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Retirement and Lifetime Income: An Achievable Reality

By Kevin Rafferty and Ryan Grosdidier



INVESTMENTS & WEALTH INSTITUTE®

Retirement and Lifetime Income

AN ACHIEVABLE REALITY

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Helping individuals ensure that they have enough money to support themselves in retirement is more top-of-mind than usual in these volatile times. Saving enough for a lifetime of retirement income seems more difficult due to trends toward earlier retirement and greater longevity, workers holding more jobs for shorter amounts of time, and the rise of the gig economy. Social Security is insufficient income for many retirees, and, the question of Social Security’s solvency aside, its future payouts are expected to remain supplemental at best. Other forms of retirement funding, such as defined benefit (DB) plans, are being replaced almost entirely by the use of defined contribution (DC) plans, which put the onus on the individual to manage savings and investment options.

For financial advisors, plan providers, and those helping workers invest, the use of annuities in target-date funds (TDFs) bears closer examination. More than 50 percent of plan participants invest in TDFs, and more than 75 percent of plan providers offer at least one TDF option. Incorporating guaranteed income options into TDFs would provide plan participants with a guaranteed income benefit within a structure they already know and like.

Regulatory change has removed many of the risks of incorporating annuities into TDFs, opening up new investment opportunities to help guarantee sufficient income well into the decumulation years. In addition, technological advances in recordkeeping and valuation have removed the once-challenging burdens of pricing, valuation, portability, and participant experience.

THE WIDENING SAVINGS GAP

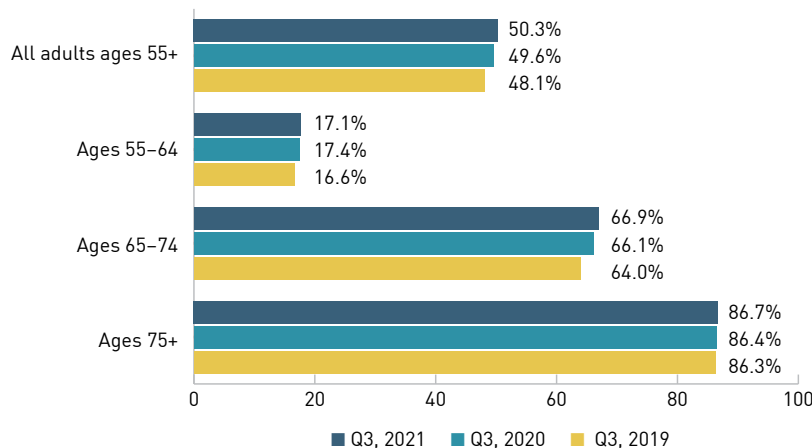
Retiring early and living longer sounds nice. This combination, however, results in more years out of the workforce and a need for a larger pool of assets to support lifetime income. But the widening of the savings gap—the difference between what retirees have saved and what they will need—is a reality check.

A recent study by the Pew Research Center shows a growing number of adults in retirement. Figure 1 shows that, as of Q3 2021, 50.3 percent of adults ages 55+ considered themselves out of the workforce. In Q3 2019 it was 48.1 percent. Between 2008 and 2019, the number of retirees ages 55+ grew by about 1 million a year. The study further found that the number of retirees grew by 3.5 million in the past two years.¹

Life expectancy, however, is a complicated statistic. Variances due to race, gender, socioeconomic level, and access to health care get smoothed out when life expectancy is examined in aggregate. But those differences can be significant and should not be dismissed. For example, figure 2 shows the difference for life expectancy in the United States based on gender.

On the whole, as reported by the Centers for Disease Control, life expectancy in the United States has increased, from 73.7 years in 1980 to 78.8 years in 2019. Better health care and better access to health care are the primary reasons for the increase. Life expectancy dipped to 77.7 years due to the COVID pandemic, but should that trend reverse itself—which may be likely given vaccines and medications—life expectancy could continue to

Figure 1 PERCENT OF OLDER ADULTS WHO ARE RETIRED



Note: “Retired” refers to those not in the labor force due to retirement.

Source: Pew Research Center analysis of July, August, and September Current Population Survey monthly files (IPUMS). See <https://www.pewresearch.org/fact-tank/2021/11/04/amid-the-pandemic-a-rising-share-of-older-u-s-adults-are-now-retired/>.

rise. Consider as well the Social Security Administration’s caution that life expectancy is an average metric. As such, a healthy 65-year-old may live until age 85, which is at least six more years than the average life expectancy.

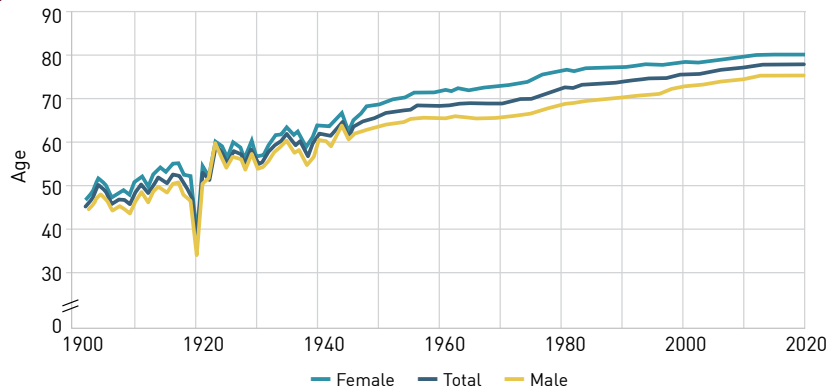
But retirement readiness—no matter when one stops working or how long one lives—starts with retirement savings. The percentage of workers who have a retirement fund is an essential indicator of how many people are saving. According to the Federal Reserve’s “Report on the Economic Well-being of U.S. Households in 2020,” 75 percent of Americans have a retirement plan and are saving either through their employer plans or individually. That’s certainly positive. But it also means that 25 percent are not saving specifically for retirement. However, 64 percent of those with a retirement plan think they aren’t on track to save enough for retirement or are not sure.²

As that statistic shows, having a retirement fund does not always equate to saving enough. According to a 2017 Government Accountability Office (GAO) report, the median retirement savings for Americans ages 55–64 was about \$107,000. The GAO cautions that this amount would translate into a monthly payment of only \$310—and only if it was invested in an inflation-protected annuity. Even with minimal inflation and Social Security as a supplement, \$310 a month likely is not enough to support the balance of life. A 2020 report from the Center for Retirement Research shows that retirement account balances for that same 55–64 age cohort grew to \$120,000, which is still insufficient to increase those monthly payment projections significantly.³

The use of a retirement fund also might shift due to how—and where—people work. For example, Statista reported that individuals in the United States changed jobs every one to five years during 2015–2018. Although a job change does not necessarily mean an employer change (and therefore a change in retirement

Figure 2

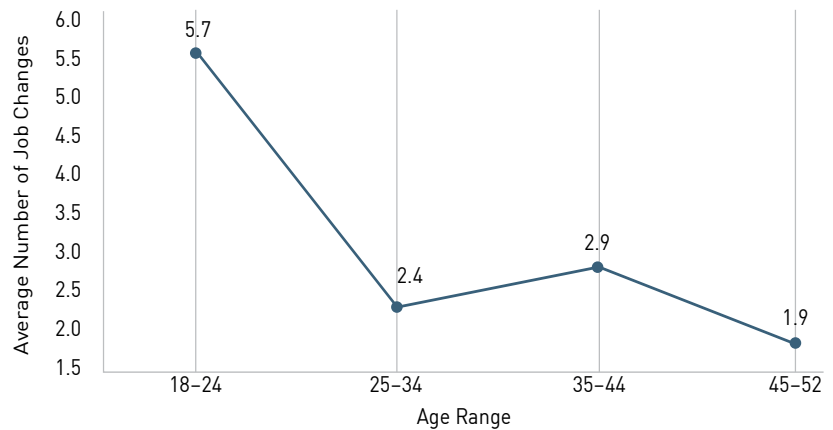
LIFE EXPECTANCY BY GENDER: THE UNITED STATES, 1900–2019



Source: National Center for Health Statistics, National Vital Statistics System, Mortality. <https://www.cdc.gov/nchs/data/nvsr/nvsr70/nvsr70-19.pdf>.

Figure 3

AVERAGE NUMBER OF JOB CHANGES BY AGE



Source: “21 Crucial Career Change Statistics [2022]: How Often Do People Change Jobs?” <https://www.zipppia.com/advice/career-change-statistics/>.

plan), recent trends have pointed toward more mobility in employment, with younger generations more comfortable with frequent job changes and even career changes (see figure 3). Ninety-one percent of millennials—those born between 1977 and 1997—expect to change jobs every three years.

Forbes reported that the gig economy swelled 33 percent in 2020, with 2 million new gig workers that year. By late 2021, 35 percent of U.S. workers were employed in on-demand gig-related jobs.⁴ Statista expects that the number of gig workers will rise to about half of the total U.S. workforce by 2027⁵—an outstanding share. This expectation highlights the need for better pension

and retirement options for gig workers, most of whom don’t have access to traditional DC plans.

TDFs ARE ATTRACTIVE—AND IMPORTANT

Appropriate investment selection is an integral part of retirement readiness. Managing the risk–return balance to preserve assets and generate sufficient growth is critical to achieving lifetime income. As a result, TDFs have emerged as a valued—and attractive—option.

According to data collected by the Employee Benefit Research Institute (EBRI) and the Investment Company Institute, by the close of 2018, 56 percent of 401(k) participants in the

database held TDFs. TDFs were popular across all demographics, with 62 percent of participants in their 20s using the funds and 50 percent in their 60s using them. TDF assets accounted for 27 percent of 401(k) assets in the database, equating to 51 percent of 401(k) plan assets for individuals in their 20s and 23 percent for those in their 60s.⁶ TDFs are indeed mainstream. But TDFs begin to shift assets into larger fixed income allocations as savers finish their accumulation years, and bond funds alone may not deliver enough earnings for increasingly longer retirements.

Therefore, the use of annuities within retirement funds to provide a steady income stream throughout the decumulation years bears examination. The first TDFs that included annuities launched in the late 2000s. Deferred annuities have been permissible in TDFs since 2014, when the Internal Revenue Service issued guidance on their use in qualified plans. However, exposure to the potential insolvency of annuity-issuing insurers and the challenges of pricing and valuing these assets posed a significant risk. As a result, plan providers, financial advisors, and consultants (when acting as fiduciaries) bore the risks and the exposure should an issuer go under and the related annuity fail to pay out. Additionally, portability became a problem because valuation calculations were difficult to maintain when shifting annuities to new or different retirement accounts. These factors provided a strong disincentive to invest in annuities either in a qualified plan or as part of a TDF.

REMOVING THE BARRIERS TO ANNUITIES IN RETIREMENT PLANS

Critical roadblocks to the inclusion of annuities in qualified plans were removed in December 2019 when the U.S. Congress enacted the Setting Every Community Up for Retirement Enhancement (SECURE) Act. The SECURE Act significantly reduced the risks for plan sponsors and advisors of incorporating annuities in retirement plans with a “safe harbor” provision.

Under the safe harbor provision, providers are protected from exposure if they choose an annuity for a DC plan that has, for the previous seven years:

- Been licensed by the state insurance commissioner to offer guaranteed retirement-income contracts
- Filed audited financial statements following state laws
- Maintained reserves that satisfy all the statutory requirements of all states where the annuity provider does business⁷

The SECURE Act also addresses the portability of annuities. For example, an employee who leaves a job can transfer the annuity held in that job’s employer-sponsored 401(k) plan to a new or other 401(k) plan or an individual retirement account (IRA) without charges or fees. This is a significant change when considering the increased—and increasing—frequency with which employees change jobs.

Fortunately, regulatory momentum for DC retirement reform and facilitating the use of annuities in retirement funds continues. In 2022, the U.S. House of Representatives passed the Securing a Strong Retirement Act (SECURE 2.0), which expands the ability to include annuities in retirement funds and reduces the risks for plan providers that wish to include annuities. Although not yet passed by the Senate, there is bipartisan consensus for the bill, and in June 2022, the bill was approved by the Senate Finance Committee. If passed by the full Senate, the SECURE 2.0 would change the required minimum distribution (RMD) rules for annuities in IRAs and DC plans, including features such as guaranteed annual benefit increases. Rules for qualified longevity annuity contracts (QLACs), which are assets that begin to pay benefits at a future date, also are updated. The update makes it easier for retirees to defer income streams, protecting them as they age, perhaps for longer than expected, and draw down savings.

STRUCTURING ANNUITIES IN TDFs

In the 2020 EBRI Retirement Confidence Survey, 75 percent of respondents expressed interest in putting some or all of their savings in a guaranteed income option.⁸ A similar number said income stability was more important to them than preserving wealth. Secure Retirement Institute finds that an estimated 61 percent of employees who are currently saving in a DC plan would be somewhat or very likely to contribute to a guaranteed lifetime income investment option.⁹

Annuities offer plan sponsors and participants flexibility when incorporated within a TDF structure. The plan provider or participant can choose how much money to allocate to the annuity—and when—which will vary the amount available later in a payout stage. Annuities can be variable or fixed. The return rate for variable annuities depends on the underlying investments and, therefore, it may rise or fall. The variable structure allows an investor to realize any upside from investment gains and also protect against downside risk. Fixed annuities deliver a set rate of return regardless of market performance. As such, they are less risky than a variable annuity but have less upside potential. Fixed index annuities pay an interest rate based on the performance of an underlying market index.

The retirement-income product manufacturer can determine how the funds will be invested based on the type of income stream desired (variable or fixed), which will determine the rate of return based on the commensurate level of risk. Hence, a retirement-income product provider has flexibility to use annuities to best suit the plan participant’s investment horizon and risk-return preferences.

The following are some of the types of annuities being used within retirement-income TDFs:

Deferred annuity. A deferred annuity pays out the benefit over time, beginning

at a future date. The initial investment can be made at once or as a series of payments. The term of the future payments can be fixed (e.g., for 25 years) or for the investor's lifetime. The longer the term or the number of payments, the lower the value of each payment.

QLAC. A type of deferred annuity, a QLAC is designed to deliver payments throughout one's lifetime, reducing the risk of outliving one's retirement savings. The QLAC is intended to be purchased with accumulated retirement funds, which leads to tax advantages because the purchase value (up to a set amount) isn't considered a taxable withdrawal from the retirement account as long as the annuity is not purchased in a Roth IRA or an inherited IRA. A saver can use up to 25 percent or \$135,000 (whichever is less) of their retirement savings account or IRA to buy a QLAC.¹⁰ Payments can be deferred up until age 85, allowing individuals to hedge against longevity risk. Income payments depend on the amount invested, the date payments begin, and the percentage of growth guaranteed under the contract. Unlike 401(k)s or traditional IRAs, there is no RMD at age 72 for the funds invested in the QLAC. This effectively lowers the RMD because the value of the QLAC is not included in the mandatory withdrawal calculation.

The following are types of guaranteed benefit income solutions:

Guaranteed lifetime withdrawal benefit (GLWB). A GLWB delivers a minimum lifetime payout benefit. The payout is guaranteed, even if the value of the initial investment declines. A vital feature of a GLWB is that the withdrawal amount is based on either the benefit base (amount invested or paid in) or the cash value (value with investment gains and losses) at the time of the first withdrawal. For example, suppose the value of the variable annuity has declined due to unfavorable investment performance. In that case, the investor can apply the withdrawal rate to the benefit base and

generate a greater payout. In addition, cash can be withdrawn from the fund on a scheduled basis or as needed, subject to the lifetime cap. Early withdrawals may, however, lower the withdrawal rate.

Guaranteed minimum withdrawal benefit (GMWB). A GMWB offers a steady payout regardless of market conditions. Should the investment value decline, the withdrawal benefit stays the same until the value of the initial investment is reached. Maximum annual withdrawals are usually 5–10 percent. Riders also can obtain a withdrawal rate higher than the initial rate. This boosts income in the event there are market and investment gains.

Guaranteed minimum income benefit (GMIB). Usually only linked to a variable annuity, a GMIB pays a steady value regardless of market conditions. The payment value is determined by the expected future value of the initial investment. For example, payout values might be calculated based on the initial investment with a fixed compounded rate of return, the highest value the investment ever achieved, or the actual value of the investment. The contract begins once the annuity has been annuitized.

Immediate. An immediate annuity is the most basic type of annuity. A lump-sum investment is annuitized into an ongoing, guaranteed income stream for a specified period of time or for a lifetime. Withdrawals will begin immediately thereafter.

TDF GROUP AND INDIVIDUAL ANNUITY SOLUTIONS

A group annuity contract is another option to guarantee income within a TDF structure at the institutional level. A product provider can add guaranteed income within a TDF in various ways. Product providers aim to simplify access to guaranteed income by selecting the appropriate annuity partners and structure, so the participant does not have to. To add value, retirement-income solutions need to focus on the benefits of the guaranteed

income the participant will receive, not on the specifics of the annuity.

Incorporating an annuity outside the TDF structure might allow for more flexibility for an individual saver and the ability to adjust the annuity payout to meet specific goals and financial situations. For example, a participant builds assets within a TDF and has an opportunity to purchase an individual annuity separately from the TDF. A robust digital participant experience, supported by appropriately licensed call center support representatives, will be essential in guiding participants to the best solution to fit their personal needs.

RETIREMENT-INCOME PORTABILITY INNOVATION

A hybrid annuity solution allows participants to purchase and hold an annuity within a retirement plan as part of the asset allocation. However, unlike an embedded product, where the annuity is purchased for the group, it is held for the individual. As such, ownership can be transferred to the participant upon separation. This option may be helpful for someone who expects to change jobs frequently and shift retirement funds from plan to plan or to an individual account outside of the plan.

TECHNOLOGY TO SIMPLIFY THE USE OF ANNUITIES

We've established that savers are interested in the benefits of annuity-based retirement-income solutions and that regulations have cleared many of the riskiest fiduciary hurdles. So why do fewer than 10 percent of 401(k) plans include a guaranteed income offering?

Servicing the annuity within a retirement plan is a complex operation. It requires data connectivity among several players, guarantee calculations, and tracking of and accounting for various underlying investments. Many plan providers only support investment into their own firm's annuities. Some fund recordkeepers cannot service annuity-based solutions on their platforms,

making it challenging to transfer other assets or annuities when shifting plans.

Middleware—technology sitting between recordkeepers and product providers—is a solution supporting simple and effective connectivity between plan providers, income product providers, and recordkeepers. Figure 4 is a simplified graphic that describes how middleware works. It offers a one-to-many guaranteed income solution marketplace for data connections, servicing, oversight, guarantee calculations, and distribution. Because it is platform-agnostic and able to service all annuity types and work with any recordkeeping platform, it promotes the seamless portability of an investment and its associated benefits. Whether a participant wishes to change plans, a plan changes recordkeepers, or the product is dropped, middleware can help accurately and appropriately account for the investment.

Some middleware platforms include online annuity account-opening capabilities. These digital platforms streamline a participant's investment into annuities with efficient, fast, participant-friendly tools to educate, inform, and model potential benefits and risks. In addition, data-powered microsites supply targeted tools and calculations to help

providers and participants understand the options, how much they may cost, and how any selections impact future income streams.

ACHIEVABLE LIFETIME INCOME

There is no single solution to closing the savings gap. Progress will take awareness and action from all industry participants. Yet, the widespread acceptance and use of TDFs and the clear demand for guaranteed income solutions have created a real opportunity for plan providers to incorporate annuity-based guaranteed solutions into their investment offerings. At the same time, regulation has removed many of the risks previously associated with annuities, and advanced middleware technologies have eliminated the need for significant infrastructure investments. Wider adoption of middleware promises to make lifetime income options—and annuities in TDFs—a more achievable reality for all participants. ●

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ENDNOTES

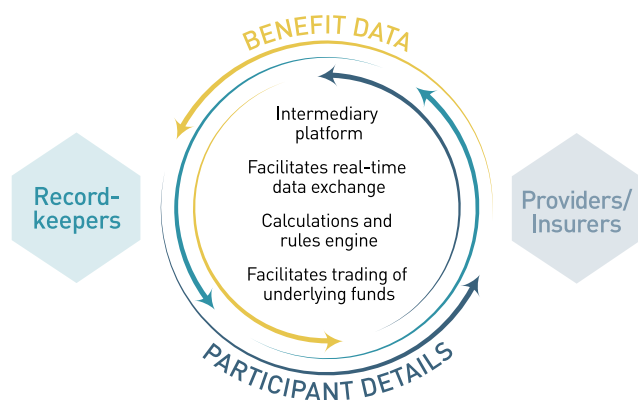
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CONTINUING EDUCATION

To take the CE quiz online, go to www.investmentsandwealth.org/IWMquiz

Figure 4

HOW MIDDLEWARE WORKS





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