

Retirement Income Products: Which One Is Right for Your Plan?



Volume 4, Number 1

Introduction

As 401(k) plans have evolved from a supplemental retirement or capital accumulation plan to the sole retirement vehicle offered by most plan sponsors, sponsors and participants alike are increasingly focused on the decumulation phase—practically speaking, how to make the money last a lifetime.

For the majority of plan participants, the transition from work to retirement is one of the greatest challenges they will face. After spending decades earning a paycheck to provide for living expenses, newly minted retirees are suddenly expected to know what to do to convert a lump sum of amassed savings into a monthly income stream that won't run dry.

To address this need, product providers are offering a growing number of institutionally priced retirement income products. For plan sponsors, understanding the different types of products available is the first step toward selecting the right retirement income product for their participants. Although it will likely be the first time most plan sponsors have considered an option that involves guarantees and annuity features, many of the points in the process are the same as in the selection of a mutual fund option for the plan. The sponsor must follow the prudent steps necessary in the selection of any option and, of course, the process must be well documented.

This paper presents a framework to organize the major types of retirement income products available in the marketplace today and examine the merits of each in the context of the goals and objectives of a typical plan sponsor, as well as steps plan sponsors should follow as they explore retirement income products for their participants. It will take you from determining if there is a need to understanding

product types to examining the pros and cons of the individual products.

Framing the Big Picture

There are three questions that frame the important issues. A plan sponsor's answers to these questions will locate them in the "neighborhood" of products to consider:

- Do plan participants want or need a retirement income product?
- What is the best way to offer such a product—as an option at point of retirement or as an investment option inside the plan?
- How important is it to offer a product with income guarantees?

Once the plan sponsor arrives in the specific neighborhood, he should then undertake a thorough process of due diligence, consideration of product features, costs and benefits for the plan and participants, and how the product will be communicated to participants.

The table below outlines the range of products available today, along with a few key attributes.

In-Plan or Out-of-Plan?	Guaranteed or Non-Guaranteed?	Product Options Available
Out-of-Plan Products	Non-Guaranteed	Managed payout products Systematic withdrawal program
	Guaranteed	Annuity purchase program
In-Plan Products	Non-Guaranteed	Systematic withdrawal program Discretionary investment advice program
	Guaranteed	Deferred fixed annuity products Guaranteed minimum income benefit (GMIB) Guaranteed minimum withdrawal benefit (GMWB)

Do My Plan’s Participants Need a Retirement Income Product?

The first question a plan sponsor needs to answer is “Do my plan participants need, and will they use, such a product?” At a high level, the plan sponsor will want to consider:

- Average age of the company’s workforce
- Average income of participants
- Average participant account balance
- Availability of a defined benefit plan
- Participant demand for retirement income
- Participant acceptance of a lifetime income product

These are just a few of the factors to consider when deciding if a retirement income product makes sense. Once the decision to offer a retirement income product is reached, plan sponsors then need to decide whether to offer an “in-plan” or “out-of-plan” product.

Before advancing too far, it is important to mention two practical issues governing product availability. First, if a plan sponsor is considering a product that provides income guarantees using insurance or annuity features, he would be wise to invest a little time in determining availability of these products in the state (or states) where the company has locations. These products are regulated on a state-by-state basis, and although they are approved for use in most states, there are a few notable exceptions.

Second, some retirement income products require recordkeepers to integrate their technology with the retirement income product provider. Chances are good, at this point, that most recordkeepers support a range of products—but probably not all of the products available in the market. They are happy to provide a list of supported products to help narrow plan sponsors’ focus.

In-Plan or Out-of-Plan?

All of the products are designed to provide participants with an institutionally priced, predictable stream of income through retirement—but the devil is in the details. As a plan sponsor walks through this decision-making process he will quickly learn that each junction in the journey offers benefits as well as drawbacks. Each of these points should be carefully weighed and considered in light of the specific needs of the plan and participants.

On the out-of-plan side of the ledger, the sponsor has less fiduciary liability because investments are made in an Individual Retirement Account (IRA) after the participant leaves the plan. However, in-plan products are generally more easily communicated; they can be incorporated into employee communications efforts long before retirement. Another positive of in-plan retirement income products is the ability to retain participant assets in the plan, which may help to offset plan administrative expenses for the benefit of all participants.

Out-of-Plan Products

Out-of-plan products are not plan investments, per se. They are essentially referral programs that assist participants in making decisions on how best to invest once they reach the point of retirement and terminate from the plan. In that regard, they should really be thought of as integrated rollover programs.

Out-of-Plan Products—Guaranteed

Guaranteed out-of-plan products are generally institutionally priced IRA annuities offered through a firm that matches up participant needs with an appropriate annuity product and payment stream. This process removes many of the fees and expenses associated with retail annuity products. In the case of a retiree purchasing a \$500,000 annuity, the difference between the institutionally priced product

and its retail equivalent can mean thousands of dollars of additional income over the course of a participant's retirement.

With out-of-plan products, the purchasing service is responsible for gathering and comparing the costs and features of different products being made available. This greatly simplifies the plan sponsor's responsibility, which is limited to ensuring that the annuity purchasing service provides accurate information to participants and carrying out the administrative processes to facilitate the rollover transactions.

When purchasing an annuity using this type of service, the participant must answer a number of questions:

1. How much of my rollover do I wish to invest in the annuity?
2. Am I interested in a single-life or joint-and-survivor (or spousal) benefit?
3. Do I want a payout that is period certain, guaranteed for life, or a combination of the two (i.e., life with period certain)?
4. Am I interested in a benefit that provides inflation protection?

At that point, the purchasing service will receive bids from several insurance companies. These bids will be provided to the participant who then decides to make or not make the investment. Once the annuity purchase is made, the participant's assets leave the plan and move to an IRA with the insurance company.

We have seen very little usage of these products. The reasons for this low level of acceptance are well-documented. One common concern about this approach stems from the fact that the annuity purchase is an intimidating and irrevocable decision. The participant loses control of the assets and cannot pass any residual balance on to heirs upon death.ⁱ

Another significant concern is interest rate—or point-in-time—risk. When participants reach their “golden

age” and are finally able to retire, the attractiveness of these products is directly linked to interest rates. In recent years, the appeal of guaranteed income has had a difficult time overcoming the low-interest-rate environment. While the present low-interest-rate environment may persist a while, at some point, interest rates are likely to rise. When that happens, the appeal of these products may get a boost.

Finally, as with all guaranteed products, the participant must assess the creditworthiness of the insurance company and its ability to pay the benefit, hopefully for many decades.

Out-of-Plan Products—Non-Guaranteed

There are out-of-plan products available that do not involve income guarantees or insurance. These products are typically referred to as “managed drawdown” or “managed payout” funds (or programs), and come in two basic flavors.

One type of managed drawdown account provides a percent of principal paid to the retiree each year, which can range from 3 percent on the low end to as high as 7 percent in some cases. While a higher payout rate may be appealing, it is important to note that greater risk must be taken in the underlying portfolio. This typically means a higher allocation to equities. Up to a point, a higher equity allocation can help support higher withdrawal rates; however, beyond a 60 or 70 percent allocation, higher portfolio volatility increases the probability of the participant outliving his retirement portfolio.

The other managed payout product is designed to liquidate principal over a specified time period, typically a 10-, 20-, or 30-year period. More macabre advisors call these products “target death” funds—a play on “target date” funds, which are widely used as an accumulation-oriented investment option in 401(k) plans. While these portfolios are constructed with the goal of providing a consistent payout, the amount paid

in a year will vary based on actual investment returns realized.

These funds address a retiree's reluctance to give up control of his savings and satisfy a desire to leave residual savings to heirs, but they do not provide guarantees. The payment amount can change—or even cease. Thus, there is a very real threat of a participant outliving his assets or being forced to live on far less than expected.

In-Plan Products

In-plan products are options that are available as an investment option in the plan, just like “regular” investment options—meaning that participants can select them from the plan's menu and direct some or all of their contributions to the option. To date, adoption of these products has been limited, perhaps because they tend to be more complex than other options available. Or perhaps they have not been communicated effectively to participants.

An important new trend that may be emerging is plan sponsors considering using in-plan retirement income products as their plans' Qualified Default Investment Alternative (QDIA). This is certainly permissible and addresses many of the behavior-based adoption challenges that retirement income products have had to date. Evidence of a trend is mostly anecdotal at this point, but one notable development this year was United Technologies' launch of a program called Lifetime Income Strategy. Lifetime Income Strategy is a model program—used as the plan's default investment option—that allows participants to dollar cost average into a diversified portfolio with a guaranteed income component.ⁱⁱ

Whether they are considering a retirement income product as an add-to-menu or default investment option, plan sponsors should do their homework and thoroughly document the due diligence process they follow.

In-Plan Products—Non-Guaranteed

Systematic withdrawal programs have been available in many plans for decades but have seen little usage. These programs allow a retired participant to determine the amount and frequency of his retirement income stream. This form of drawdown strategy allows the participant to both budget for regular income and take periodic lump sum distributions as the participant feels necessary.

Another in-plan distribution method that has recently seen traction is a discretionary investment advice or managed account program. In this option, a professional investment manager oversees the participant's assets, managing an investment strategy created using information provided by a participant and updated annually. These programs are intended to help a participant effectively get to retirement and also manage assets through retirement. They allow a participant to move seamlessly from accumulation to decumulation without having to change advisors.

In-Plan Products—Guaranteed

We will now focus on retirement income products with an annuity component that can be made available as an investment option in-plan and that can be selected years in advance of a participant's retirement date. We will examine three types of products—deferred fixed annuity, guaranteed minimum income benefit (GMIB), and guaranteed minimum withdrawal benefit (GMWB) products.

Although the features and benefits of these in-plan products vary from provider to provider, at a high level they share the following defining attributes.

Product Type	Defining Attributes
Deferred Fixed Annuity Products	<ul style="list-style-type: none"> • The participant systematically purchases a deferred fixed annuity through regular contributions. • Guaranteed future income is computed based upon actuarial assumptions and prevailing interest rates at the time of each contribution. • To receive this income, a participant must annuitize at time of retirement and, thus, loses control of the asset.
Guaranteed Minimum Income Benefit (GMIB) Products	<ul style="list-style-type: none"> • Participant contributions purchase a minimum level of guaranteed future income. • The level of income guaranteed can increase based upon performance of the underlying investment portfolio. • The participant must annuitize his account at time of retirement to realize the income benefit.
Guaranteed Minimum Withdrawal Benefit (GMWB) Products	<ul style="list-style-type: none"> • Contributions fund the participant's "benefit base," which is used to calculate guaranteed withdrawals in retirement. • A participant continues to have control over this account, both before and after retirement. • Guaranteed income is based upon a specified percentage (e.g., 5 percent) withdrawal rate applied to the benefit base. • Good performance of the underlying investment portfolio can increase the benefit base, positively impacting the guaranteed income stream in retirement. • The benefit can be captured without a requirement to annuitize. • These products provide a guaranteed withdrawal—not a guarantee of principal.

Due Diligence Process

Once the plan sponsor determines the preferred type of in-plan retirement income product, the process for selecting a specific product can begin.

Investment Product Evaluation

Many of the in-plan products have underlying investment vehicles and asset allocation strategies. The plan sponsor needs to understand the underlying asset allocation by answering a few questions:

- Does the asset allocation change as the participant ages?
- How does the asset allocation match the risk tolerance of the plan participants?
- Is the level of risk appropriate given what I know about my plan participants?

Here we normally find a plan sponsor following steps similar to those used in the selection of a target date or risk-based fund, including an examination of the asset allocation, asset classes employed, underlying funds, and acceptance of the product in the retirement plan marketplace, as well as recordkeeper availability.

Fees and Expenses

Similar to the selection of other products in a 401(k) lineup, the plan sponsor is not obligated to select the lowest-cost provider. However, it is important to understand the fees and expenses of any investment option in the plan. When evaluating fees for retirement income products, plan sponsors should consider total expense of the product, including the cost of underlying investment products (if applicable) and the cost of annuity features or income guarantees associated with the product.

When evaluating the cost of underlying investment products, plan sponsors should compare the fees to mutual funds or other investment vehicles with similar investment objectives, such as balanced, target date, or risk-based funds. Although the cost of income guarantees may be more difficult to analyze due to the limited number of “peer group” products offered in the marketplace, plan sponsors should make every effort to compile fee information of similar products and evaluate the reasonableness of fees relative to the guarantees provided.

Another consideration when evaluating fees involves contract provisions related to fees. For example, if the contract allows for fee changes, how often can they be changed and by how much? Plan sponsors should note any previous fee changes for the product under consideration, because the provider’s past behavior may be a prologue.

We also find plan sponsors taking comfort in the knowledge that other sponsors have performed due diligence on these products. A high level of acceptance of a particular product by the plan sponsor community is often perceived as an important check in the plan sponsor’s fee evaluation.

In the end, plan sponsors must combine all these elements into a complete understanding of fees and expenses that may be charged to a participant—and

make an assessment of the reasonableness of that fee, given the benefits offered.

Strength of the Guarantee

Because of the long-term nature of the guarantees offered by this type of retirement income product, the ability of the provider to meet its obligations into the distant future is a critical aspect of the evaluation process. Many sponsors look at the ratings of these insurance companies assigned by independent rating firms. However, as a result of criticism these firms received during the financial crisis, one would expect plan sponsors to take a deeper look into the providers’ viability.

One area of focus should be on the source of these lifetime income payments. Are they coming from an insurance company’s general account—which is subject to creditors’ claims? Or are they coming from a separate account, where assets are cordoned off from creditors of the insurer? We find that documenting the insurance company’s balance sheet strength, corporate structure, availability of reserves, and other related financial information is extremely important. The analysis is similar to the kind of review that plan sponsors do when considering stable value providers.

A plan sponsor should also evaluate the insurer’s risk-management capabilities, specifically its ability to hedge the risks associated with these products. There were many lessons learned during the financial crisis of 2008 that provided a real-life “stress test” to help sponsors evaluate the insurers’ risk-management practices.

One final step is to explore what protection may be provided by state guarantee associations for the retirement income product in question. It is important for plan sponsors to understand the specifics of their situation. Because insurance products are regulated

on a state-by-state basis, coverage can vary dramatically.

Portability

Another critical consideration for these products is portability of income guarantees that have been accrued. Portability takes two different forms—participant-level portability and plan-level portability.

When a participant leaves a plan, can lifetime income guarantees be retained or rolled into an IRA? If so, what is the cost? And do product features change? If the plan sponsor changes recordkeepers, can the new recordkeeper keep the product intact or provide a similar product?

In some cases, we have found that the guaranteed benefit can be retained and frozen—even though no new contributions are accepted. Another possible approach to plan sponsor portability is to allow in-service distributions for participants near retirement. This allows individual participants to decide if they want to roll into an IRA and retain their accrued benefits.

Portability is a major issue today but should wane as a concern as these products gain greater availability and acceptance in the marketplace. We expect to see retirement income products evolve—much as mutual funds did—from proprietary products and closed platforms to complete open architecture. However, at this time, a plan sponsor must understand the cost of divorce before entering into a marriage with an insurance company.

Participant Education and Communication

These products can appear complex, with many restrictions and rules to follow. Benefit calculations may not be immediately intuitive to the average plan participant. Further, annuities have historically carried a negative stigma due in part to the high cost of retail

annuity products and the loss-of-control issue previously described. Product providers have attempted to address these concerns through product design and institutional pricing, so these “legacy issues” may be more perception than reality. Nonetheless, practical experience tells us that if these products are not framed properly for plan participants, adoption will be quite low.

As with any product new to the 401(k) marketplace, education is necessary to ensure proper use. Plan sponsors should understand who will be providing participant education—the product provider, the recordkeeper, or an independent advisor—and what form that education will take. Ideally, communication with participants should take multiple forms, including printed mailers and collateral, web-based events or recordings, in-person group or one-on-one meetings, and call center support. Plan sponsors should also consider and evaluate tools, such as income or retirement planning calculators, to assist participant decision making. To be most effective, the participant education strategy and mix of specific tactics employed should be evaluated and tailored to fit the plan sponsor’s workforce.

Increasing use of in-plan retirement income products as QDIA presents plan sponsors with both an opportunity and a challenge when it comes to participant communication. Taking an opt-out approach means they can drive product adoption through participant inertia, enabling participants to accumulate guaranteed retirement income without requiring them to make an active decision.

Still, it is incumbent upon plan sponsors to help participants understand plan investment options—especially the QDIA—so they can make good decisions about their savings. It is also important to communicate the benefits these products provide to help participants “bridge” from retirement assets accumulated to retirement income that they can

expect. A better understanding of how assets translate into income may allow them to know when it's time to retire and do so with greater confidence.

Conclusion

Retirement income products are helping plan sponsors and participants address growing concerns about how best to create reliable income in retirement. This paper has addressed multiple considerations and provided a framework to assist plan sponsors as they seek to understand and evaluate retirement income products for their plans and participants.

Although retirement income products are relatively new and may be unfamiliar to many plan sponsors, the process plan sponsors follow to evaluate these products should not be fundamentally different than the process used to evaluate other, more "traditional" products. Plan sponsors should take the time and effort to understand the choices available in the marketplace and the cost and benefits of those choices for their participants. For plan sponsors with minimal experience working with these types of products, prudent consideration should be given to the utilization of external subject matter experts.

About the Author

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ⁱ http://www.nytimes.com/2011/06/05/business/economy/05view.html?_r=0

ⁱⁱ <http://www.investmentnews.com/article/20120628/FREE/120629920#>