RETIREMENT INCOME... A DEEPER DIVE

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In our previous article, we provided the rationale for the importance of implementing a withdrawal plan once a retiree initiates distributions from his or her defined contribution assets. There are a number of risks that could lead to a retiree depleting their resources. Having a withdrawal plan significantly reduces or may even eliminate those risks. The prior article introduced two generic types of withdrawal plans that are effective at reducing the probability of resource depletion: systematic withdrawals and annuities. This article will examine these withdrawal plans, known popularly as retirement income solutions, in greater detail.

One can examine retirement income solutions in three dimensions:

(1) In-plan or out-of-plan

(2) Product, managed or self-managed

(3) Guaranteed withdrawals, non-guaranteed or a combination of the two

In-plan or out-of-plan

The decision to offer in-plan retirement income solutions is driven largely by the plan sponsor's desire to keep retired and separated participants' assets in the plan. Why would the plan sponsor want to keep the assets in the plan? The answer is based on the human resource objectives of the employer. Does the employer want to actively support the retirement income objectives of its employees? Perhaps this paternalistic approach is a carry-over from an era when the plan sponsor's defined benefit plan, now terminated, was the primary retirement income vehicle. Some employers may offer in-plan retirement income solutions as a tool to provide a smooth transition to retirement and an effective method to manage its workforce. Some plan sponsors may view the decision primarily from a fee perspective. More assets in the plan help retain scale to reduce per-unit investment and administrative fees and allow access to investment products with high minimums.

The primary reason why a plan sponsor would encourage employees to withdraw all assets at retirement is liability risk. In our litigious environment, plan sponsors may desire to reduce participants and their assets in order to reduce liability exposure.

From a participant's perspective, there are a different set of advantages to in-plan solutions. Participants may benefit from lower fees with institutional pricing for investment management and elimination or reduction of transaction costs. Participants will also benefit from an additional layer of oversight with the plan sponsor managing the investment options offered in the plan. On the negative side, there are usually fewer retirement income choices offered with in-plan solutions.

The in-plan/out-of-plan decision is not as black and white as it may appear. The plan sponsor may not want the retiree's assets in the plan for liability reasons; however, the sponsor may support the retirement income and human resource objectives described previously. In this case, the sponsor may actively promote out-of-plan solutions, providing guidance to employees regarding choice and access, and assist with the asset transfer.

Product, managed or self-managed

Retirement income solutions can be grouped according to how the solution is packaged. There are no hard boundaries between these three categories as we will see.

With a managed program, the retiree's assets are invested by a professional investment advisor. The advisor

A product is managed by a financial institution, is broadly available to the retail or institutional marketplace, is usually regulated at either the state or federal level, and is not customizable to the retiree. The most common examples of products would be annuities and mutual funds. The fees for products are usually not negotiable.

The retiree may use products as part of his investment strategy (mutual funds) or part of his withdrawal plan (annuities) .

typically has discretion over the assets. The advisor will discuss with the retiree his risk tolerance, tax situation and financial objectives. From this information, the advisor will determine an appropriate asset allocation and develop a withdrawal plan. The advisor will implement the investment and withdrawal plan, monitor results and alter the program as the retiree's circumstances change. The advisor may use financial products to implement the solution. The advisor receives a fee for services, usually a percentage of the assets under management.

A self-managed program is, as the name implies, managed by the retiree. The retiree makes the decisions regarding asset allocation, investment choices and withdrawal plan. They will monitor results and make changes as needed. The retiree may use products as part of his investment strategy (mutual funds) or part of his withdrawal plan (annuities) . A key element of a self-managed program is education and guidance. The retiree will need help in selecting investments, developing an asset allocation, and constructing a withdrawal plan. The withdrawal plan may be composed of a systematic withdrawal strategy, an annuity or a combination of the two.

Withdrawals: Guaranteed, non-guaranteed or combination

Retirement income solutions are either guaranteed, non-guaranteed or a combination of the two. With a guaranteed solution, payments are guaranteed for a certain period, or the life or joint lives of the retiree and his or her beneficiary. This is commonly referred to as an annuity. A non-guaranteed solution is a systematic withdrawal strategy where there are no guarantees on the number of payments. Depending on investment returns and the amount of withdrawals, the retiree may or may not have adequate resources for the remainder or his or her life.

Guaranteed solutions (annuities)

There are many different types of annuities that would serve as a retirement income solution. A review of the most common annuities follow:

Immediate fixed income annuity. An annuity that commences immediately upon purchase where the payment is a fixed monthly amount. It would be payable for the life of the retiree or the joint lives of the retiree and his or her beneficiary.

Deferred fixed income annuity. This is the same as an immediate fixed income annuity except that payments are deferred to a certain date, usually the retirement date.

Immediate variable income annuity. This annuity is similar to the fixed income annuity except that the payment amount is adjusted periodically to reflect the performance of an investment portfolio that the retiree has selected. One variation of this type of annuity is where there is a minimum income guarantee.

Deferred variable income annuity. This is identical to the immediate variable income annuity except that payment commencement is deferred to a certain date.

Inflation-adjusted annuity. This is an annuity where the payment amounts are adjusted periodically to reflect inflation.

Qualified Longevity Annuity Contract. This type of annuity allows retirees to transfer 25% of qualified plan assets (up to $125,000) into an annuity that commences payment no later than age 85.

The advantages of annuities are the guarantee of payments for the retiree's lifetime and the elimination of investment risk or, in the case of variable annuities, the reduction of investment risk. The primary negatives are that annuities are not liquid and loss of funds should the retiree die shortly after payments commence.

Non-guaranteed solutions (systematic withdrawals)

Systematic withdrawals are rules-based approaches to determining retirement income, but, unlike annuities, the periodic payments are not guaranteed for the life of the retiree. The risks with systematic withdrawal strategies are asset depletion and investment risk.

There are three types of systematic withdrawal strategies that are commonly used: (1) Constant dollar method. A dollar amount is determined at retirement based on a percentage of the retiree's assets committed to the strategy. This dollar amount may be adjusted annually for inflation or other rules-based measures. (2) Endowment method. Each year a constant percentage of assets is withdrawn. (3) Life expectancy method. Annual withdrawals are based on the remaining life expectancy of the retiree (or joint life expectancies of the retiree and partner).

These withdrawal strategies can be managed in many different ways. The withdrawal strategy can be packaged in a product, known as a managed payout fund. This is a mutual fund with a built-in systematic withdrawal strategy. The investment approaches in these managed payout funds run the gamut. It could be a retirement tier in a target date fund series. It could be a multi-asset investment approach, a balanced (equity and fixed income) approach or a fixed income approach. Plan sponsors should confirm if these types of products are available on their record keeper's platform and are also operationally feasible due to required investor disclosures.

The withdrawal strategy could also be managed by a professional investment advisor. The advantage is that the withdrawal strategy can be customized to the retiree's needs. Finally, the withdrawal strategy could be self-managed.

Combination

A third approach to retirement income solutions is to combine guaranteed withdrawals with non-guaranteed withdrawals. One method is a product known as a guaranteed minimum withdrawal benefit (GMWB). This an insurance product that combines systematic withdrawals with an annuity. A minimum monthly payout is guaranteed for the life of the retiree or joint lives of the retiree and beneficiary. There is usually a feature for an increase in the monthly payment if investment performance is favorable. There is some liquidity as retirees may withdraw a portion of their account balance although that may reduce the guaranteed amount. Investment management and insurance fees are assessed against the account balance.

Another method is to buy an annuity with a portion of the retirement assets and run a systematic withdrawal strategy with the remainder of the assets. This could be done in either a managed program or a self-managed program.

In future articles we will review the advantages and disadvantages of retirement income solutions in greater detail and explore where the marketplace is headed. There is a clear need for innovative solutions along with enhanced communication and education as more retirees come to depend on defined contribution assets.

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