Retirement Income

Plan sponsors should start thinking of their defined contribution plans as retirement income vehicles rather than just savings plans. By reframing the purpose of the defined contribution plan, say the three industry experts that P&I brought together for a wide-ranging discussion, the spotlight moves from simple accumulation to the drawdown phase, providing income to participants in retirement. It’s an area that has seen a lot of discussion and a lot less action in the past few years.

That trend is beginning to reverse, as the industry develops solutions to meet a range of plan sponsor and participant needs, and the regulators weigh in with some new guidance that provides clarification. Participants are asking for help. The way forward is, however, not completely clear. That’s because it’s a complex area where few solutions can be described as simple. Nevertheless, the industry is gearing up to move forward, particularly as it’s likely to be a lengthy process without a one-size-fits-all solution.

P&I: Why are defined contribution plan sponsors more interested today in retirement income solutions?

Jim Smith*: There are a couple of different factors driving this interest. There are demographics — a huge group of baby boomers is nearing retirement. A lot of them, at least for the latter half of their careers, have been covered by DC plans. Reality is hitting them: they are retiring and they need a plan to spend these savings in retirement. Help is also being requested by groups of participants. They want a solution to help them in the drawdown phase.

Plan sponsors and the investment community have also realized that we have moved from addressing the accumulation stage to having to address the drawdown stage. For the accumulation stage, we looked at various products and solutions, so why aren’t we doing the same thing with the drawdown stage? Plan sponsors want to know what will work with their plans and what variety of options are available.

Roberta Rafaloff: As Jim said, there’s an ongoing recognition that, for most workers today, a 401(k) plan is really their only significant retirement savings program. Plan sponsors also understand that the majority of the responsibility and risks associated with retirement — longevity risk, investment risk, economic risk — rest with the individual plan participants. They are going to have to make sure that the savings that they have accumulated in these plans last as long as they do.

Some of the research we’ve done at MetLife shows that two-thirds of DC plan sponsors believe that it is very or extremely important for them to offer solutions that help their employees create a sufficient retirement income. We believe that this is a promising development because plan sponsors who do act in the best interest of their participants really do have a critical role to play in enabling the right outcomes for the plans for which they are responsible. For years, plan sponsors have focused almost singularly on encouraging their participants to save for retirement, but that’s only part of the retirement equation. Enabling participants to turn at least part of their savings into a stream of income that can’t be outlived is the other.

Drew Carrington: There has clearly been some regulatory focus on this topic. The Treasury Department has issued several pieces of guidance and the Department of Labor has also been active in this space. There is talk about incorporating income projections on participant statements so there has been a bit of a nudge on that side. I echo both Roberta and Jim’s comments on the way that plan sponsors are thinking about the retirement income challenge. I would also add a couple of things.

One is that we are starting to see a move beyond viewing this challenge through an exclusively altruistic lens. Plan sponsors don’t just need to help participants with retirement because it’s the right thing to do. They are actually starting to treat it more as a nuts-and-bolts business decision.

There are reasons to do this to ensure that participants who have accumulated enough are able to retire so that plan sponsors can avoid what I’ve heard referred to as RIP—Retired in Place. That is, workers who would like to retire and would otherwise be able to—but because we haven’t prepared them, or given them the right tools or communications—they don’t know how to go about the process of retiring. So today, there is a business reason for providing retirement income solutions.

P&I: Picking up on Drew’s point about the nudge

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from the regulators, is this enough to dislodge what seems to be a logjam?

Roberta Rafaloff: We’re hopeful that some of the regulatory actions will start to drive things a little forward. If you think about what’s happened even in the last 12 months, you’ve got the regulations from Treasury on qualifying longevity annuity contracts (QLACs) that really enhance the product offerings that can be made available to DC plan participants. We think these regulations will be very helpful. We are still waiting for the proposed rulemaking from the DOL on getting income projections onto benefits statements.

We hear from Congress and from academics that products such as annuities all satisfy a very important and crucial need. But until we start to see some more guidance from Washington, the movement will continue at its current pace.

Jim Smith: More action from regulators would move the cause along. It’s beginning to happen. To pick up on another of Drew’s points, I do see some plan sponsors, especially larger ones, viewing their DC plan from more of a business standpoint and starting to address retirement income more concretely.

I don’t think we can rely entirely on regulation to clarify matters and drive retirement income forward. There have been steps in the right direction and that’s good to see. I’m just not sure that I’d wait for all to be crystal clear and clarified by the regulators.

P&I: If this interest in retirement income is a paradigm shift, as some say, why is this so important for participants?

Roberta Rafaloff: Most workers accumulate money for retirement in some sort of retirement vehicle, but most don’t know what that translates into in terms of income. On top of that, they have no idea how long that income is going to have to last.

Most people today live paycheck to paycheck to meet basic living expenses. Connect that to the fact that most experts believe that workers are going to need up to 85% of their pre-retirement income just to maintain their standard of living in retirement and it’s clear that asking people to figure out how to generate enough monthly income becomes incredibly important. But for most people, this is a really daunting challenge.

Drew Carrington: It is a complex problem. It’s further complicated by the fact that most folks are going to have multiple sources of retirement income and have to figure out how to integrate all of them. The other day I read that, for a working married couple aged 62 that both worked, there are over 567 combinations of ways to claim Social Security.

When you start thinking about this problem, as Roberta says, it’s daunting. The stakes are high. If you make a mistake with regard to retirement savings when you are 30, you can fix it. You can save more. You can change the investment mix, you can save more, and so on. But if you make a mistake in retirement, it’s very difficult to correct.

~ Drew Carrington, Franklin Templeton Investments

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FRANKLIN TEMPLETON INVESTMENTS

<gain from our perspective*>
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It may be useful to think of all the retirement income solutions that are available as a spectrum that runs from maximum flexibility to maximum guarantee.

A systematic drawdown program would be at one end of the spectrum, offering full flexibility and few guarantees. At the other end would be the annuity offering or a complete guaranteed income solution.

~ Roberta Rafaloff, Metropolitan Life Insurance Company

If you make a mistake in the years close to retirement, it is much more challenging. The estimated date of retirement is harder to move. It’s harder to save more to correct a significant error. You may have already suffered a significant decline in your portfolio, as many people did in 2007-8. It’s harder to increase your savings enough to overcome an asset allocation misstep.

The decumulation piece of the puzzle is far more complicated. Does anyone outside the industry even know what decumulation means? We prefer spending "in retirement" instead. It needs to be solved over an unknown time horizon. It involves probabilities; the popularity of lottery tickets proves that Americans are not particularly good at assessing probabilities. Plan participants are looking to the plan sponsor, their employer, to help them. They take cues from the plan and plan sponsor on the correct course of action.

Jim Smith: From the perspective of the average participant, other than their house, their 401(k) is their largest asset. I don’t think most people would say that they are very well-armed to address the whole retirement question. They don’t know how to hedge longevity or hedge inflation. They don’t know what the appropriate drawdown is. We in the industry spend hours and hours poring over the research on these questions. But there is a huge chunk of the population that doesn’t have any interest in educating themselves on these topics.

Just look at Social Security. So many people take it as soon as they are eligible for it rather than waiting for full benefits to kick in or analyzing their situation with their spouse. It may not be the wisest decision for so many people to take Social Security starting at 62.

P&I: Explain what products and solutions are available today for plan sponsors that wish to add retirement income solutions to their defined contribution plan. What are the pros and cons?

Drew Carrington: Simply stating that the plan can help with the distribution phase would be an important first step for many plans. For do-it-yourself participants who know what they want, they can access the marketplace. But for most participants who need guidance with spending in retirement, there are a number of ways to tackle the challenges: advice, investment products and annuities.

On one end of the spectrum, you have advice-oriented calculation engines and services where advice is given about an appropriate asset allocation and a sustainable withdrawal rate. Then there are investment products oriented toward producing predictable cash flow in retirement. These typically are designed to be liquid, more familiar and less costly, as well as fitting easily within the context of a qualified retirement plan.

A broad range of annuities exists; immediate, deferred and variable. Some of these solutions exist in plans today. The most prevalent would be a variable annuity, a wrapper around the portfolio that provides a guaranteed minimum withdrawal benefit (GMWB).

These are also not mutually exclusive tools: an advice engine can recommend a combination of investment products and annuities. There are pluses, minuses, challenges and opportunities with each option. From a plan sponsor’s perspective, what is available today covers just about everything you could want, but you need to take advantage of it.

Jim Smith: There are product-based solutions and service-based solutions. I don’t see a single silver bullet that a plan sponsor can use and say, if we put this product in, it’s going to address all our retirement income needs, because the needs at the individual level are so varied.

I think it’s important that plan sponsors look at the benefits of a given solution or product for their plan, that they look at the demographics of their plan and consider what best addresses the variety of the needs within those demographics. Maybe there are certain products they want to offer. Maybe there are ancillary services that they can attach to that product offer. It could be as simple as an installment payout option in their plan.

What a plan sponsor wants to offer will vary from sponsor to sponsor. For a company that has both a DC and a DB plan, it could be a very different solution than a company that has never had a DB plan so the DC plan is the only retirement benefit.

Roberta Rafaloff: It may be useful to think of all the retirement income solutions that are available as a spectrum that runs from maximum flexibility to maximum guarantee. To use Drew’s example, a systematic drawdown program would be at one end of the spectrum, offering full flexibility and few guarantees. At the other end would be the annuity offering or a complete guaranteed income solution.

In recent years, we’ve seen the emergence of many new products that go up and down this spectrum. The issue is that all this competition and innovation does have the potential to cause confusion both for sponsors and participants.

Drew Carrington: Before we go any further, I’d like to pick up on Jim’s point about the silver bullet. In the meetings I have with plan sponsors, I find that they are waiting for what I call the magic pink flying unicorn that is going to fly us all to a happy retirement. The magic pink flying unicorn is an amazing beast that will fly us all to a happy retirement! It handles longevity and inflation risks, it’s low cost, and liquid. But as long as we are waiting on the magic pink flying unicorn which, by the way, doesn’t exist, we are stuck doing nothing. That’s a terrible mistake on the part of the industry as a whole.

Jim Smith: That’s a really important point. A lot of plan sponsors are saying, ‘there’s no perfect solution so I’m not going to do anything. That way I can’t do any harm.’ But I would argue that there are many participants going into retirement today and by not doing something about retirement income, plan sponsors are leaving it


2The information, data, analyses, and opinions presented herein by Jim Smith do not constitute investment advice; are provided as of the date written and solely for informational purposes only and therefore are not an offer to buy or sell a security; and are not warranted to be correct, complete or accurate. Past performance is not indicative and not a guarantee of future results. The Morningstar Investment Management group, a unit of Morningstar, Inc., includes Morningstar Associates, LLC and Ibbotson Associates, Inc., both registered investment advisors and wholly owned subsidiaries of Morningstar, Inc.
It would be ideal if everyone in a plan could work with a financial planner with no associated cost. But that’s just not going to happen. So services are being developed that help individual participants to take the appropriate steps down the road toward a personalized solution.

— Jim Smith, Morningstar Investment Management

up to participants alone. And they know full well that the majority of those participants are not drawing down properly. So I think there is a false sense — and here I would echo Drew’s comments — that as there isn’t a perfect solution, I’m going to do nothing because it’s the wiser choice. What I would say is that you need to make some choices because what is happening now is not resulting in appropriate behavior in retirement.

P&I: Given the complexity of the issues facing participants and plan sponsors when they contemplate the plan as a whole, do you see a move toward more individual solutions?

Jim Smith: I’ll declare my bias upfront because Morningstar does offer services that we would argue do provide an individual solution. But it isn’t just us. We see others in the market developing a personalized service for the individual. In the end, what’s the ideal solution? It would be ideal if everyone in a plan could work with a financial planner with no associated cost. But that’s just not going to happen. So services are being developed that help individual participants to take the appropriate steps down the road toward a personalized solution.

Roberta Rafaloff: I would return to the theme of simplicity. I think it’s great that there’s all this new attention on a variety of solutions in qualified plans. But to Jim’s point, we are never going to get to the point where everyone has access to a financial planner or someone to walk them through the myriad options and choices they need to make. To the extent that we can keep it simple and provide folks with the best of both worlds and without all-or-nothing solutions, it will drive the understanding and education process.

P&I: Do you expect to see most retirement income solutions embedded within target-date funds or other default options?

Roberta Rafaloff: Honestly, I expect to see a wide range of options take hold. They will range from deferred income annuities within target-date funds to immediate income annuities to longevity-related products. It’s not a one-size-fits-all need. It’s critical for plan sponsors to offer the ability to partially annuitize; it’s not an all-or-nothing proposition. To the extent that we can offer flexibility with simple solutions, that is what will drive action and drive take-up. Whether it is target-date funds with annuities embedded in them or other types of offerings, there will be broad product development.

Jim Smith: Certain products will lend themselves to being more easily embedded in solutions like target-date funds. I expect this is what you will see first.

On the partial annuitization point, that solution could be easily utilized, especially in larger plans that are developing their own custom target-date funds. Here it’s possible to take into account the demographics of their participants and incorporate an appropriate level of annuitization, depending on the type of annuity within the fund. In a sense, it’s an ideal place. Of course, you could create an off-the-shelf target-date fund that has some annuity component, but is it going to be appropriate for every single participant in the workforce?

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2 As of December 31, 2014.
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Just taking that step sheds light on what measures they
might want to use. There is a push to put some sort of
sustainable retirement income projection on participant statements, which is one measure. But there is lots of
data available within retirement plans. They could look
to see how many of their participants between 50 and 55 are on track to fulfill the needed requirement income.
Are they behind? How far behind? Are these participants adequately diversified? They may be on track but poorly allocated. You could also pull in broader measures of financial wellness.
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participants are on track to hit their retirement income
goals, particularly those that are nearing retirement.
Drew Carrington: Many DC plans are still called savings plans or savings incentive plans. One measure of success would simply be to communicate that these plans are retirement plans! Plan sponsors need to be able to measure the value of the money they’re spending on the administration, company match, oversight and associated risks. Are they helping their participants get ready for retirement, and are their participants retiring on time?
We need to be careful when it comes to the assumption that the plan represents the entirety of a participant’s wealth or we’ll make mistakes. Many participants change jobs every five or six years, which means, in a typical career, seven or eight jobs. Many of those will have some sort of retirement coverage.
Evaluating retirement readiness is going to have to involve a flexible methodology. As Jim alluded to, some
of these issues go to financial wellness, which needs to incorporate the complexity of a typical individual’s financial situation.
Jim Smith: Actually, I would argue that it’s doubled up when you look at retirement readiness at the household level, if they are married. The spouse has the same issues, so those seven job turnovers become 14.
Roberta Rafaloff: Employees need to have adequate retirement savings. This is a critical element to ensure retirement income adequacy. If you don’t have the savings, you can’t create the income. But unless there is a shift from the accumulation-only focus of a savings plan to what it is really meant to be, which is an income replacement plan, we aren’t going to get to where we need to be. Providing income forecasts on statements and translating lump sums into income streams — these sorts of developments will drive change.
I expect to see people saving more. For most people in this country, $200,000 or $300,000 in retirement savings is more money than any asset other than the value of their home. But when that is translated into a monthly income in retirement, they will be shocked. So hopefully that will make people save more.
From a plan sponsor perspective, the success metrics will need to be updated or expanded because the asset accumulation messages are no longer enough. They will need to develop other metrics that ensure that plan participants receive the retirement security they need.
P&I: What role do you see participant education playing in today’s conversation about retirement income?
Drew Carrington: The messaging in participant education is changing. We are no longer trying to turn participants into their own chief investment officers. Instead, we spend less time on defining stocks and bonds, or taking about diversifying between domestic and international. Instead, we spend time on topics that participants can actually influence — how much can you save, can you save more next year, why you don’t want to make a hardship withdrawal, and rolling over and staying in a qualified plan format. This is about financial wellness. In large plans in particular, employers are recognizing that financial stress is a significant source of productivity friction. If they can help in simple and straightforward ways to lessen that stress, it can lead to improved productivity.
Roberta Rafaloff: Education is essential. Our plan sponsors that provide education and tools, and talk about their plan as an income plan, definitely have a better take-up rate for annuities than those that don’t.
Education paved the way for an understanding of the benefits of the 401(k) plan over the years since it was introduced 40 years ago and as it has taken the place of the defined benefit plan in many companies. Another point is that these plans in their infancy were very simple, with just three or four different investment options. You could only make changes or transfer assets once a year, as opposed to the daily valued plans with multiple investment options. That’s why I keep going back to the idea of simplicity, because we need to make sure

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Drew Carrington: I go back to my earlier comment about 30-year-olds. It’s hard to go wrong for this participant. They all have similar challenges and similar time horizons when it comes to retirement savings. When you talk to 60-year-olds, they are all very different. Their needs are probably poorly addressed by a one-size-fits-all approach like a target date fund. The point of maximum heterogeneity in the population with respect to retirement actually occurs right around retirement because people retire at different ages, in different circumstances and with different needs.
I look to quasi-default solutions where a participant may opt into a solution that has some automation. They would be contacted at an appropriate age and if they wish, they can sign up for an automated plan. There’s a myth that participants never respond and never act in their plan. In fact, when participants are over 50, they are much more likely to respond and act on targeted communications. So if you offer a semi-automated service, those over 50 are more likely to act than those who are 30.
P&I: What has to change for plan sponsors to move forward with retirement income solutions? How should plan sponsors be defining success?
Jim Smith: Plan sponsors have been very focused on success defined through participation and savings rates, and looking at whether people are maximizing the match. These metrics are very accumulation-oriented. So the first thing that needs to happen is that plan sponsors need to focus on retirement readiness.
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everyone can understand their options and take the appropriate action to prepare themselves for retirement. Let's get people to shift their idea of what a 401(k) is. It isn't a bag of cash at age 65. It's designed to be an income replacement tool. So alongside shifting the focus, plan sponsors need to provide the education and tools for participants to understand how to transition into retirement. At MetLife, we believe creating and introducing a retirement income education program can be an important first step in reframing a DC plan from a savings to a retirement income program. A "communications audit" can also be very helpful in determining how effective current communications are in underscoring retirement income messages.

Jim Smith: I agree that it's about reframing the education focus. But I would also say that education takes place on different levels. There is a small segment of the population that wants very detailed information on, say, how do I hedge longevity, or show me how asset classes correlate.

Most do want a simpler approach. The first part here is focusing on outcomes. Here is where you are today. Here is what that translates into in retirement income. Here is where you are today. Here is how they could be put together to get you from Point A — your current sustainable income in retirement — to Point B — where you want to get to, using various combinations of these different products and different levers.

You can always provide the ability for someone to drill down for more information, but for most individuals nearing retirement, they are looking for basic answers. How much income can I draw if I retire at 65 vs. 66? What is the impact of taking Social Security at 62 or 65? Education is still relevant. It just needs to be reframed.

P&I: What role do retirement plan advisers play?

Roberta Rafaloff: Plan sponsors place a lot of trust with their retirement plan advisers, so they play a critical role when plan sponsors are contemplating any type of plan design change — and specifically an income solution. We hope that retirement advice would become more comfortable with the different retirement income products that are available in the market, how they conduct due diligence on annuity offerings and how they will recommend which solution best meets the need of the plan and its participants.

Jim Smith: I would return to Drew's earlier analogy. I would hope that plan advisers could work with plan sponsors to convince them not to wait for the magic pink flying unicorn. Advisers could be very influential here by saying that it is wise to take some steps now, to look at your plan demographics, its needs and benefits, and determine what products and services could be used to address retirement income. We may not be perfect on day one, but we can make huge strides in the right direction. Don't wait for that one solution that is going to answer everything, because it's never coming. I would hope that advisers could play that role with plan sponsors who are uncomfortable with taking that first step.

Drew Carrington: I would expand the adviser question to include the administrator, legal counsel and record-keeper. In the past, some proposed solutions proved difficult to record keep or administer at first, but strides have been made. For everyone that advises plan sponsors, keep an open mind when your clients say they're thinking about retirement income solutions. I would also point out that the regulators have made it crystal clear that they want employers to offer participants help with spending in retirement. There is no hidden agenda here.

Jim Smith: I would like to reinforce the point that the regulators want plan sponsors to address retirement income and they are open to various solutions. My concern with regulation is that plan sponsors are waiting for a specific safe harbor before moving forward. I just don't think it's necessary nor is it necessarily going to happen.

Roberta Rafaloff: Regulations are not going to be the sole driver for retirement income. But what they are doing to drive it forward is helping. I do think that fiduciary relief through a safe harbor is important.