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Fiduciary Must Be More Effective In Converting the Accumulated 401(k) into a Reliable Lifetime Income Stream

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Americans are living longer today than at any other time in history. Improved nutrition, breakthroughs in the fight against life-threatening diseases, and healthier, more active lifestyles have contributed to our nation's unprecedented longevity—and life expectancy is likely to continue to increase. When plan participants or their advisors use life expectancy estimates to determine how much money they will need for their retirement, they usually think of "life expectancy" as an estimate of how long they are likely to live. However, life expectancies are actually a measure of how long people live on average.

This means that half of plan participants who use life expectancy averages as a guide for the number of years to fund in retirement may outlive their retirement savings. In fact, while only 15 percent of plan participants may live to age 95, in theory 100 percent of the participants will need to fund for this possible event if such funding is being done on an individual basis. If they do not, they have no way to make up the shortfall caused by life longevity if they should be lucky enough to experience it. What is really needed—and what is a more practical solution is- some type of mortality pooling or longevity insurance to be utilized by most defined contribution plan participants to cover the risk of running out of money in their later years of retirement in an economical cost-efficient fashion.

- *Longevity Risk* is the risk that the individual will exhaust his or her account before death and experience a substantial decline in income and living standard.
- *Sequence Risk* is the risk that an investor will obtain a few bad years of investment results just before or just after they retire. Even though the average return over a 20-year market cycle for them ends up being reasonable, they will experience a retirement income failure.
- *Investment Risk* is the risk that the assets in which the individual has invested his or her retirement account will decline in value.
- *Inflation Risk* is the risk that price increases will cause the individual's retirement income to decline in purchasing power.
- *Unexpected Events Risk* such as divorce, the death of a spouse, the cost of medical care, or a need for long-term care services are also financial risks.

There are strategies for dealing with each of these risks, but no single strategy can effectively handle all of them. For example, purchasing a life annuity insures against longevity risk and it shifts the investment risk to the insurer. However, only purchasing an annuity depletes the purchaser's available assets by the amount of the premium. These assets are no longer available to the retiree in the event of a catastrophic illness or other unexpected major expenses. To date, the demand for annuities has been low. There are many reasons for this low demand, but one of the most important has been that many potential annuity purchasers do not understand, and therefore do not value, the longevity insurance provided by annuities.

In addition, a worry for plan sponsors is the fiduciary responsibility for annuities. Given the complexities of these products and the bad news currently swirling around the insurance industry, consultants warn employers to really do their due diligence [Chen, Z., "Guaranteed Minimum Withdrawal Benefits (GMWB): The Next Subprime Crisis? Cheriton Symposium 2007]. In this situation, a discretionary trustee following the DOL "Safe Harbor" guidelines for annuity purchases can be of great benefit to both the plan sponsor and the plan participants.

In the past the general trend for defined contribution plans was to only offer lump sum distributions. This is unlike the defined benefit plan where the typical distribution was a life annuity of regular monthly income payments. However, since many defined contribution plans only provide lump sum distributions, which may not be effectively managed by retirees, the ERISA Advisory Council asked the DOL to revise the rules to make it easier to offer annuity options in defined contribution plan [ERISA Advisory Council U.S. Department of Labor, “Report on the Spend Down of Defined Contribution Assets at Retirement,” 2008]. In addition, the PPA directed the DOL to issue guidance to clarify that Interpretive Bulletin 95-1 (dealing with defined benefit annuities) did not apply to defined contribution plans and to issue regulations stating that the selection of an annuity contract as an optional form of payment from a defined contribution plan is not subject to the safest available annuity standard.

The DOL established a safe harbor for selecting an annuity provider and annuity contracts for benefit payments from defined contribution plans [U.S. Department of Labor Proposed Regulations, 29 C.F.R. Part 2550 RIN 1210–AB19 Selection of Annuity Providers—Safe Harbor for Individual Account Plans, *Federal Register* 58447-50, October 7, 2008]. The regulations clarified that the DOL is not establishing either minimum requirements or the exclusive means for satisfying fiduciary duties for selecting an annuity provider.

The DOL annuity selection safe harbor requirements are satisfied if the plan’s fiduciary:

- Engages in an objective, thorough and analytical search for the purpose of identifying and selecting providers from which to purchase annuities. This process must avoid self-dealing, conflicts of interest or other improper influence and should to the extent possible, involve consideration of competing annuity providers;
- Appropriately considers information sufficient to assess the ability of the annuity provider to make all future payments under the annuity contract;
- Appropriately considers the cost (including fees and commissions) of the annuity contract in relation to the benefits and administrative services to be provided under such contract;
- Appropriately concludes that, at the time of the selection, the annuity provider is financially able to make all future payments under the annuity contract and the cost of the annuity contract is reasonable in relation to the benefits and services to be provided under the contract; and
- If necessary, consults with an appropriate expert or experts for purposes of compliance with these provisions.

The final regulations clarify that engaging an independent expert is not required in all cases.

Although an annuity provider’s ratings by insurance rating services (e.g., Standard & Poor’s, Moody’s) are not part of the safe harbor, in many instances plan fiduciaries may want to consider them, particularly if the ratings raise questions.

In response to market volatility several insurance companies have promoted “market hedged” Guaranteed Minimum Withdrawal Benefit (“GMWB”) variable annuity products [Goodman, B., Tanenbaum , S., “The 5% Guaranteed Minimum Withdrawal Benefit: Paying Something for Nothing?” CREF-TIAA Institute, April 2008]. These products allow the plan participant to withdraw over his or her lifetime five, six, or in some cases, even seven percent of a portfolio value that is the greater of their initial investment or market value. This “have your cake and eat it too” concept can be very appealing to plan participants frightened by the recent market volatility. The GMWB insurance product seems to offer everything that retirees are looking for. However, a deep dive into the data will reveal that it does not offer much value due to costs and risks listed below:

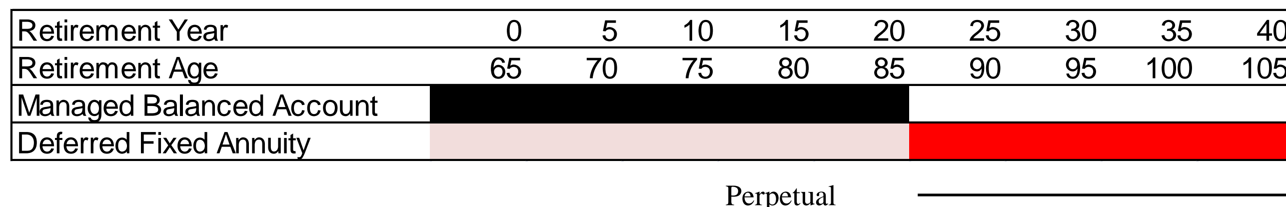
- *Hedge Cost* is the cost of the market hedge. The hedge coast can be 50 basis points to 300 basis points (0.50% to 3.00%) per year. This effectively eats up much of the excess market return above fixed income return. As markets become more volatile the cost the hedge jumps significantly.
- *Hedge Mis-Match* is the risk that equity hedge (generally S&P 500 futures contract) does not perform in line with the actual portfolio holdings. In 2008 for example, many equity assets classes such as mid-cap value, international equities and REITs performed significantly worse than the S&P 500.
- *Carrier Risk* is the risk that the insurance carrier may fail. Many carriers offering GMWB products either did not hedge, incorrectly hedged, or failed to price the hedge in line with actual hedging costs. This resulted in near failure of many carriers and a need to re-price (higher costs) the products in the future.

This GMWB insurance product only has value if the performance of the underlying funds is extremely poor. Assume the plan participant has purchased a 5 percent GMWB product with $100,000. The 5 percent minimum annual payout would be $5,000. If the S&P index has a 0 percent return for 20 years, and the policyholder is still alive, then the $5,000 income guarantee has value; at that point the account balance is zero but annual payments of $5,000 will continue for life. But the vast majority of the time, the investor is only receiving his or her own money back, along with its investment earnings. And for this, he or she is paying an extra 50, 100 or even 300 basis points per year. In addition, as this paper will demonstrate later, late annuitization is a better way to guarantee lifetime income.

In a recent survey more than 70 percent of financial advisers said they were concerned about the risks insurers have taken on with guaranteed-minimum variable annuities—and nearly a third said they doubted the insurers themselves understood those risks [Scism, L., "Brokers Fear Many Insurers Are Ignorant of Annuity Risks," *Wall Street Journal,* April 6, 2009].

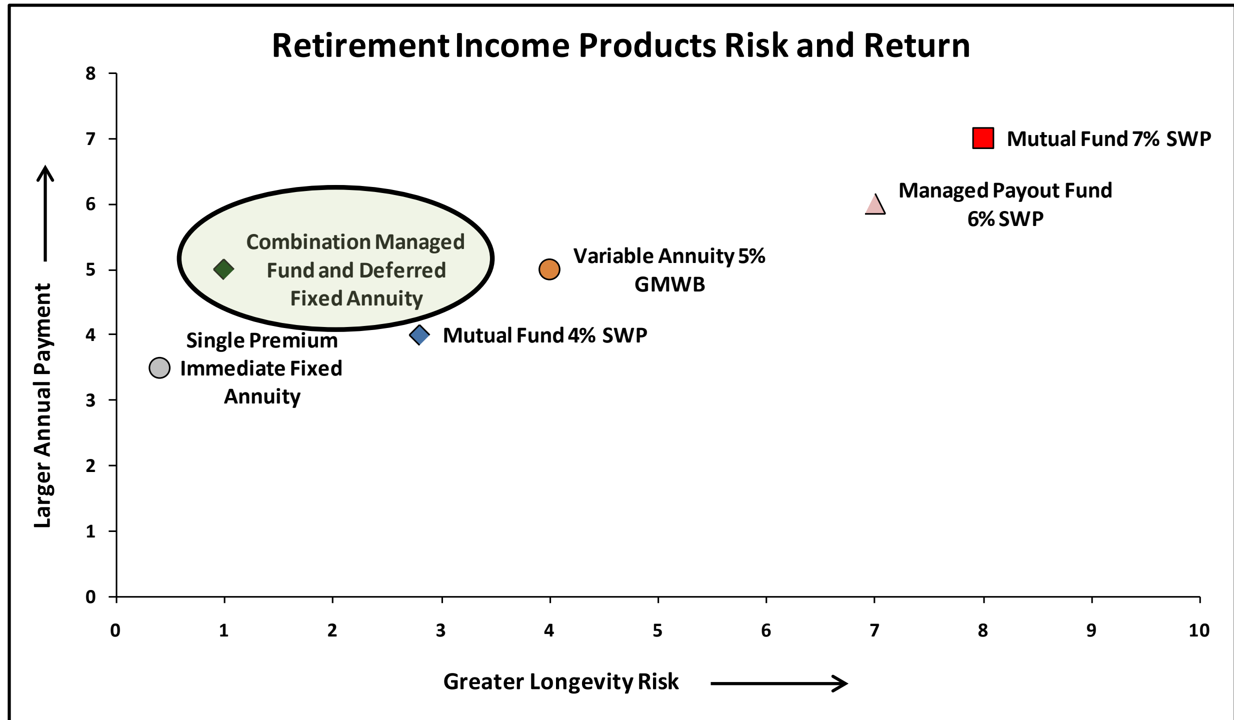
After the 2008-2009 bear market numerous big insurers significantly reduced the aggressiveness of their offerings, many citing the soaring costs of the financial hedges they buy to offset their market exposure [Shidler, L., "Lifetime-Guarantee Annuities Could End Up Biting Insurers," Investment News, February 26, 2007]. Some have tweaked guarantees to offer less-generous benefits at higher prices to new customers, while others have suspended sales of certain guarantees as they await regulatory approval of more fundamentally retooled versions. Consultants and analysts say it is too soon to tell how far-reaching this trend will be [Goodman, B., "Annuities: Now, Later, Never?" CREF-TIAA Institute October 2006].

Because no single strategy protects against all five risks, we believe the optimal strategy is *"Dual Phase Portfolio."* The Dual Phase Portfolio is a combination of a managed balanced account and a deferred fixed annuity.



Retirement Year	0	5	10	15	20	25	30	35	40
Retirement Age	65	70	75	80	85	90	95	100	105
Managed Balanced Account									
Deferred Fixed Annuity									

This process includes both a 20-year diversified market-based balanced portfolio and a deferred fixed annuity to protect against longevity risk beginning with a lifetime payout at age 85. This combination offers the best compromise between having a low longevity risk and earning enough equity risk premium to provide inflation adjusted attractive monthly income payouts.



1. Combination Managed Balanced Account and Deferred Fixed Annuity
2. Variable Annuity with 5 percent Guaranteed Minimum Withdrawal Benefit ("GMWB")
3. Single Premium Immediate Payout Fixed Annuity
4. Mutual Fund Portfolio with 4 percent Systematic Withdrawal Program "SWP"
5. Mutual Fund Portfolio with 6 percent Systematic Withdrawal Program "SWP"
6. Managed Payout Fund with 6 percent Systematic Withdrawal Program "SWP"

There is no one method that works for all participants, but in general a fiduciary template can be created as a starting point. The most useful method is to create a "Dual Phase Portfolio" for the retirement income client. This approach is attractive for the retirement client seeking an inflation adjusted five percent real annual total portfolio payout with only modest risk of failure. The actual real (inflation adjusted) annual payout from the managed balanced sub-account would be 6.4 percent to 7.1 percent, depending upon the fractional allocation placed in the deferred fixed annuity and capital market forecasts.

A more prudent course of action involves hedging longevity risk rather than trying to hedge the stock market [Antolin, P., "Policy Options for the Payout Phase," OECD Working Paper on Insurance and Private Pensions, September 2008]. Longevity risk can effectively be hedged with a deferred fixed annuity that only begins to pay out starting at age retirement plus 20 years. This annuitization delay also gives the retirement client some estate planning flexibility as well, since death prior to the annuitization date leaves the funds in the plan participant's estate.

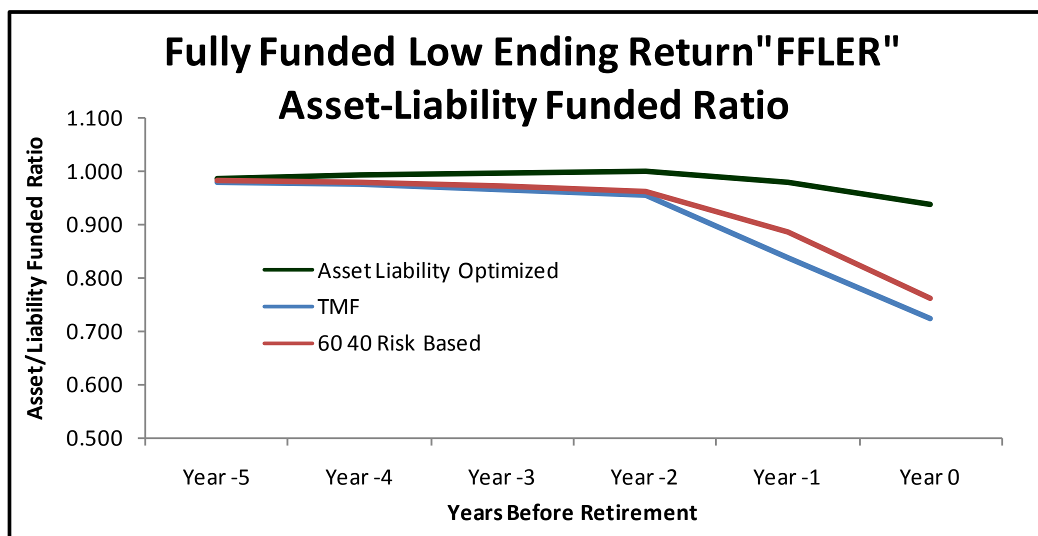
In the future successful plan fiduciaries must produce a seamless transition from the accumulation of

the distribution phase. Plan participant communications and meetings must focus to a greater degree on the monthly retirement income that their portfolio is likely to produce, as opposed to absolute portfolio values. This requires a change in thinking of the 401(k) as a "wealth accumulation tool," to a "retirement income producing process." The participant mindset must change from having to decide "what to do" with their money when they retire to one of expecting a monthly income from the plan when they retire.

The plan participant's portfolio performance matters most during the period when they have the most invested. In the accumulation phase this is at the end, whereas in the distribution phase this is at the beginning. The problems with target date funds losing significant amounts of a near-retiree's 401(k) balance are well documented [Kimes, M., "Target Funds Miss the Mark," CNN Money, April 27, 2009]. If ever there were a product whose time has come, a guarantee that the plan participant would not lose the money as they near retirement, whatever happens with the market, would seem to be it. Many insurers argue this is necessary for people age 50 and over, who may not have time to recoup big investment losses. Employees near retirement need reliability because, even with high success Monte Carlo simulations, as they only get one shot at retirement.

The 2007–2009 market slide showed that there is a great need for guaranteed 401(k) products, but it also raised questions about just how well insurers understand the risk of dealing with complex financial instruments—such as the ones used to guarantee investments. The near-collapse of a big name like AIG heightened some employers' concerns about setting up relationships with insurers that need to last decades. So the ability to hedge and guarantee 401(k) plans exposed to full stock market risk is highly questionable. A different answer must be found.

There is no evidence of proven methodologies that reduce equity market sequence risk in a portfolio. One answer is less equities (risk) for those who are actuarially fully funded. The future defined contribution plan must allow the discretionary trustee to select from different risk portfolios based upon funded status and other BPS criteria. The chart below shows a 60 year-old fully funded plan participant near retirement in a bad economic environment. On an actuarial basis, he or she is fully funded for an adequate benefit beginning at the Social Security Normal Retirement Age The participant has three possible choices: a risk-based 60 percent equity, 40 percent fixed income fund, a typical target date fund or a trustee-managed asset-liability matched QDIA portfolio. We call this the "Fully Funded Low Ending Return" participant.



Only the lower risk actuarial asset-liability match ("ALM") produced a reliable retirement benefit for the fully funded participant with low ending return ("FFLER"). This is due to a more conservative

portfolio that still produced an adequate benefit—without any market timing forecast. The higher equity (risk) of the static 60 percent equity lifestyle portfolio and the target date glidepath experienced a significant decline in benefit adequacy as the market returns tailed off at the end of the accumulation period. This significantly reduced the account value below that needed for a reliable fully funded benefit

Employers typically experience significantly higher rates of turnover among younger segments of their workforce. For many employers, reducing turnover among these ranks is critical to their overall success. Employees younger than 35 who value their plans most highly and are very satisfied with them are more likely to remain with their current employer than other young employees. This is particularly true for defined benefit plans. Of those who are happy with their defined benefit plan and consider it very important, one-half say they firmly expect to stay with their employer. On the defined contribution side, those who value their plans and consider them very important also indicate a greater likelihood of sticking around, but the difference is less pronounced than it is for defined benefit plans.

Lower employee turnover reduces costs and improves productivity, and thus can significantly increase shareholder value. To measure the influence of both types of retirement plans on employee behavior, Watson-Wyatt examined how a plan's value to employees affected their desire to stay with their employer [Watson Wyatt—Insider, "How Do Retirement Plans Affect Employee Behavior?" April, 2005]. Of employees highly satisfied with their benefits 73 percent were also satisfied with their jobs. Of employees not satisfied with their benefits only 22 percent said they were satisfied with their job. Employees who consider their defined contribution plan very important are 2.5 times more likely to intend to stay with their current employer. It may surprise plan sponsors to learn that total shareholder return is several time higher in companies where the employees are satisfied with their defined contribution plan. According to a Money study of 26,000 employees, people who are satisfied on the job actually put in longer hours than less satisfied employees. Not surprisingly, younger workers who do not consider their plans important and are not particularly satisfied with them appear much less committed to their employer [Kelly, R., "Most satisfied employees work longer," April 12, 2006 © CNN Money].