years also depends on the investment environment they experience. For example, a participant that invested in an index of 60% S&P500/40% US Aggregate Bond portfolio starting in June of 2007 would have a 10-year annualized return of 6.25%.[3] Meanwhile, an individual investing in the same index structure but with a start date just two years later, in mid-2009, would have achieved a 10.0% return.[4] The path of investment returns takes on greater importance in the defined contribution space versus a defined benefit structure as the return is dependent on the participant's start date, not the overall return of the plan over time.

[3] Source: InvestorForce.

[4] Source: Ibid.

In a DC plan, participants not only have to manage the uncertainty of investment returns, as noted above, but are also responsible for ensuring their savings will last them through a long life expectancy. DC plan participants are increasingly concerned about outliving their savings during their retirement years. Doubts concerning the viability of the Social Security system and the impacts of higher costs due to inflation have added to the worries of participants.

As the prevalence of defined benefit plans has decreased, and in many cases been replaced with defined contribution plans, plan sponsors and industry participants recognized the increased importance of DC plans to participants' retirement wellbeing. In the early years of DC plans, fixed annuities were the primary means by which participants could convert their account balances into a fixed income stream for life throughout their retirement. However, given the complexity of these products, potential employer liability, lack of flexibility, lower relative returns, and potentially high costs, many participants, and even plan sponsors, have sought alternative solutions or chosen to forego annuities.

Legislators have further recognized the need for better participant options and introduced the Setting Every Community Up for Retirement Enhancement Act ("SECURE Act") in 2019 (this act was further supplemented by the passage of SECURE 2.0 in 2022). This legislation provided plan sponsors, assuming certain provisions are met, a fiduciary "Safe Harbor" for the selection of a guaranteed retirement income contract or GRIC (annuity product). The SECURE Act also included provisions to enable "portability" of lifetime income investments. To help participants better understand the potential lifetime income that could be generated by their existing account balances, the SECURE Act required that individual account plans add a "lifetime income stream equivalent"[5] disclosure to at least one benefit statement furnished to a participant during a twelve-month period.

[5] Defined as "the monthly payments the participant or beneficiary would receive either as a single life annuity or a joint and survivor annuity." Source: Section 203 of SECURE Act.

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The increased focus on the decumulation phase of a participant's life is a welcome change. The remainder of this paper will highlight existing strategies that emphasize retirement income and discuss the benefits and considerations of these approaches. We will center our observations on "in-plan" solutions,[6] as these fall under the responsibility of the plan sponsor. We will also discuss evaluation criteria that plan sponsors may find helpful as they contemplate adding retirement income products to their line-up. It is important to note that the following is not intended to "recommend" a specific strategy or approach, as each plan and participant base is unique, with varying needs and demographics.

[6] In-plan options are choices available within the plan, such that a participant's dollars do not leave the trust. Out-of-plan options require that the participant dollars leave the sponsored plan and are invested outside of the trust.

The retirement income landscape

Traditional annuities

Annuities come in many forms, but generally they are a contract between an individual and an insurance company in which the individual pays the insurance company a sum of money (either a lump-sum or series of payments) in exchange for a guaranteed stream of payments (starting immediately or sometime in the future) typically for the individual's life. Until recently, it was uncommon for private DC plans[7] to offer annuities to participants given potential liability concerns. To help address this concern, the SECURE Act contained a provision that relieves employers of some of this potential liability, allowing them to incorporate an annuity provision into their defined contribution plans. With this relief, in-plan annuity options are increasingly being made available.

[7] 403(b) plans are the exception and still commonly feature annuities.

In-plan annuity offerings generally benefit from "institutional pricing" (plan sponsors can typically negotiate more attractive terms due to the larger asset base they represent compared to an individual) that affords participants a greater benefit, all else equal. The switch to in-plan annuity offerings also eliminates the "middle-man," which should reduce costs. That said, annuities are still likely to be more expensive than most of the other options offered in a plan, which may influence participants against their adoption.

Fees	Variable Annuity	Indexed Annuity	Fixed Annuity	Income Annuity
Commissions	✓	✓	✓	✓
Administrative Fees	✓	✓	✓	✓
Surrender Charges	✓	✓	✓	
Mortality Expenses	✓	✓	✓	✓
Investment Expense Ratio	✓	✓		
Riders	✓	✓	✓	✓
Rate Spreads	✓	✓		

FIGURE 1
Annuity Fees by Type
Source: Annuity.org.

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Historically, annuities were offered by brokers, some of whom sold products to individuals that were costly, complicated, and perhaps not suitable for the client. These practices have served to damage the reputation and perception of annuities. This is unfortunate because annuities offered via a plan can provide participants assurance that the underlying insurance provider has been vetted by a plan sponsor. Further, one of the key benefits of offering annuities as part of the retirement plan are the institutionally negotiated fees.

Additionally, annuities are not well understood by the average participant. The wide variety of options available may increase this confusion. This, coupled with the lower returns relative to the "risk seeking" options typically available in a plan, has resulted in generally lower adoption rates. This may be changing as participants are starting to better understand annuities and the benefits they offer. In a 2021 survey, Plan Sponsor Council of America found that only 12.7% of plans offered annuities to participants. Of the plans that offered annuities, 56% were a distribution option to purchase an annuity, 29% were 'in-plan' immediate, 9% were in-plan deferred, and 6% were categorized as 'other'.

Target Date Funds ("TDF")

TDFs have quickly taken over the defined contribution industry as the most prevalent form of plan qualified default investment alternative ("QDIA"). Prior to the Pension Protection Act ("PPA") of 2006, the primary default option in a DC plan was a capital preservation option. Following PPA and the introduction of the QDIA, there was a shift from capital preservation to predominately target date funds. As of 2020, approximately 86% of 401(k) plans offer a target date fund as the QDIA.[8]

Like the industry as a whole, these strategies have continued to adapt and evolve, as many structures now include a feature for purchasing annuities. These approaches are beneficial due to their relative ease of use. Participants generally invest in the TDF that corresponds with their anticipated retirement date and, as they near or enter retirement, the TDF will automatically increase the exposure to deferred annuities, thus providing for a guaranteed income stream in retirement.

As noted above, TDFs are generally easier for participants to understand and incorporate a professionally managed strategy focused on the participant's anticipated retirement time frame. That said, they still contain complexities surrounding the "annuity decision" that may confuse the average participant. As with traditional annuities, Annuities within a TDF may be fixed or variable, the pay structure may start to pay immediately or be deferred, and there are a multitude of different options available with various complex fee structures that can increase participant confusion. Additionally, while in-plan annuity solutions generally offer participants more attractive "institutional" pricing, the costs for an annuity within a TDF can still be higher than non-guaranteed products and contain restricted flexibility once the decision to annuitize has been made.

Alternatively, some TDFs incorporate a glide path such that the fund becomes a "retirement income" structure when the prescribed retirement year is reached. While

[8] Source: EBRI 401(k) Plan Asset Allocation, Account Balances, and Loan Activity in 2020, November 2022.

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income stream for life, the focus on income-oriented assets typically means a more conservatively positioned strategy. Additionally, while these strategies target a strong income component, some incorporate "growth" assets into the strategy with the recognition that retirement may last 20 years or more.

Retirement strategies with a guaranteed floor

To help combat the negative impact that a severe market downturn can have on retirement balances, some asset managers have designed products to provide a "floor" to a participant's guaranteed income amount. These strategies integrate the purchase of annuities into their structure, so may be appropriate only for participants that are comfortable with those products. While there are multiple ways in which this can be achieved, generally these products periodically adjust a participant's "floor" (i.e., the lowest amount from which a guaranteed income stream for life can be derived) based on contributions/withdrawals and market appreciation/depreciation. If the market appreciates (and/or a participant makes additional contributions), the floor on which the guaranteed income stream is based will increase. However, if the market declines, the participant's floor remains steady.

Over the course of a participant's career, the floor is designed to increase as the participant makes contributions and the market value of the account goes up. Upon retirement, each participant's floor amount is converted to a guaranteed income stream via annuities. These strategies provide greater certainty to the participant concerning the guaranteed amount of income and periodic downside protection. However, the returns for these strategies may be lower than a participant may achieve by investing in a long-term, "growth" orientated strategy. Additionally, these types of strategies require a participant to adopt the strategy well before they are ready to retire.

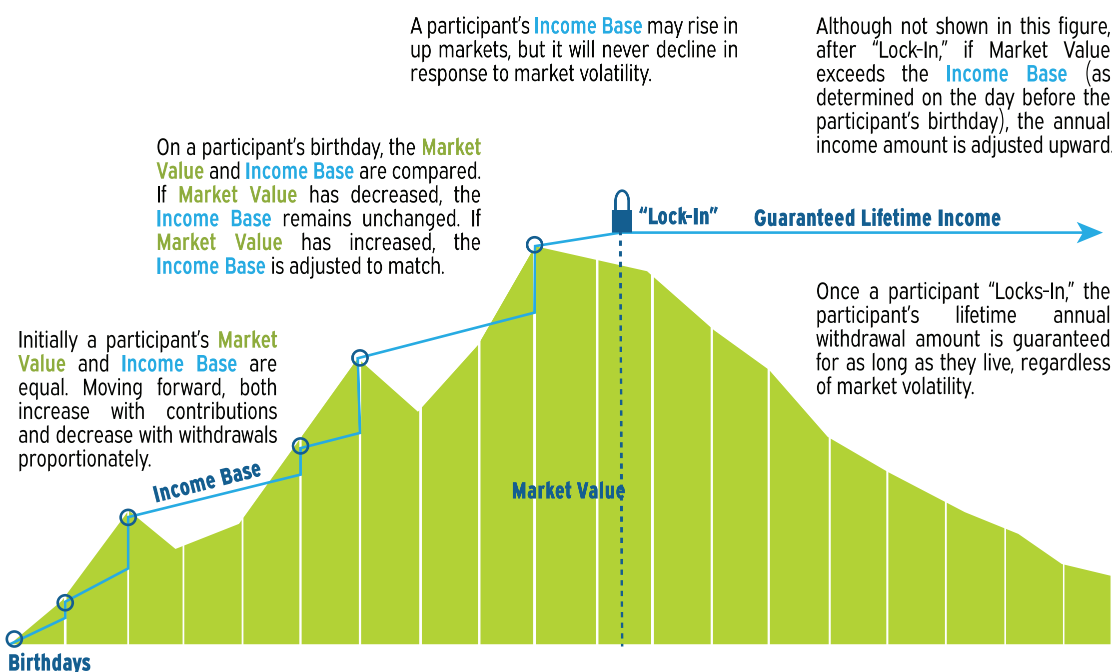

FIGURE 2

Example of the Accumulation and Decumulation Phases

Source: Prudential.

Note: The hypothetical situation is for illustrative purposes only. It does not reflect an actual experience with the product, an actual account value or the performance of any investment rate of return. Withdrawals or transfers (other than transfers between IncomeFlex Target Funds) proportionately reduce guaranteed values prior to Locking-In. After Lock-In, withdrawals in excess of the Lifetime Annual Withdrawal Amount will reduce future guaranteed withdrawals proportionately or eliminate them entirely.

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Personalized withdrawal strategies

Most of the strategies described above benefit from ease of use. That said, participants will generally pay a fee for convenience. For participants that desire to take a more hands-on approach, the building blocks for constructing a retirement income strategy are generally available in most plans. While there are many different approaches that participants can consider, they typically have some commonalities. Most of these scenarios require that participants calculate their expected expenses over the next several years (many record keepers provide online tools which are designed to help participants calculate anticipated expenses). Monies to cover these expenditures are invested in a conservative vehicle such as a stable value fund. A second "bucket" for intermediate expenses is funded, and so on for additional periods/expenses (e.g., several "buckets" may be constructed per the participant's preferences). As expenses are realized, the conservative bucket is used and refilled with the intermediate bucket and so forth. The remainder of the balance is typically invested for growth based on the participant's risk tolerance.

FIGURE 3
Retirement Buckets

Source: Meketa Investment Group, 2023.

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Over the years there have been multiple estimates for how much participants could spend each year (e.g., "the 4% Rule")[9] to ensure they do not run out of money in retirement. While these strategies may have the benefit of potentially lower cost and provide the ability for participants to leave any remaining assets to heirs, there is no guarantee that the DC balance will last through a participant's lifetime (i.e., the participant still bears longevity and market risk). Additionally, this approach requires continually monitoring and rebalancing, and there is the risk that cognitive decline may impact the results of the approach.

[9] The 4% "Rule" is a practical guideline for how much a participant can spend each year (i.e., 4% of their total balance) to ensure they will have adequate funds to last them through retirement. That said, life expectancy and the return environment which the retiree faces will greatly impact the efficacy of the strategy.

Participant advice offered by third party providers

The concept of participant advice has gone through multiple iterations as regulations have changed over time. Most record keepers tend to offer guidance versus advice. That said, some record keepers offer participants guidance on how they might construct an income stream in retirement. Most offer some type of online calculator that factors in the participant's various assets (defined benefit assets, social security, other DC plans, savings, etc.) as well as expected expenses, and suggests asset mixes to help achieve these goals. Many plans also offer periodic in-person meetings or participant call lines to help participants as they near or enter retirement. Like the withdrawal strategies discussed above, these solutions do not guarantee an income stream and results in the participant bearing longevity and market risk.

One form of actual "participant advice" offered by some plan sponsors is a managed account construct. In this arrangement, a participant's account is managed by a professional asset manager. The manager will generally meet with the participant to understand their needs and goals, risk tolerance, etc. Once these have been clarified, the manager will generally have the investment discretion to implement and monitor the investment program on an on-going basis. While these strategies can be customized for each participants' objectives, they generally require a substantial account balance and often carry a high cost.

Plan sponsor evaluation and considerations

Fiduciaries for a plan have obligations regarding the proper evaluation and monitoring of menu options made available to participants. Fiduciaries are expected to carry out their duties "with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims."[10] Furthermore, fiduciaries should discharge their duties with respect to a plan "solely in the interest of the participants and beneficiaries"[11] and act for "the exclusive purpose of providing benefits and defraying reasonable expenses of administration." To fulfill these obligations when selecting plan options, a fiduciary generally needs to engage in a prudent process, giving appropriate consideration to the facts and circumstances that the fiduciary knows (or should know) are relevant to the particular

[10] Source: ERISA Section 404(a).

[11] Source: ERISA Section 404(a)(1)(A).

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investment, and then act accordingly. If the fiduciary does not possess the required knowledge to properly evaluate the various options, the regulations indicate that they should engage an appropriate expert for guidance. While the above comments pertain to the evaluation of all investment options, the SECURE Act provided additional guidance designed to make the decision regarding retirement income products similar to the other options in the plan.

When evaluating insurance carriers (e.g., those that may provide annuity products to plan participants), fiduciaries need to consider "the financial capability of such insurer to satisfy its obligations under the guaranteed retirement income contract".[12] To help streamline the process, the Secure Act of 2019 indicates that the plan sponsor may rely on the state insurance regulators and an annual certificate provided to the plan sponsor confirming the insurer's solvency. As with any product evaluation, the fiduciary must consider the costs (inclusive of fees and commissions) relative to the benefits and product features of the contract. Fiduciaries should periodically review the continued appropriateness of the insurer and the product being offered to participants (verify the financial capability of the insurer to meet its obligations). If the plan sponsor determines that insurer can no longer fill its obligations as originally determined, it needs to end the relationship. However, since the plan sponsor cannot undo a participant's previously made annuity purchase, the obligation is to remove the carrier as an option and seek a replacement provider (if the plan wants to continue to offer annuities).

[12] Sources: The US Chamber of Commerce, "The Secure Act Summary and Applications" 052319_final_secure_act_summary.pdf (uschamber.com) and What the SECURE Act means for annuities - InvestmentNews.

As plan sponsors contemplate the possible retirement income options to include in their DC plans, it is also important to understand the participant base. Plan sponsors should consider the level of participant engagement in the plan. For plans that include a financially experienced, engaged base, some of the more complex structures may be appropriate. In many cases, participants do not have the time or knowledge to constructively evaluate the options, and hence they may disengage due to frustration and confusion. If so, a "one-stop" solution may be preferred. In any case, it is incumbent on the plan sponsor (and record-keeper) to provide the necessary participant education relating to menu options to enable participants to make informed decision. Specific education detailing the options for guaranteed income for those employees near or at retirement is recommended. This type of education can also be constructive for employees early in their career, especially if a plan option includes products like those that "purchase" guaranteed retirement income contracts throughout employees' participation in a product.

Summary

The defined contribution construct shifts many of the risks to participants, such as return and longevity risk, that pension plans had traditionally assumed. As defined contribution plans have increasingly become the primary retirement savings vehicle for individuals in the United States and a greater number of participants near and enter retirement, the investment community has recognized the need to offer additional retirement solutions.

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Many sponsors want to help their participants better manage longevity risk and the increasing concerns surrounding the viability of the social security system. Whether a plan offers a retirement income solution similar to those strategies discussed above or provides additional financial education to participants, all of these are steps in the right direction. Retaining more assets in the plan can increase the “buying” power of plan sponsors and continue to compress fees. Bolstered by recent legislation, including the SECURE Act of 2019 and SECURE 2.0, there has been an increase in the number strategies/products being offered to participants.

While annuities were historically the primary vehicle offered to provide a guaranteed income stream in retirement, they were often expensive, misunderstood, and generally produced less income than return seeking “growth” strategies. Newer annuity structures often benefit from “institutional pricing” that helps lower expenses and thereby increases the potential net income to participants. These structures also benefit from plan sponsor “due diligence” of the underlying provider and increased portability. While still complex, additional education is available to help participants make an informed choice.

Legislators, plan sponsors, and the investment community recognize the need to better help participants ensure their savings last through their retirement. Products that integrate “growth” strategies and guaranteed income to last a lifetime are available. Plan sponsors should evaluate the strategies available and make the best choice for their participant base, considering factors such as the level of financial literacy, demographic make-up, and account balances. Offering the “correct” product will not only benefit the participants but can also help employers better support their workforce.

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