# Institutionally Priced Retirement Income Solutions Deliver More Income

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A formal program of retirement income within defined contribution (DC) plans can significantly boost the retirement incomes of plan participants, as well as offer other important advantages. These are the conclusions from a recent joint report from the Stanford Center on Longevity (SCL) and the Society of Actuaries (SOA), titled *The Next Evolution in Defined Contribution Retirement Plan Design: A Guide for DC Plan Sponsors to Implementing Retirement Income Programs.* Such programs are a low-cost employee benefit improvement that can significantly improve the lives of older workers.

Most 401(k) and DC retirement plans currently pay retirees a lump sum at retirement, who are then on their own to figure out how to generate retirement income that lasts the rest of their lives. But there's a better way: Plan sponsors can use their bargaining power, scale, ability to standardize, and distribution efficiency to improve the retirement security of plan participants by offering their retiring plan participants a limited selection of retirement income generators (RIGs) that take advantage of institutional pricing rather than retail pricing. These solutions have the potential to increase retirees' incomes by five to 20 percent or more.

This article examines three RIGs that can be offered in employer-sponsored DC plans: systematic withdrawals, immediate annuities, and guaranteed lifetime withdrawal benefits (GLWB, which are also known as guaranteed minimum withdrawal benefits, or GMWB). These three RIGs were each described, analyzed, and compared in the SCL/SOA report mentioned above. We compare how each RIG performs assuming institutional pricing typically available within a DC plan relative to retail pricing typically available outside a DC plan. Comparison of the RIGs relative to one another is not the focus of this article.

## Systematic Withdrawals

With systematic withdrawals, a participant's savings remain invested in the funds of the employer's DC plan, and the participant uses an installment payment feature to generate periodic retirement payments. The withdrawal amounts are usually determined based on the intention that the payments will last for life; however, there's no guarantee that will happen if the employee experiences poor investment returns and/or lives a long time.

Plan sponsors can help by providing low-cost investment funds that reduce the negative impact on net returns due to higher investment management fees. Low-cost index funds have consistently delivered higher net investment returns than higher-cost, actively managed funds over periods of five, 10, and 15 years or more, according to many studies[1, 2, 3, 4].

The SCL/SOA report prepared projections of retirement incomes using institutional and retail pricing under two applications of systematic withdrawals. The analysis assumed that institutionally priced funds were charged 0.50 percent per year (50 bps) for investment management fees and that retail funds were charged 1.50 percent (150 bps) per year.

The first application of systematic withdrawals used the frequently analyzed "four percent rule," where the annual withdrawal amount is calculated as four percent of assets at retirement and increased for inflation each year. This withdrawal amount is paid until the employee dies or the money runs out, whichever comes first. With this application of systematic withdrawals, the SCL/SOA report projects that institutional pricing helps the retiree's savings last two to three years longer when compared to retail pricing.

With the second application of systematic withdrawals, the annual withdrawal amount is determined as a constant percentage – four percent -- of remaining assets at the beginning of each year. Favorable net investment returns increase retirement income, while unfavorable returns reduce it. In this case, the funds should last indefinitely, since the withdrawal amount is always four percent of the remaining assets. The SCL/SOA report projects that after 10 years, the retirement paycheck would be 10 percent higher with institutional pricing and 21 percent higher after 20 years.

Note that the real comparison is between low-cost and high-cost funds. It's possible to find both low-cost retail investment funds and high-cost funds in DC plans. DC plan sponsors can enable retiring participants to improve their retirement outcomes by offering a structured installment payment feature combined with low-cost funds.

**Immediate Annuities**

Immediate annuities, also known as single premium immediate annuities (SPIAs), are insurance contracts that guarantee a lifetime retirement income, no matter how long a participant lives and no matter what happens in the capital markets. Typically the income payments are provided as a fixed dollar amount, although it's possible to buy annuities that increase at a fixed rate or for inflation.

DC plan sponsors can help by offering an annuity bidding service that finds the most competitive annuity purchase rate among reputable insurance companies at the time of retirement, and by reducing transaction charges compared to buying annuities on a retail basis. The SCL/SOA report states that competitive bidding has the potential to increase retirement income by 10 to 20 percent, and that reduced transaction charges have the potential to increase retirement income by 4 to 8 percent.

**Guaranteed Lifetime Withdrawal Benefits**

GLWBs are insurance contracts that combine the features of systematic withdrawals with the lifetime guarantees of annuities. GLWB contracts offer the potential for retirement incomes to increase if investment returns are favorable, but the retirement income won't be reduced if returns are unfavorable. Participants can also access funds during retirement, and any unused funds upon the participant's death are available for a legacy; these last two features usually aren't available with the SPIAs described above. GLWB contracts typically assess an annual insurance fee in addition to investment management fees.

The annual insurance and investment management fees can be as much as 200 bps lower with institutional GLWB contracts compared to retail products. Also, the initial income amount can be as much as 12-1/2 percent higher for institutional contracts compared to retail GLWB products. The SCL/SOA report projects this gap in income will widen to 16 percent after 10 years and to 19 percent after 20 years, due to the reduced fees for both insurance charges and investment management expenses. The report also projects that the amount of remaining savings will run out six years earlier with the retail product, although the retirement income will continue due to the insurance guarantee.

**There's More**

The SCL/SOA report analyzed just three methods that DC plan sponsors can use to help their retiring employees generate reliable retirement income. But there are other methods that can also deliver reliable retirement income, and it's likely that institutional pricing will deliver the same kinds of advantages for these additional methods as described above.

In addition to increasing retirement incomes through institutional pricing, a program of retirement income offers other advantages. Plan sponsors often have the resources to complete the due diligence necessary to offer reasonable solutions for generating retirement income, a task that's beyond the capabilities of most plan participants. Additionally, when plan participants are on their own to generate retirement income, many withdraw amounts that are too high, with the risk that they'll outlive their savings; others may withdraw low amounts out of fear of exhausting savings, forcing spending cutbacks that may not be necessary. In addition, some workers may delay retirement out of fear of outliving savings if they aren't confident in converting their savings into a reliable income stream.

A program of retirement income in a DC plan can also help prevent a loss of savings due to fraud or by making investment mistakes. Plan sponsors offer these options strictly as a benefit to their participants -- they don't view their plans as a source of profit, which is the case with virtually all for-profit, retail financial institutions and advisors that retired participants could potentially use. As a result, a DC plan is usually a safe place for participants to keep their savings in retirement.

**What Are The Costs?**

DC plan sponsors will need to spend the time to conduct the due diligence required to design a program of retirement income, then select and monitor the appropriate products and services. They may also need to spend money on outside consultants to help them conduct this due diligence and/or with their plan administrator to help implement and communicate the retirement income solutions. It's important to note, however, that the increase in retirement income is achieved without an increase in contributions. The positive features described here result from more efficient use of the employer contributions and participants' savings to retirement plans.

DC plan sponsors can help their workers increase their retirement income and/or extend the duration of payments from their retirement savings. This will likely improve their retirement confidence and readiness of older employees. It is logical to expect this could have a positive impact on workforce renewal. These outcomes are consistent with the primary purpose of any retirement plan – to increase the retirement security of plan participants.

Footnotes:

1. SPIVA U.S. Scorecard, Mid-Year 2014 (S&P Indices vs. Active) http://us.spindices.com/resource-center/thought-leadership/spiva/
2. The Arithmetic of Investment Expenses, by William F. Sharpe. Financial Analysts Journal, Volume 69, Number 2. http://www.cfapubs.org/doi/pdf/10.2469/faj.v69.n2.2

3. The Arithmetic of "All-In" Investment Expenses, by John Bogle. Financial Analysts Journal, Volume 70, Number 1. http://johncbogle.com/wordpress/wp-content/uploads/2010/04/FAJ-All-In-Investment-Expenses-Jan-Feb-2014.pdf
4. The case for index fund investing, Vanguard Research report, April, 2014. https://pressroom.vanguard.com/content/nonindexed/Updated_The_Case_for_Index_Fund_Investing_4.9.2014.pdf

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## About the Author

**Steve Vernon, F.S.A.,** is President of *Rest-of-Life* Communications, and a Research Scholar at the Stanford Center on Longevity. In both roles, he speaks, writes, and conducts research on the most challenging aspects of retirement, including finances, health and lifestyle. For more than 30 years, he consulted at Watson Wyatt and Mercer, helping Fortune 1000 employers design, manage and communicate their retirement programs.

Steve currently writes a regular column on retirement for CBS MoneyWatch. His books include:

- *Money for Life: Turn Your IRA and 401(k) Into a Lifetime Retirement Paycheck*
- *Recession-Proof Your Retirement Years: Simple Retirement Planning Strategies That Work Through Thick or Thin*
- *The Quest: For Long Life, Health and Prosperity* (a DVD/workbook package)
- *Live Long & Prosper! Invest in Your Happiness, Health and Wealth for Retirement and Beyond*
- *Don't Work Forever! Simple Steps Baby Boomers Must Take To Ever Retire*

Recent articles include:

- *The Next Evolution in Defined Contribution Retirement Plans: A Guide for DC Plan Sponsors to Implementing Retirement Income Programs,* Stanford Center on Longevity
- *Foundations in Research for Regulatory Guidelines for the Design & Operation of Retirement Income Solutions in DC Plans,* Stanford Center on Longevity
- *Retirement Income in DC Plans: The Next Evolution in Plan Design,* Benefits Magazine
- *The Role of Annuities in Retirement,* Journal of Retirement

He also serves as a member of the Institutional Retirement Income Council (IRIC). He is a Fellow in the Society of Actuaries, and a Member of the American Academy of Actuaries.