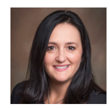
It’s Time to Get Serious About Retirement Income Solutions

Assisting participants through their full retirement journey.

June 2019



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KEY INSIGHTS

- Thoughtful consideration of a participant’s journey, both up to and through retirement, can help participants meet their retirement goals—and better position plans to retain assets.
- More defined contribution (DC) plan participants are keeping their savings in plan after they retire, and future retirees expect to derive a greater share of retirement income from their DC plan balances.
- Despite more assets remaining in plans, money is being distributed at lower levels. This suggests that participants may need help converting DC plan assets into an income stream once they reach retirement.
- Every participant has their own unique circumstances that will impact their preferences for certain product features, such as income yield, income duration, income volatility, asset liquidity, and asset preservation.
- There is no one-size-fits-all solution for retirement income. Participants’ unique and changing needs require various solutions to help them achieve their goals.

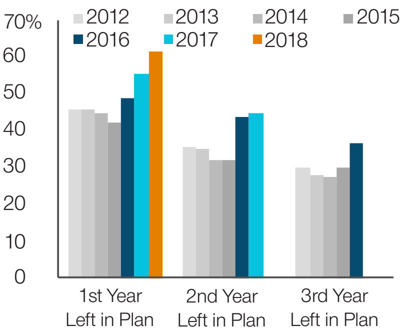
More Participants Are Sticking Around

Emerging data suggest that more DC plan participants are keeping retirement balances in their employer-sponsored plans *after* retirement. We first detected this trend within T. Rowe Price’s proprietary recordkeeping data—a source that we regularly mine to unearth productive insights for our clients and partners. Over the last three years of available data, participants who separated from service at age 65 or older retained more assets within their DC plans than in prior years. For example, in 2012, 45% of account assets remained in plans at least a year after retirement. That figure catapulted to 61% in 2018.[1]

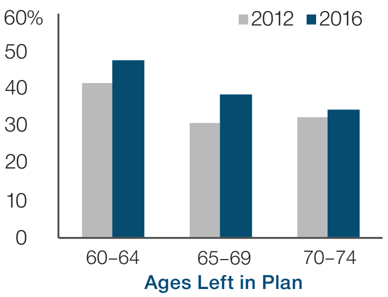
Our observations were corroborated by data from the University of Michigan Health and Retirement Study (often referred to as the “HRS database”). The survey’s data also suggest that retired participants have started keeping more assets in employer-sponsored plans. Among retired respondents age 65 to 69, the percentage who left assets in a prior employer’s plan jumped from 31% in 2012 to over 38% in 2016.[2]

(Fig. 1) Retirees Are More Likely to Keep DC Plan Balances

T. Rowe Price Data:
DC assets retained, separated from service, age 65+[1]

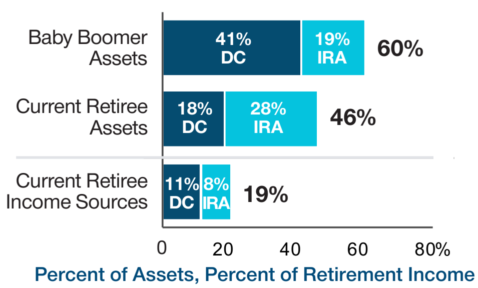


Public Data (HRS):
Respondents Who Kept Money in Plan[2]

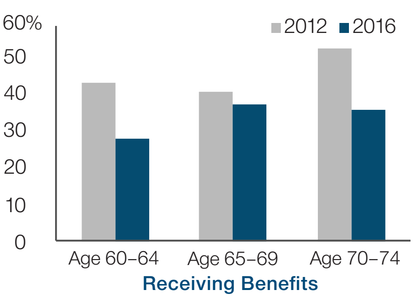


(Fig. 2) More Wealth in DC Plans but Less Retirement Income?

T. Rowe Price Data:
Retirement Assets, Income Sources[3]



Public Data (HRS):
Respondents Receiving Benefits[2]



Today's Participants Expect to Rely on DC Plans for More Income

Giving a more detailed voice to plan participants' stated expectations, recent T. Rowe Price-sponsored research with over 4,000 DC plan participants found that while current retirees receive, on average, 6% of their retirement income from DC plans, current workers (i.e., future retirees) anticipate that 29% of their retirement income will come from their DC plans.[3] This discrepancy suggests that future retirees will expect more income from their DC plans than retirees of today.

Many Plan Sponsors Want Their Participants to Stay

Many plan sponsors have signaled a desire for their plans to become "destination accounts" where participants aggregate assets and ultimately transition those assets into, and remain throughout, their retirement. In fact, T. Rowe Price research with plan sponsors revealed a widely held preference to keep retiring participants within their plans. Fewer than 6% of large plan sponsors* indicated a desire for retiring participants to leave their plans. In contrast, 50% of large plan sponsors articulated a clear preference for participants to stay in their plans as they transition into retirement.[4] Whether their aim is to increase or defend their plan's assets (and the economies of scale that come with it) or to better assist participants with achieving the best outcomes possible, plan sponsors and their participants are apparently aligned—more retirees are staying in plan, and many employers are happy to keep them.

*For the purpose of the study, large plan sponsors were noted as managing plans with over $500M in plan assets.

An Income Enigma?

The data reviewed thus far suggest a one-way trend toward greater use of DC plans to not only save for retirement, but to cover ongoing living expenses as well. However, drilling further yields another interesting but conflicting layer of findings.

While more participants are keeping money in DC plans after they retire, a smaller percentage of this accumulated wealth is being distributed now than in years prior. Within our same sample of DC participants referenced earlier, DC-sourced assets make up 46% of current retiree financial assets (Fig. 2). However, these assets are currently only attributed to providing 19% of retirees' income. In other words, a disproportionately small amount of income is being derived from this growing pool of DC household wealth.[3] Looking to HRS data for another perspective, we see a similar trend. Far fewer respondents reported receiving benefits from their retirement plans in 2016 than in 2012.[2]

So what is this telling us? While defined benefit (DB) plans were specifically built to generate income in retirement, the DC system was designed to support supplemental savings. Given the DC system's origin and historical focus on accumulation, DC plans today typically provide few (if any) reliable tools or investment solutions that can help participants strategically convert their savings into retirement income.

Participants Need Help

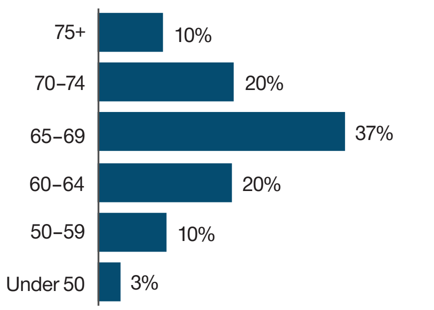
Taking stock of the current state, many DC plans allow participants to receive partial withdrawals or even schedule automated withdrawals over time, so structuring retirement income from these DC plans is possible. However, creating a strategic plan for retirement income is not a simple process.

(Fig. 3) Two Variable Factors That Influence Retirement Income Needs

(1) The matter of when...

Many Americans are working in some capacity beyond the traditional retirement age of 65. In fact, T. Rowe Price's own polling shows that only 37% of DC plan participants intend to retire between ages 65 and 69. Decisions on when to retire can greatly alter a participant's financial expectations and planning needs.

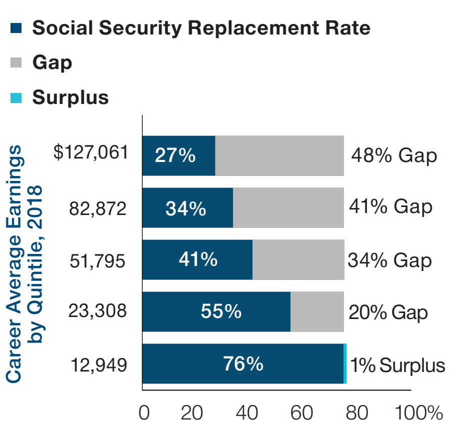
Q: At what age do you expect to retire?[3]



(2) ...and how much

Social Security income is not as consistent across populations as some believe. Among high earners, in particular, Social Security is likely to fall short of desired income goals. This means DC plans are expected to make up the difference.

Social Security replacement rates by income quintile and implied gaps at targeted 75% replacement[5]



Replacement Rates for Hypothetical Retired Workers in First Year at Normal Retirement Age

Why? With a career's worth of accumulated assets—not to mention possible household assets from a spouse—retiring participants have a wide range of assets from which to generate retirement income.

In a nationwide study on retirees conducted by T. Rowe Price, we found the number one need for advice or support was for managing a plan to convert your retirement assets into a stream of income in retirement.[3]

Furthermore, in terms of objectives and needs in retirement, the participant landscape is varied. The points highlighted in Figure 3 show two fundamental challenges that plan sponsors and retiring participants face when addressing retirement income needs—the question of when they will need to begin using their retirement savings, and how much money they may need to live comfortably in retirement.

However, a variable retirement age and the amount of income Social Security will replace is just the beginning. Retirees also wrestle with the issues of longevity risk, planning for health care costs, choosing higher consumption now versus planning for higher potential health care costs later, and the desire to leave a financial legacy to heirs—the list of needs and considerations is long.

The Case for Choice in Income Solutions

As participants reach retirement, there is often a need to set a personal course for their portfolio based on their unique financial situation, preferences, and objectives.

At first, this may seem somewhat at odds with the DC industry's innovation born from the Pension Protection Act of 2006 and the "automatic revolution" that it quickly inspired. Although plan features such as automatic enrollment can aid early-career retirement planning by simply helping participants save as soon as possible to take advantage of compounded returns over time, it's difficult to address retirement income needs in a similar one-size-fits-all way.

The Savings Tier

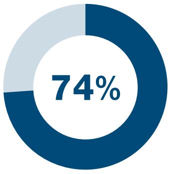
Prior to retirement, plan participants are typically focused on saving. Thus, plan sponsors typically offer a variety of investment choices with that goal in mind. Common offerings include a suite of target date funds, a diverse mix of equity and bond mutual funds, and even a self-directed brokerage option. Additionally, the plan sponsor may offer education and insights that provide guidance on proper saving levels, investment choices, and more.

The Retirement Tier

Plan sponsors can continue their relationship with participants after they retire by continuing to offer relevant products and services, but with a focus on income rather than saving. Sponsors can help participants with distributions and adjust fund offerings to include more income-focused investments. Moreover, education and insights can be geared toward retirees who are seeking guidance on proper income levels and the appropriate asset allocation.

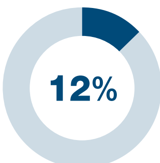
Research suggests that plan sponsors are acutely aware of the varying needs of their retired participants. In fact, nearly three-quarters of plan sponsors surveyed agreed that a suite of retirement income solutions would better serve retired participants due to their varied individual needs and objectives. In contrast, only 12% indicated that a singular retirement income solution incorporated into the DC default was the best approach.[3]

(Fig. 4) Different Needs May Require a Range of Solutions[5]



...of Plan Sponsors STRONGLY AGREE or AGREE

"Retired participants are best served by a SUITE of retirement income solutions within their DC plan to solve for varied individual needs and objectives."



...of Plan Sponsors STRONGLY AGREE or AGREE

"Retired participants are best served by a SINGULAR retirement income solution incorporated into the DC plan's default."

A Strategic Move to Action

Rather than simply developing new ways to repackage traditional income solutions in DC plans, we contend that a strategic, objectives-based approach is more appropriate; evaluating these four steps should lead to a plan-specific outcome:

1. Assessing participant income preferences,
2. Evaluating the spectrum of solutions,
3. Mapping revealed preferences to the solutions that best suit participant needs, and then
4. Rethinking communication strategies to better drive understanding, engagement, and outcomes.

1 | Each Participant Has a Unique "Retirement DNA"

Every plan participant has their own unique income and asset preservation needs in retirement. An understanding of these preferences should be valuable to plan sponsors as they evaluate the spectrum of income-centric solutions they may offer.

For purposes of discussion, we classify five distinct income preferences that allow us to match a participant's retirement profile with the range of available retirement income solutions. In this example, participants differ in their preferences related to income yield, duration, and volatility, as well as the liquidity and preservation of their assets.

As outlined in Figure 5, the purple line shows the hypothetical preferences of one participant, while the yellow line shows the hypothetical preferences of another. These unique preferences, when shown together, build a visual that is remarkably reminiscent of DNA—suggesting that, similar to genetic DNA, each participant has their own retirement DNA—which plan sponsors should take into consideration.

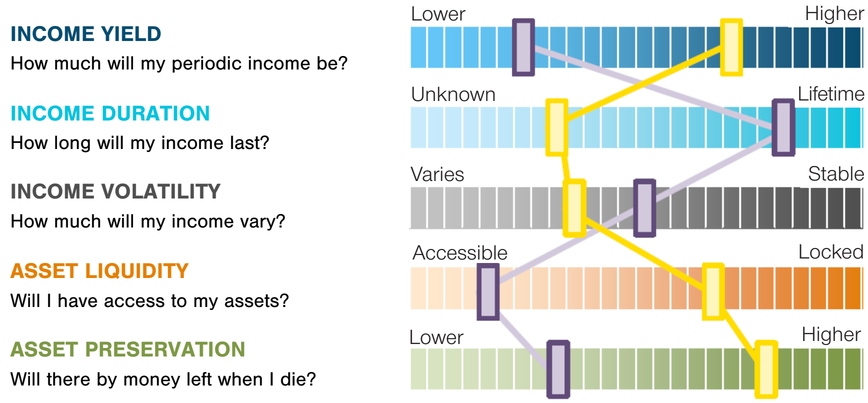
2 | Assessing the Solutions Spectrum

Assessment of income preferences provides a foundation for a more objectives-based approach, but how does that match up to the range of income solutions? In Figure 6, we've arranged income solutions corresponding to selection complexity for plan sponsors, from least to greatest complexity.

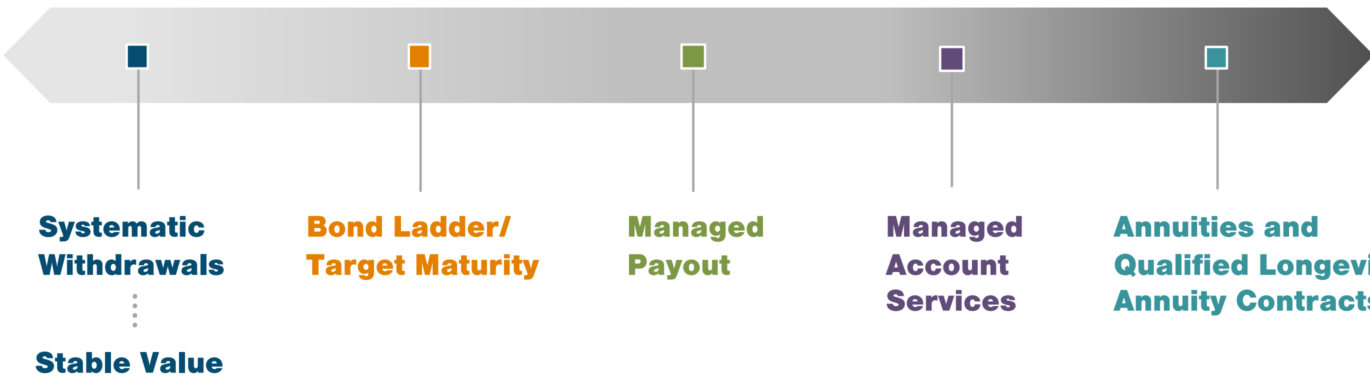
Systematic Withdrawals: In terms of plan sponsor evaluation and oversight, introducing or expanding systematic withdrawal options may be the least complicated choice. Many plans already offer systematic withdrawals in some form, and these do not require the

(Fig. 5) What Are Income Preferences?

This figure represents two different retirees with two different sets of income preferences.



(Fig. 6) Solutions Spectrum



addition of income-specific investment solutions to a plan's lineup. Participants manage their scheduled withdrawals and can set an amount and cadence that makes sense for them. However, increased freedom to schedule withdrawals doesn't address the participant's burden of determining an appropriate or sustainable withdrawal amount—or help with asset allocation.

Stable Value: Used in tandem with systematic withdrawals or as a component of another strategy, stable value investment options are unique to DC plans and offer capital preservation paired with potential for higher total return than standard money market funds or low-duration fixed income investment options. Stable value may be a suitable solution for a portion of retirees' retirement portfolio to provide additional liquidity and volatility management for retired participants.

Bond Ladder/Target Maturity: There are fewer existing product options within this category, but bond ladders can provide a transparent and relatively reliable source of future income, assuming bonds are held to maturity. At the same time, bond ladders remain liquid and can be adjusted, if the need arises. However, bond ladders are finite and cannot address longevity risk.

Managed Payout: Although details vary, this category of solutions offers a combination of investment management and features that may be appealing to a broad pool of participants. Usually liquid, managed payout investment solutions typically offer a periodic distribution strategically calibrated to the investment's performance for use as income by retired participants. Managed payout investments may target a steady drawdown of principal over time (e.g., 20 years) or may provide an ongoing distribution with no targeted liquidation date.

Managed Account Services: A broad and diverse category, some managed account services provide income planning solutions for retired participants. As with all managed account services, the accuracy of the resulting plan or allocation is dependent on the amount and accuracy of personal financial information shared with the managed account service provider. From a plan sponsor's perspective, selection and monitoring of managed account services may require in-depth evaluation of algorithms and assumptions that underlie the service.

Annuities and Qualified Longevity Annuity Contracts (QLAC): Annuities directly address longevity risk and provide contractually stable income over time. We believe annuity-based solutions can play a significant role within a broader income strategy. However, limited flexibility and liquidity may limit their appeal among retired plan participants, perhaps due to relatively poor fit with income preferences. Mirroring somewhat limited demand for annuities in the broader investment market, retired and working DC plan participants currently receive or expect to receive only a modest portion (4%) of their retirement income from annuities purchased on their own or through a workplace retirement plan.[3]

Importantly, use of annuities does not have to be an all-or-nothing proposition. In fact, partial allocations as part of a total retirement portfolio can be a beneficial way to leverage annuities.

Ongoing legislative efforts may address the issue, but as of this writing, lack of a clearly defined safe harbor may complicate implementation of annuity-based income solutions within DC plans.

3 Mapping Preferences to Solutions

The scoring of income solutions shown is hypothetical and subject to individual interpretation, but Figure 7 demonstrates that a best practice evaluation of retirement income solutions often requires consideration of multiple variables and viewpoints.

Across this spectrum, solutions that offer more stable and predictable streams of income in retirement may be more complex, may require more thorough evaluation by plan sponsors, and may offer less flexibility to participants. Selecting a mix of solutions that offers the most utility to plan participants, in aggregate, requires careful judgment and balance on the part of plan sponsors, plan investment committees, and their advisors.

4 Rethinking Communication Strategies

One sensible consideration for sponsors is to develop an engagement strategy for participants based on how sponsors wish to position their plan for retired participants. Figure 8 offers insight into what sponsors are doing today and reveals that there is room for improvement.

While the majority of plan sponsors report providing general information to their participants about their ability to stay in plan after they retire, and many offer tools and education, far fewer communicate specific information about the potential benefits that their plan can provide to participants in retirement. Therefore, it seems that a good first step for many plans may reside in simply providing more information about the solutions they *already* provide.

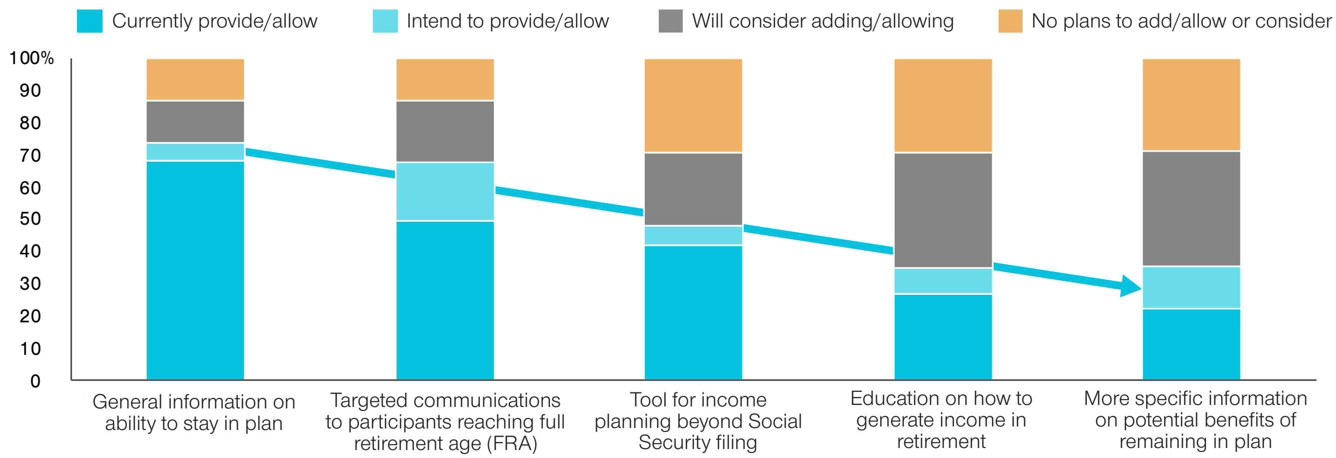
(Fig. 7) Mapping Preferences to Solutions

Excellent · Good · Variable · Poor · Very Poor

	Systematic Withdrawals	Bond Ladder	Managed Payout	Managed Accounts	Annuities
INCOME YIELD	Variable	Good	Good	Good	Excellent
INCOME DURATION	Variable	Variable	Good	Good	Excellent
INCOME VOLATILITY	Variable	Excellent	Good	Good	Excellent
ASSET LIQUIDITY	Excellent	Excellent	Excellent	Excellent	Poor
ASSET PRESERVATION	Variable	Variable	Good	Good	Variable

(Fig. 8) Participant Resources

Q: What resources do you provide to help participants decide what to do with their DC plan balances after they retire?



For "General information on ability to stay in plan" and "More specific information on potential benefits of remaining in plan," results came from 177 DC plan sponsor respondents. For "Targeted communications to participants reaching FRA," results came from 175 respondents. For "Tool for income planning beyond Social Security filing" and "Education on how to generate income in retirement," results came from 178 respondents.

Assisting Participants Through Their Full Retirement Journey

Aiding your participants' journeys beyond retirement may seem daunting, but plan sponsors should not be intimidated. Just as importantly, they should avoid searching for one perfect investment to address every participant's income needs—because it's unlikely that one exists.

Rather than engage in a fruitless search for a single answer, plan sponsors should take incremental steps to build out a suite of solutions that can help a broad set of their participant base. Offering this suite will encourage participants to stay in plan and allow them to benefit from lower in-plan investment costs and fiduciary oversight while generating a steady stream of income.

Regardless of what is ultimately selected for a plan, there is an opportunity to help participants achieve better retirement outcomes by helping them to transition from saving to income in a strategic and thoughtful way.

"Increasingly, plan sponsors are realizing there can be significant advantages for participants—as well as for their plans—by integrating plan-based retirement income solutions.

CONCLUDING REMARKS

For all but a small minority of plans, development and implementation of retirement income solutions has remained stagnant for well over a decade.

We believe a shift is upon us.

Research suggests that every participant has their own specific income preferences—their own retirement income DNA, so to speak—so a one-size-fits-all approach should be avoided. Plan sponsors must think strategically and incrementally when evaluating approaches to income and should consider the participant's entire retirement path, from the start of saving all the way through to income generation.

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Footnotes

[1] Percent of account value retained by defined contribution (DC) plan participants, age 65 or older after 1, 2, 3, 4, or 5 calendar years following separation from service.

[2] Health and Retirement Study, (HRS Core) public use data set. Produced and distributed by the University of Michigan with funding from the National Institute on Aging (grant number NIA U01AG009740). Ann Arbor, MI, 2014 and 2016.

[3] RSS4 © 2018 NMG Consulting. All rights reserved. Conducted for T. Rowe Price by NMG Consulting.

[4] See *What DC Plan Sponsors Prefer Retiring Participants Do and Why It Matters* at troweprice.com/dcio.

[5] Clingman, M., Burkhalter, K., and Chaplain, C. (April 2019), *Replacement Rates for Hypothetical Retired Workers.* Actuarial Note 2019.9. Social Security Administration, Office of the Chief Actuary. On the Web at: https://www.ssa.gov/OACT/NOTES/ran9/an2019-9.pdf.

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