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Session 70PD
Retirement Income Options: New Annuity and Life Insurance Products

Track: Retirement Systems Practice Area, Product Development

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Panelists: TAI BRIGHT†
PAUL A. HALEY

Summary: Faced with investing in a defined-contribution account and/or the lump sum obtained from a defined benefit plan, employees have ample choices. This session touches on some of the new and innovative alternatives for retirement income available in today's market, such as variable immediate annuities, fixed immediate annuities, retirement income programs and nontraditional retirement income vehicles/products.

This session provides attendees with information on the latest available retirement income products, advantages and disadvantages of each and the impact of the low interest rate environment on those products.

MR. NOVIAN E. JUNUS: The first panelist is Paul Haley. He is senior vice president and chief actuary for wealth and income management for GE Financial Assurance. My second panelist is Ty Bright, executive vice president for sales and relationship management for Fidelity Investment's life insurance company. And I'm Novian Junus. I'm consulting actuary with Milliman USA in Seattle.

It's all about income, and that's what we're trying to present here. The reason I asked Paul and Ty to be here is that they are both market leaders in terms of payout products. Their presentations will focus on is why it's a compelling business

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†Mr. Tai Bright, not a member of the sponsoring organizations, is executive vice president for sales and relationship management for Fidelity Investment's life insurance company.

Note: The chart(s) referred to in the text can be found at the end of the manuscript.

proposition or rationale for them to have focused a lot of energy and time and effort in this market and essentially being the leaders out there. They'll postulate and give us a sense of how the industry or how we can succeed in this market.

I'll be focusing more on the fact that there are a lot of retirement income options and really trying to give you a sense as to why there's such an appeal and rationale for choosing those income options as opposed to what we have to offer. Then I'll present to you some of the opportunities and a lot of the obstacles that we need to overcome in order to actually build that business.

Now I present to you Paul Haley.

MR. PAUL A. HALEY: At GE we're positioning ourselves to go after the retirement income market, and I want to talk about why we came to that conclusion and why we think the retirement income market makes sense for us, but not so much about specific products that we have in mind.

Why does retirement income make sense? Why is that a big marketplace? Obviously, there's a great deal of interest at this conference in retirement income options, and if we could get the same level of interest in the buying public at large, I think we could see that the marketplace would be there. There's a change in terms of product features. Again, this is a little bit of a focus on the variable side, but people are interested in guarantees. You can see it in what's coming out there. You have guaranteed minimum income benefits (GMIB), guaranteed minimum acceleration benefits (GMAB). People are looking, asking, "What kind of guarantee can I get?" But they were focused more on accumulating income or wealth. "I just want to get a big pot of money, and then I'm going to figure out what I want to do with it."

We're starting to see a shift now, even in terms of the features on variable annuities, to where, instead of focusing on accumulation, people are looking at the income aspect of it. So, you're seeing a guaranteed minimum withdrawal benefit (GMWB). "How do I get my money back out?" You're seeing guaranteed minimum death benefit (GMDB). "How do I protect my money in case of death?" And the questions that we have really are: Why is there a focus on income, and why are you seeing it now?

There are a couple demographic issues that are starting to drive this. People are saving less money. In terms of the national savings rate, back in the '50s and '60s, people were saving at a 10 percent to 12 percent rate. That has steadily come down to where it's looking to be about 4 percent, while at the same time the consumption rate has gone up. So, people have less money saved for their retirement.

If we look at Social Security and defined benefit plans, something that our parents were able to rely on, what's happening with those? Current projections show a

retirement shortfall for Social Security beginning in 2013. The Social Security Administration believes that they'll need an immediate and permanent increase in Social Security taxes or a cut in benefits to continue and stay solvent. Defined benefit plans have decreased by more than 60 percent. In 1985, there were more than 114,000 plans in this country, and now there are fewer than 40,000. So, people don't have that as a platform on which to build their retirement anymore. One in five working heads of the family is now covered by a defined benefit pension plan. Finally, if you look at male workers born in 1964, last year of the baby boomers, only 17 percent of their retirement income need, on average, will be covered by a defined benefit pension plan. People have to find other ways to fund their retirement income.

People have touted 401(k) plans as the replacement for defined benefit. People have defined contribution. It makes more sense. Well, the problem is the participation and contribution levels are not adequate to fund retirement. It makes sense in theory, but it's not really working well in practice. People who all of a sudden are confronted with a defined contribution plan rather than a defined benefit plan don't have investment expertise, and companies, for some very good reasons, have been unwilling to necessarily suggest where people should invest their money. They don't want to take the risk. If it turns out badly, they could be sued. So, you have people who don't necessarily have investment expertise now making the investments that their retirement is going to rely on. There's lack of a plan. Even the people who are putting money away in their 401(k) plans have not thought about how much money they need to accumulate to get to retirement, how they will convert that to an income and how they will survive through their retirement years.

And then if you look at what's actually happening, you find that people put money in 401(k)s, but they take it out for various reasons. They change jobs, and they have to move it. Sixty percent of the people don't roll it over into their new plan. They take the money, pay tax on it now and that retirement income base is lost. Then you see that 16 percent of all participants have loans. So, clearly the idea of this being a retirement income vehicle is not getting through to the end customers. They don't understand that the best idea is to just put the money away and leave it there, or it won't be there when you retire.

I think the most telling aspect of Chart 1 is how it looks at where people get their earnings from when they're in retirement, and this is people who are actually retired now. As you go forward, Social Security will probably become a smaller part of the pie. Defined benefit pension plans will obviously become a smaller part of the pie. But almost a quarter of people's income in retirement comes from earnings. So they retire, but they have to go back to work to make ends meet. Look at all that together, and it seems to us that clearly there's an underserved market there, and people need some way to get their retirement income. We call it "ride the wave." People have talked about the age wave. It's a retirement income wave that's coming, and we're trying to get out in front of it.

There is much market opportunity. As we look at it, there are 100 million U.S. households in which someone will retire in the next 10 years. In that time, $4.4 trillion, or 25 percent of all the U.S. financial assets, will need to be converted to income, or at least there's an opportunity for them to convert to income because people will be moving into the retirement phase of their lives. And that's the big issue. Obviously, financial assets have been moving into the retirement phase, but we haven't done a good job of converting them to income. We're seeing a change in investor mindset as, again, guarantees are starting to become a much bigger deal as people have moved through the last few years of the equity market. We're seeing health care costs rising faster than the consumer price index. Based on everything we're hearing, I don't see that slowing down. If you look at the presentation that was made yesterday on genetic testing, health care costs will continue to increase.

Alan Greenspan in 2002 said, "One of the most complex economic calculations that most workers will ever undertake is, without doubt, deciding how much to save for retirement." We are uniquely positioned to help people figure out how much they need to save for retirement, and that's what we need to do. It's complex. We did some brainstorming on the things that people should be thinking about as they go through retirement and plan for it. The two things that we think we're uniquely qualified to address are longevity—getting people aware of the longevity risk and getting them to understand how buying an annuity can protect them from that risk—and market volatility.

I want to walk you through how market volatility impacts different people in different economic circumstances. We'll look at two different people who have different economic plans and what the impact on market volatility can do to that. The first person has $100,000, and she has a buy-and-hold strategy. So, all she's really looking to do is accumulate as much wealth as she can over the next 30 years. Now let's assume that the market grows at 10 percent for 30 years. Through the power of compound interest, at the end of the 30 years she has $1.9 million. Whether or not that's enough is another question that we can deal with later. Now, let's just intrude a little bit of market volatility into it. The market goes down 10 percent for the first two years, and then it grows at 11.6 percent for the next 28. Over the 30-year period, she still averages 10 percent. She still accumulates the $1.9 million. Market volatility has no impact on this person. Great!

Now let's look at someone who wants income. So, John has $1 million, and he wants to spend that $1 million over the next 30 years. He plans to withdraw $60,000 a year. He'll increase it 3 percent for inflation because he wants to make sure he maintains his buying power. Again, we'll assume a 10 percent market growth for 30 years. It's great. Not only does John have enough money to live on, it actually grows. So at the end of the 30 years, he has $3.5 million. Let's throw a little market volatility into John's situation because we're really talking about income here and what happens to people who are pursuing an income strategy. He has the same market volatility that Kelly experienced that didn't really impact her—

10 percent down for two years and then an 11.6 percent market growth. John crashes. He runs out of money in Year 25, and he runs out of money because of the market timing risk. Okay? He lost so much money early on that he just couldn't catch up anymore.

The message that we have to get across to people is that market volatility—even if you have a wonderful plan that works on a deterministic basis—can kill an income plan. And the longer you need money for, the worse this can get. So, what are we doing? Again, we're focusing on retirement income and protection. We're moving away from a two-part strategy. To our mind what's been going on in the marketplace is that people preparing for retirement have looked at it in two distinct phases. One is to accumulate as big a pile of money as you can get. That's what variable annuities, fixed annuities and everything has been focused on over the past few years. It is: How much money can I get? without really worrying about whether it's enough, and how you convert it to income. The second phase has been to worry about converting that wealth to income later. The problem for us is getting people to part with their big pot of money.

We're moving to selling income directly. The idea behind it is instead of saying, "We'll accumulate all this money, and then at some point later on we'll figure out how to get it to income," we want to sell you an income stream. So, in exchange for periodic premium, single premium or however it's set up, we'll guarantee you a minimum amount of income. We won't talk about whether it's a 3 percent, 5 percent or 10 percent accumulation rate because ultimately we think what really matters to people is the income level. That's what you get in your defined benefit pension plan. Nobody tells you what the actuarial assumptions underlying your defined benefit pension plan are or how much people have to pay in for it. It's an income level that you're getting, and that's the direction in which we're trying to move.

There's a suite of products available out there. There are single-premium immediate annuities that have been around. Obviously sales have gone down over the past year as interest rates have plummeted. We need to figure out the right mix between what keeps the distributor happy and what makes sense for the customer to see how those ride out interest rate cycles. Immediate variable annuities still have issues with floors, which are very expensive to write at issue. They become a lot easier to write if they can be delayed into the future, and that's one of the things that we've been trying to work on.

And then there are variable annuities. With the variable annuity, you're asking: What's the plan for converting that to income? Our idea is that you have got to look for novel ways to deliver income. But again, we think the message has to be about income rather than the amount of money you have, and the reason for that is very simple, as the marketing people taught me in my company. Income is king because you have to eat. It doesn't matter how much money you have, you have to eat. You have to have income every day.

MR. JUNUS: Next we have Tai Bright. He comes to us from Fidelity.

MR. TAI BRIGHT: I want to give you a little perspective on Fidelity Investment's life insurance company and give you a sense of where we come from and how we are looking at the retirement income opportunity. It was about 18 years ago that our chairman, Ed Johnson, made two very critical hires. The first was hired to create and lead our 401(k) business at the time when defined benefit plans were moving toward defined contribution plans. He knew that Fidelity Investments could see success in that marketplace, and we have. On the same day he hired another individual to start from scratch an insurance company because he knew that if we were successful in the defined contribution marketplace that at some point more money would be moving out of those 401(k) plans than would be moving in, which is the case today. So he wanted to form an insurance company that could offer products that would convert those defined contribution plans back into personal defined benefit plans.

That's been our focus at the insurance company at Fidelity Investments, and we have been fortunate to see some very good success there. In the early 1990s, we began offering income annuities and in 1993, we introduced our own variable income annuity and have seen success there. By 2001, our sales reached just under $1 billion in both variable income and fixed income annuities. Over the last decade then, we have spent a lot of time refining our thinking on the retirees' issues, our approach to income planning, and the construction of good retirement income portfolios, and that's the information that I want to share with you today. I'll just highlight very quickly what I want to do over the next few minutes that we have together. I want to talk about our approach to retirement income planning and where we're seeing some success. I'll talk about some of the challenges that we're seeing and also some of the challenges that retirees are facing and how we're trying to handle those situations with customers. Then I'll take just a brief look into the future.

I think this Society has done a tremendous job of identifying some of the real challenges that retirees face. There are a whole host of challenges, —and any one of them could derail a retiree's plan and their lifestyle during their retirement. A combination of two or three or four of these things, which could be likely, could be that perfect storm for a retiree during their lifetime. I was reading an article by Ken Dychtwald, the author of *Age Wave* and a leading authority in the aging population. He said, "A typical scenario today is a 52-year-old now needing to work until 74 and then maybe caring for a mother-in-law, stepchildren, a divorce, a new business and a chronic illness." That's what we're working toward, I guess. These are pretty serious issues, and the truth is that planning for a successful retirement is very complicated. There are a lot of unknowns out there for most investors, and education is really, really important, and I'll talk a bit about that.

At Fidelity, as I mentioned, we've been refining our approach for the last 10 years, and we have built five guiding principles, if you will, that we call the Fidelity "We

Believes." When something at Fidelity becomes a "we believe," that really becomes part of our culture and what we impart with customers. I want to review these five "we believes" and then go into some of the things that come up most often as we work with customers.

First, we believe that every retiree should have a retirement income plan that incorporates realistic estimates of anticipated expenses. That's the first kind of cornerstone—that we have to identify realistically what are those expenses during one's lifetime, and we'll address those. The second is we believe that essential expenses, including health insurance, should be covered by sources of lifetime income—sources such as annuities, pensions, Social Security—and that those sources of lifetime income cover essential expenses. I'll touch on that. Third, we believe that a retirement income plan should not expire before the retiree expires; they won't outlive their assets. That's very important. Fourth, we believe that every retirement income plan should have an asset allocation that addresses inflation and health care costs—big issues—and balances the need for long-term investment growth with taking into consideration the shorter-term volatility from the market. And then finally, we believe that a retirement plan should be flexible, so that it can be changed as retirees' situations change over time. Just think about how your life has changed over the last 20 or 30 years. A retiree or an individual going into retirement today will experience similar types of changes or just-as-dramatic changes over the next 20 to 30-plus years, so we need to build a plan that can address those things.

A challenge for us is how to simplify all of these issues in such a way that it is not so overwhelming for the average investor, yet still address all of the important issues so that the plan can be bulletproof or rock solid. A lot of things around financial security depend on understanding a series of risks and tradeoffs that can, if not addressed, seriously erode someone's life savings. These are the five biggest challenges that we look at when we're creating a lifetime income for an individual. They include inflation risk; longevity risk; asset allocation risk, or not being too conservative or too aggressive; the risk of taking too much money out, or the withdrawal rate risk; and addressing the risks that can devastate a plan from health-care-related expenses during retirement.

We find that customers fall into the trap of following conventional wisdom or poor rules-of-thumb very often. I want to go through some of the things that we hear from customers most often and how we look at addressing them. The first one is around longevity. Conventional wisdom is that you plan for life expectancy. Nobody knows that better than this audience that when it comes to planning for lifetime income, if you plan for life expectancy, you have a pretty faulty plan. The deal, then, is not life expectancy but longevity. That's the most important thing, yet it's also probably the least understood variable for people creating a plan or moving into retirement. A couple, age 65, has a 50 percent chance that one of them will still be living at age 92. Yet, there is a one-in-four chance that one of the couple will still be living at age 97. The typical investor or retiree does not look at a life

span necessarily that long and thus often will underprepare or plan for a retirement that ends up being a lot longer than they expected.

For the second one, let me jump to the risks of health care and the expenses that are incurred there. The conventional wisdom is that Medicare will cover your health care costs during retirement. Health care costs pose a very real risk in throwing an income plan off track if they are not taken into consideration, and the trend in this area is not very good. With longer life spans, with medical costs rising faster than the rate of general inflation, with declining medical coverage by private employers and impossible shortfalls with Medicare and Medicaid, all of these things add up to a real critical challenge for retirees to address. We did a study last year and identified that a couple retiring today at age 65 will spend in excess of $160,000 just on medical-related expenses during their lifetime. That's not including the possibility of them going into a nursing home, for which the odds are fairly high. Nursing homes now run upwards of $60,000, $70,000, $80,000 and even $90,000 in the more expensive states like Connecticut or Massachusetts. These types of costs have to be considered when you build a plan to last one's lifetime.

As for the risk of inflation, conventional wisdom is that you'll spend less in retirement. The rule of thumb is that you need 70 percent of your preretirement income. You'll spend less the older you get. We know that's not true if you understand inflation. Through the 1990s and even up until today, I think there has been a false sense of security that inflation will stay low. But possibly, like the asset bubble of the 1990s, recent experiences may be more likely to be an exception than a reliable indicator for the future as it pertains to inflation. Retirees are not always aware that even with modest inflation, such as 3 percent, that over a 25-year time period their expenses will more than double. If inflation were at 5 percent during a 25-year retirement, your expenses would more than triple during that time. That's something that's very important for investors and retirees to consider.

The conventional wisdom regarding asset allocation risk is that you become more conservative in retirement. You move to bonds. You move to cash. Yet, there's some analysis here that I'll share with you that I think has to be considered very seriously as one moves into those retirement years. Chart 2 shows the historical likelihood that assets will last based on a 5 percent withdrawal rate adjusted for inflation. We have three different portfolios. One is a short-term portfolio that is very conservative—100 percent cash. That's the line on the left. The middle line represents a conservative portfolio that includes 20 percent stock, 50 percent bonds and 30 percent short-term investments. The final line represents a more balanced portfolio of 50 percent stocks, 40 percent bonds and 10 percent cash. You can see that with a 5 percent withdrawal rate, all three portfolios will be able to throw out the very reliable income for the first 15 years with no problem. There is a 100 percent likelihood that all three portfolios will succeed. Yet, if you move out to 25 years, the ultraconservative short-term portfolio has a zero percent likelihood of success. These are the Ibbotson numbers through a Monte Carlo process with 90 percent probabilities. There is no percent chance of that portfolio succeeding.

Even the conservative portfolio, which is the conventional wisdom, has only a 40 percent chance of success. At the same time, a balanced portfolio—not aggressive—with 50 percent stocks and 40 percent bonds, still has an 80 percent likelihood of success. If you move out to 30 years, which is very likely for a retiree today, even the conservative portfolio only has a 10 percent probability of success. For many, this is really counterintuitive and goes against what people have heard for years and years as you reach retirement.

For withdrawal risk, conventional wisdom is that the stock market averages 10 percent or so growth every year. So, if I take out 8 percent, I should be fine. In fact, my principal will probably continue to grow. Chart 3 shows what that trap really is. If an individual were to take out that 8 percent based on a 90 percent confidence level, again using Ibbotson data and a balanced portfolio of 50 percent stocks and 40 percent bonds, that 8 percent withdrawal rate will likely only last 15 years. Individuals who were taking 8 percent over the last several years during this market have either had to return to the workforce or considerably downsized their budgets and have really felt the impact of that. Comparatively, a 4 percent withdrawal rate lasts 33 years.

Now, putting it all together and moving from Monte Carlo simulations, Chart 4 seems to help as we work with customers to explain withdrawal rates, asset allocation, longevity and actual history. It depicts a 65-year-old couple retiring in 1972 with $500,000 in a balanced portfolio of 50 percent stocks. During this time period, there was obviously the great bull market in the '90s. There were two of the worst bear markets. There were five recessions, two major wars and serious inflation in the '70s. Chart 4 shows what happened. If funds were withdrawn at a 6 percent rate, this 65-year-old couple would have depleted their assets by 1988, when they were 81 years old. There would be more than a 90 percent probability that one of them would still be living, but their assets would be gone. At a more modest 5 percent withdrawal rate, income from the portfolio would last nearly 25 years, much longer than the 6 percent, yet there would still be a 63 percent chance that one of the members of that couple would still be alive. Now, if you were to move to a 4 percent withdrawal rate, adjusted for actual inflation, that portfolio would provide an income through today, and the assets would not be depleted. In fact, those assets would have hit a peak of $1.7 million a few years ago and then settled back into $1.3 million today. The couple would be 95 years old and there would be a 35 percent chance that one of them is still living. This is how we try to demonstrate combining all of the issues or many of the issues together for a retiree going into retirement.

How do we take this combination of longevity, asset allocation, withdrawal rate risks, et cetera, and create a plan? We believe that the foundation of a sound income plan is to divide your expenses into two main categories, and I'll step you through how we look at the construction of a retirement income portfolio. I think it's different than most people would find at other locations. The first part and kind of the cornerstone of that is dividing your expenses and identifying realistic

expenses during your lifetime. There are two buckets. One is essential expenses and would include things like food, taxes and health care. . All other expenses would fall into your discretionary bucket and would include things like travel, hobbies and the golf club membership. Each of these buckets might be different for every one of us around the room. What I might call essential may be discretionary for you and vice versa.

Then we need to do an income inventory and take a look at the sources of lifetime income that the individual has. It might include Social Security, a pension and/or an income annuity. We would put all other assets to the side for a minute. Then, we would look to see if our sources of lifetime income actually match our essential expenses. If they do, we've got a good start for the plan. If there's a gap, then we need to take a look at those assets we put on the side and identify how we might be able to take some of those assets and turn those into a source of predictable lifetime income to cover the essential expenses. That might be through an income annuity. It might be through a very conservative systematic withdrawal plan. If we can cover our essential expenses for the lifetime of the investor or the retiree through sources of income that won't disappear, we've done really well for that investor as a baseline. Then we take the remaining assets and identify a portfolio that will throw off enough income for the discretionary assets—for the lifestyle, if you will, of that investor. From that point we've freed up other assets that they might use for gifting or charitable inclinations. Then we need to take a look at that and buttress that plan with areas of insurance, such as long-term care, medical insurance or life insurance, to make sure that this plan won't unravel when that storm inevitably hits at some point during retirement.

We have been refining our thinking and our processes, and at the beginning of this year, we launched a pilot with this portfolio construction with some seminars, workshops and worksheets to test it with a number of customers. I'll review what we found with our first 100 participants as it relates to our business, which I think is very optimistic for the future in doing this for our firm. The first finding is that 82 percent of the people who went through this process felt that their relationship with Fidelity was strengthened, so it proved to be a very good relational retention item for us. As for referrals, 33 percent had already made a referral when we surveyed them, and 34 percent said they were very likely to. Of the participants who went through this process, 50 percent consolidated their assets at Fidelity, and an additional 35 percent of them said that they were likely to do so. Fifty-two percent of them said that they were likely to use our asset management products, and 42 percent of them said they had purchased an income annuity to solve that essential expense gap in their portfolio.

Our focus at this point and our efforts are all around educating the 14 million clients that we have. Helping them understand these risks through seminars and workshops, newsletters, appointments and education is clearly the important thing that we're focusing on so that they can prepare and be ready for the complex situations that they will face during their retirement. Beginning in 2004, we'll be

introducing a Fidelity Lifetime Income Services service to the general public and to our shareholders that provides our methodology and programs and services and accounts. We'll be doing it in a way that customers can do it on their own over the Web, can do it over the phone with a specialist or a dedicated resource face-to-face with an account that wraps that service and that program together. We think this is the future.

This is what our vice-chairman had to say at the Commonwealth Club in a presentation earlier this year in San Francisco: "Our industry will continue to evolve from mainly an asset-gathering and asset-management business to a provider of sophisticated lifetime financial solutions. The ability to create reliable, cost-efficient, lifetime income solutions will be the single greatest challenge for every major mutual fund complex and one of the greatest competitive differentiators." We're excited about the success we're seeing. We have a long way to go. Investors need this help. This is very complex, very challenging, and the storm is looming out there for everyone. It's our hope we can help them.

MR. JUNUS: We're trying to give you a way to view and understand the market, the way it's evolving and maybe even a look into the future. You then would be able to analyze and decide for yourselves how best to attack the market because each company will be unique. If I were to classify or categorize the different potential customers out there for income solutions, one category would be people who may not have enough money right now, who have not saved enough. Another category includes those who have just enough money. Then, there are those who have a lot of money. We should be able to serve those in each of these three categories.

First, I want to give you a brief outline of what I'm going to be presenting. I'm going to point out to you that there are a lot of income options—and this is from the customer's viewpoint—and then the pros and cons of each of those options and why they're selling or not and things like that. Essentially, these are my viewpoints of the pros and cons of those different options and my sense of what's right for customers and how we should be able to serve them.

The current sources of income for the current group of retirees are reverse mortgages, defined benefit pension payments, Social Security payments and accumulated savings. Reverse mortgages are essentially spend-down strategies. The reason reverse mortgages are big as an income vehicle is that most of your assets are tied up in your home if you have not saved enough. So, people turn to reverse mortgage as one of the options to be able to get some source of income. Of course, a lot of people still have defined benefit pension plan payments. Social Security payments are still around. Then you also have accumulated savings, which really depends on how much you've saved or haven't saved.

Virtually any liquid investments that you have can be turned into income, which is how most people right now are trying to get income. A big portion of it comes from

certificate of deposit (CDs). Of course, you still have your 401(k) and IRAs. You also have annuities and a lot of mutual fund investments as well that turn into income vehicles. How do they get the income? Well, really it's taking regular withdrawals from these savings vehicles. Some withdraw just interest payments. Others take out a specific percentage or amount or just basically follow the minimum distribution rules for qualified savings, that you have to take out a certain amount of money. When you boil it down, they are systematic withdrawal programs. The kinds of services that are offered out there to try and determine how much income you can take out safely—which Tai and Paul were referring to when you're just taking a certain amount out—so you will be able to live with that income for a while. People now do stochastic assessments of income needs to try to determine how much income you can take out every year or every month.

Here are the pros for systematic withdrawal options. First of all, you have access to the funds. You saved a lot of money. You want to see your money. You want to touch and feel your money. When you take out a bit at a time, you have ready access to the funds, and that's very important. That's a pro. You can get interest for life, assuming you can live off the interest. You have safety of principal if you put it in conservative investments. These are appealing to people who have saved a lot of money and are trying to determine how best to get income to live off this money. And really, if you do put it in risky investments, you have the potential to keep up with inflation.

But here are the cons to that strategy. First of all, it is tax inefficient. We receive a favorable tax treatment for immediate annuities, but systematic withdrawals are tax inefficient unless, of course, they come from a qualified plan. There's a good chance that there's insufficient income or there's a lot of income volatility if you adjust the amount of money that you take out every year from these assets. If the principal is tapped, you can easily outlive your assets. Now, the key question from the customer's viewpoint is: What is the cost to self-insure? How do you quantify this risk for customers? Do they really understand longevity risk? Part of the biggest obstacle I need to overcome is how can we present this risk in such a way that it's compelling enough for them to do something about it? They have to feel it. That's really the key. How can they understand the cost to self-insure?

There are lots of providers out there who do a lot of illustrating of how much income you can take out to really try and get enough income out of your accumulated assets. This is the appeal of the stochastic assessment of income needs, with all these illustration software out there. It's a planning approach. You're developing a financial plan with a customer. You're building this relationship. And you can manage expectations well enough. There's some assessment of risk in the stochastic assessment of income needs—and what I mean by stochastic is a Monte Carlo assessment of income needs. And then you can do comparative valuation of different alternative plans. You can show Plan A, Plan B, Plan C and Plan D. It's flexible and understandable. Now, this is in the context of a systematic withdrawal approach to taking income out of assets from savings plans.

The cons of stochastic assessment of income needs include that sometimes it can be based on arbitrary income horizons. There is also a chance that you can outlive the assets after a short planning horizon. And there may be insufficient income, so you can't maintain your lifestyle, so to speak, if the planning horizon is too long. And, of course, again, there are tax inefficiencies for nonqualified systematic withdrawal plans.

Now we come to insurance company products. We have these traditional fixed single premium immediate annuities (SPIAs). There are SPIAs with liquidity options that are coming out right now to address those trust issues and the fact that when you annuitize your assets, you actually lose your "savings." There are a few variable immediate annuities with guarantees out there. And then there are guaranteed minimum income benefits on variable deferred annuities. These are actually being positioned as income products. These are the different insurance company products that are out there.

Now, let's discuss the cons for those insurance company products. We'll go over the pros here in a short while, which is going to be the major focus of my presentation at the end. The cons include that people feel they are surrendering savings for periodic payments or traditional immediate annuity products, and that is a huge obstacle to overcome. It's almost an irrevocable decision for these traditional immediate annuity products. But insurance companies have developed some immediate annuity products that actually provide liquidity to counter some of these effects, but at a cost. An immediate annuity can be foreign to quite a few folks. When insurance companies market anything, they tend to be very product-centric. I think from Fidelity's point of view it's more like a program, a financial planning approach or a retirement planning approach, which I think is what needs to happen. There's still income volatility if you do provide variable immediate annuities.

What's right for the customer? It is really, in essence, what they want to do versus what they need to do. We understand what they need to do, or somewhat the right option for them. What they want to do may be different. Let's put it this way. One of the biggest problems that you see, and I'm going to point out here, is that I don't think customers understand the risk that they're taking. They can't really feel longevity risk. They can't see it. Part of our task is to try to determine how best to present it in such a way that it actually hurts them, so to speak, enough to do something about it.

You're trying to look at core needs and wants. I'll just try to do a simple product mapping. This is just something simple that I've just developed to try to help put those different products in perspective in terms of how they map up to different needs and wants and then use that to determine how best to attack the market. First of all, let's look at the basic needs. They're concerned about control. It is their money. Liquidity and trust are very important. They need income. They need to eat and play. It must cover longevity, lifestyle, inflation and health care. There are lots

of other needs that you can put in here, but these are the basic needs that I've categorized.

Let me try to explain Chart 5. The checkmarks are varying sizes. The small checkmark says: "minimally satisfies," and the large checkmarks says: "really satisfies." The second-largest checkmarks indicate: "mostly satisfies" and a checkmark in a circle means "does not satisfy." This is simplistic in some sense, but I just want to kind of point out a few things here. The columns list needs—lifestyle, control—control meaning that you have control of your assets—longevity, inflation and then emergencies. What I've tried to map out are these different product options that are out there—taking systematic withdrawals from mutual funds, traditional fixed SPIAs, variable SPIAs with liquidity or taking out income from a certificate of deposit. Here are my—albeit subjective—checkmarks to indicate how much each of these products meet those different needs. For example, look at mutual fund systematic withdrawals and longevity. In some sense it can provide some kind of longevity "need" or cover some of the risk but at the expense, of course, of lifestyle. It is able to provide some kind of longevity, but it's not a guarantee.

The one thing that's bad about traditional fixed SPIA is that you can't cash it out. It's not really good for emergencies because it's meant to provide you income. With a variable SPIA with liquidity, you can see it kind of satisfies quite a few of these options. It looks like it's meeting the needs of these options, but it's kind of averaging out on all these needs.

For a CD with systematic withdrawals, you have a lot of control. You'll be taking inflation risk, but you have ability to get the money out in terms of emergencies. Now, let's take a look at the product needs map for a fixed SPIA in Chart 6. Here, I've added kind of like the cost for all these different options. You have life only, life and 10-year certain, life with cash refund and life with 3 percent increasing benefits. These are the hypothetical benefit amounts for those different options. Again, those are the lifestyle, control and longevity. These are the needs that we feel customers want.

When I was showing the product needs map earlier , you couldn't really see the cost. With this, you can really see the cost, right? So, if you want a lot of income, you're giving up control, inflation and emergencies. If you want to provide for some of that inflation protection—again, this is for fixed SPIAs—your benefit amount goes down by $300. That's a true definite cost in trying to meet those inflation needs. We have life with 10-year certain, and I'm assuming that this has some liquidity option in there. So, in essence, what I'm trying to do here is find a way that we can provide the ability for customers to determine how much they're willing to give up and how much they're willing to pay to meet these needs. That will give us the ability to kind of crack that code. I believe that we can do good business in SPIA.

In looking at this product needs map, you may not be able to meet all the needs or address all the concerns. If you do that, then it's going to be very complicated, and it may cost a lot–. But the question is how much does the customer value each feature? It may be different, depending on the cycles or where they are, but the question is, how can they choose? An obvious solution is to package multiple products, which is what Fidelity and other companies have done. They've packaged systematic withdrawals with immediate annuities and things like that.

To summarize, there are a lot of options out there—sometimes too many. I think people try to choose what they feel comfortable with. They don't necessarily look at immediate annuities or SPIAs as their ready income, a ready source, a product for them to use. But again, there are a lot of unmet needs and wants. In trying to understand that, that's part of the hurdle that we need to overcome. Our task as actuaries is to present clearly linked solutions to those needs, and there's a lot of room for innovation in this marketplace. Thank you. Paul, I was wondering if you could provide us with GE's thought about developing the Retirement Answer product.

MR. HALEY: The GE Retirement Answer is a product that we probably introduced full-scale to the marketplace around the summer of 2002, and, as I mentioned, it's on a variable annuity chassis. It's built on a variable annuity chassis largely because, given tax laws and other constraints, it was the best chassis for us from a product development standpoint. We didn't set out to build a variable annuity that had certain income features. What we were looking for, as I said, was basically to address what we saw as an income need. We wanted a product that would guarantee a floor of income and that had the potential for some upside if the investments in some equity accounts did well. But really, the chassis was immaterial to us at the time. We were really, again, focusing on this income need.

It was a long development process for us. It's like any product. I think it will take awhile to become an overnight success, but it's ramping up nicely. It's a little bit different in the marketplace. I think some of what we're seeing is not necessarily resistance but unfamiliarity with brokers as to how do you sell income as opposed to selling accumulation? But we like it. We think it meets the needs that we were talking about before. Again, it's based entirely on income. What you're buying is an income promise. You're not buying the ability to invest in certain separate accounts or to accumulate a sum of money or guaranteed withdrawals. It's an income stream that starts at a defined period in the future. There's a minimum, and you can get more.

FROM THE FLOOR: I applaud your efforts to educate individuals about the need for income, and I just wonder if there are any plans from either of your organizations to take that to the public and do advertisements about the need to really be planning for income rather than getting a lump sum of money out of their 401(k) plans.

MR. BRIGHT: We are, yes. In fact, as we speak, we are building dedicated resources on the phone and in our investor center network—building tools and systems, technologies—so that investors can do this on their own. We're developing an asset management account, if you will, that will encompass the retirement income plan. At the beginning of 2004, we will launch that entire service and go nationwide, public, with it.

MR. DEAN K. SLYTER: I've long thought that the area of payout annuities is an area where we, as actuaries, can have a community service function, where we can talk to our friends, our neighbors, civic groups and churches about the need they have to plan for the future, whether they're among those who have plenty of money and are fine, those who are borderline or those who are short. We can talk to them about planning for the future and looking at some of the options for them out there, including payout annuities certainly. I want to encourage Society members to consider doing that where you can, and I also want to ask if the kind of material that has been presented can be used in those sort of presentations. Are you willing to allow us to use some of this material that's part of the handouts as we are sharing with people about the need?

MR. JUNUS: Material is on the Society's Web site, including Tai's and my presentations, and it is available for the public.

MR. BRIGHT: We also created a white paper during the middle of this year. We call it our "Viewpoint" I took excerpts out of that white paper that is available to the public, so absolutely. We encourage you to do that.

MS. ANNA M. RAPPAPORT: On behalf of the Actuarial Foundation Consumer Education Committee, we do have a piece called "Making Your Money Last a Lifetime." That piece is co-sponsored by the Actuarial Foundation and the Women's Institute for a Secure Retirement (WISER). It really gets to the issue of the decision between lifetime income versus the decision about managing the money yourself and some of the pros and cons. What it doesn't get to at all—and maybe there's a need for a second-generation paper—is how to work your way through the maze. For example, given that I've decided that I want to buy an annuity, there are these things called SPIAs, and if you don't work in the insurance industry, that's really mysterious, as are variable annuities and other things. I'm quite concerned about how to present to the public and how to present to the pension community—because I belong to the pension community, not the insurance company community—information about annuities that once was thought to be mysterious and so technical so that people can understand how to make comparisons and also understand what is and what isn't a good value.

There's been considerable criticism historically as to annuities not being good a value, which is, I believe, one of the barriers. I didn't hear anybody talk about that particularly. The question for me is, if I was part of the public or even as an actuary, how do I tell? And if I think about this from the perspective of a client

who's an employer, a plan sponsor, before they'll encourage their employees to look at something, I think they need to understand that things are good value and they need to not be obscure. They need some impartial sources of information. They're unlikely to want to recommend specific product. They might recommend a choice, but there's an information gap, I think. There are so many choices in the market. What do they mean, and which ones are good? Which ones aren't good? Maybe they're all good, but I would say that some are surely better than others.

MR. STEVE P. COOPERSTEIN: Tai, regarding the really exciting chart that you have about how long will it last, do you take it to the next step and incorporate what happens if you incorporate an income product into that layout? Have you done something like that in your presentations?

MR. BRIGHT: We have looked at different ways to demonstrate it in a way that would be simple enough for the average person to really understand and be able to act on it. It didn't show in my presentation or the white paper, but those are the things that we have to look at in a way that provides the information that an investor can make savvy decisions, but we don't have that right now.

MR. COOPERSTEIN: In going through your plan, the expectations and the probabilities change dramatically because of the mortality element. I think, Paul, you mentioned the mortality and investment risk as the two things, and yet you didn't really continue to say how we deal with the mortality element. One of the things with income products is that we talk about the guarantee of income for life, but there's also another big guarantee that we provide, and that's the mortality guarantee, the guaranteed rate in there. Each year that you live, the people who die pay for the people who live, and is there a leverage item that comes into it? If you extend the chart, that leverage becomes a really important part of it.

I also think that, in answer to Anna, to some degree, if you unbundled the product, it becomes a very different product and a much more understandable product. We don't talk about the mortality element in the product. I think we've been afraid to. My experience in talking to the people is that this is an insurance mechanism in which you're trading your assets for income. It takes on a whole new understanding on the part of the prospect for understanding that they're not giving the money back to the insurance company when they die, but they're entering into an insurance mechanism just as they do for life insurance or auto insurance or anything else. So, I think unbundling them has a lot of potential for really making this a simple product to understand and to present, although, as you said, Paul, the distribution still has to be educated.

MR. HALEY: Just a couple points. In terms of the mortality impact of it, I think there are pros and cons to that, obviously, because one of the concerns that people have is that they'll be one of those who die and will pay for the people who continue living. I think we still have to work the right way to educate the public that the reason we can handle the longevity risk is because there are some of the

people who are dying. In terms of illustrating and the next step to showing the impact of putting an income solution onto Tai's chart, to some extent I think that's where you really want to start getting into true financial planning because the cost of the income solution changes over time. If you try to create a marketing piece that you'll be able to use for even six months, you'll have so many caveats around it, such as this was priced assuming interest rates at this level or whatever. I think it really makes more sense to try to give the tools to the financial planner so that they can show the impact at time of sale.

MR. RANDY J. VON FUMETTI: I am a financial planner, so this is all very, very applicable. First I just want to make a comment. I think the concern about income planning is very important, but I guess I would also express in general, let's not go too far that way. I think when you're working even in the middle-income market, you reach a point with people when they've accumulated some means that they start to become as concerned about wealth preservation as they do income. So, we do need to take care of income needs, but when you start talking only about income-generation-type products, then all of a sudden they not only lose control over managing the money, but then there is nothing left for the family or whoever they want to pass it onto.

The previous person who was up mentioned something about unbundled products. A potential option I thought of that you tend to use in a wealth preservation strategy, but it may work really well in an income/combination preservation strategy, is maybe more of an unbundled nature. That's a fixed SPIA, taking some of the payments to provide income to whatever extent the client needs it, and using some of it to fund a permanent life insurance contract. You then have that liquidity issue solved where you didn't with some of the other options you've chosen. It provides death benefit protection when they die, which is wealth preservation to pass on. I think when you do have the unbundling, and that's an example of one, you give a lot more options out there. Making all of that work is fairly well predicated upon how well the advisor does in explaining all of those options and presenting all the choices to the client. So, that's my comment on that. If you have any responses, I'd appreciate it. I do have a specific question for Mr. Bright.

The very first speaker talked about giving 401(k) advice and some of the inefficiencies of 401(k) plans because employers were hesitant for regulatory and compliance purposes of giving out 401(k) advice. I read an article in *The Wall Street Journal*, I think just two weeks ago, that Fidelity actually has a program where they are able to give advice to employees in 401(k) plans right on the worksite. I'd appreciate your response to that.

MR. BRIGHT: I'm not sure I have a response. I don't work in that area, and I would not be able to comment intelligently on what kind of advice we are giving on the institutional side of the defined contribution side. So, I apologize.

MS. RAPPAPORT: There are several vendors that provide online advice, and if you get the annual survey of the Profit Sharing Council of America, you can see that advice is increasing. The online advice kind of goes the next step from investment education and it's by asset class. Some of the advice vendors are separate from the investment houses, so they're companies such as Financial Engines, but there are several companies like that that do online advice. There are some companies that now have things like pop-up screens in their administrative systems so that when people are getting ready to say, "I want to change my investment option," they get a pop-up screen that says, "Did you want advice?" reminding them that it's there. Having said that, the use of the advice is fairly low, and one of the legislative issues that has been before Congress for the last couple of years is how much employers are protected if they give advice from fiduciary liability.

MR. JUNUS: There's a lot of room for innovation, and the gentleman who just stepped up there was pointing out he can use immediate annuities combined with a whole bunch of other products. One product that was developed that was intriguing to me was called DB and DC. It essentially looks like the GE Retirement Answer, but this will be a fund option in a 401(k) plan. So, you're 35 years old. You are going to put money into this fund, but that fund is not going to have any asset value. It'll only have an income value when you retire at age 65. The reason they call it DB and DC is it's a defined benefit "plan" or product in a defined contribution plan. There will be lots of people test marketing, trying out different things, but that's why the focus should be on putting yourself in a customer's shoes and trying to determine how best to market the services that you feel are appropriate for them.

FROM THE FLOOR: Have you actually looked at the impact of the tax changes that happened this year and how they might impact the tax advantages of the SPIAs versus holding that same amount of money in dividend paying preferred stock rather than paying common stock?

MR. HALEY: We've taken some looks at it. Obviously, the initial reaction when we first heard about it was, it's going to crater the industry. Then, I don't know if saner heads prevailed, but other heads prevailed, and we've done some analysis. We think there's obviously the potential to cut somewhat into the marketplace that people have for any kind of annuities, whether they're variable annuities or payout annuities. I do still think that the longevity protection that you get in payout annuities will protect it somewhat from the beneficial taxation changes that mutual funds would get. But, as I said, in the past we haven't done a very good job of showing the benefits of longevity to the public. I think this is just going to create more urgency for us as other products become less advantaged relative to mutual funds. We see it having some impact on the deferred annuity market and less on the immediate.

MR. JUNUS: Are you referring to another legislation that's being worked through to lower the income tax rates on immediate annuity payments?

FROM THE FLOOR: (INAUDIBLE)

MS. FAYE ALBERT: I want to ask about the mortality specifically. I'm involved in the Society's experience study, and we've been having a lot of difficulty getting mortality experience on payout annuities. Our estimates are that the mortality should be able to be improved at the older ages now that people are living longer. I guess my question really goes to the way that you're pricing products. What mortality are you using? People are living longer and longer, and this could certainly impact the pricing of annuities that are guaranteed for life.

MR. HALEY: I would agree that it could impact the pricing, but I do not feel comfortable sharing what our pricing assumptions are.

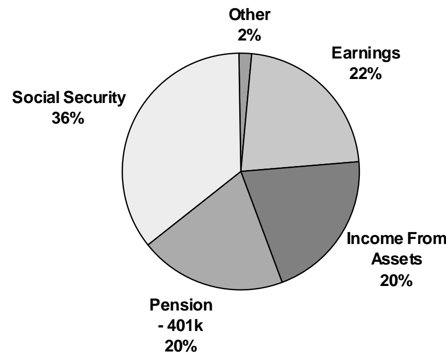
MR. JUNUS: One thing that somebody pointed out to me was that the annuity mortality experience that we have right now will not be the mortality experience of the people who may buy SPIAs in the future because there's not really a lot of people annuitizing or if they do, they're amortizing from defined benefit pension plans, where they don't have any ability to anti-select or self-select themselves. So, mortality improvement will be important, but I think more so is the selection effect of mortality, meaning that those people who are going to select individual immediate annuities are going to be the ones who tend to live a lot longer than most other people. Any more questions? Thank you

Chart 1

So You're Retired, Now What?

"America's retirement system is in transition, transferring greater responsibility to individuals for managing their own futures"

ACLI, 1999



"There is a 40% chance that an American will be poor at some point after age 60"

Source: AARP –Beyond 50 June 2001

Source: EBRI tabulations of the March 2000 US Census Bureau Current Population Survey

An Underserved Market Beckons

6

Chart 2

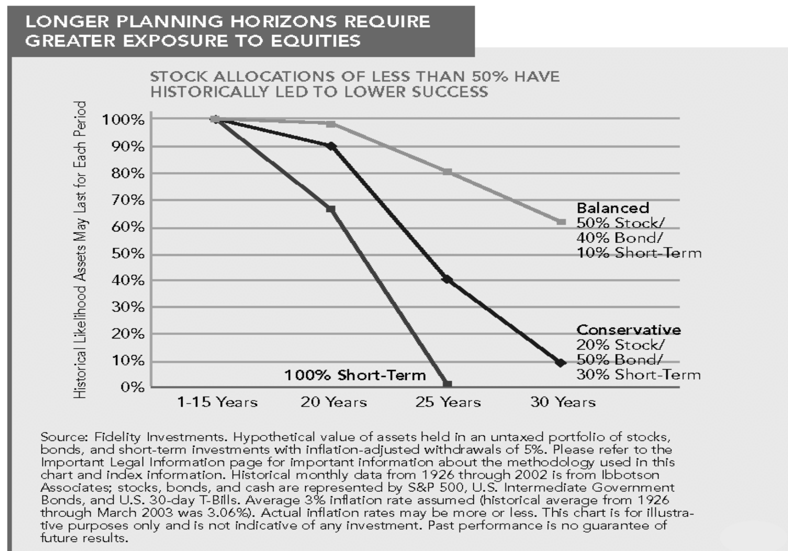


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Chart 3

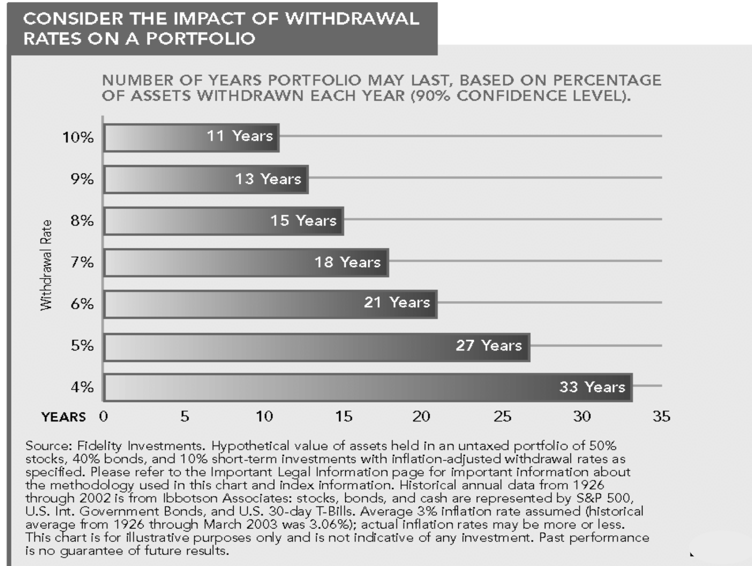

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Chart 4

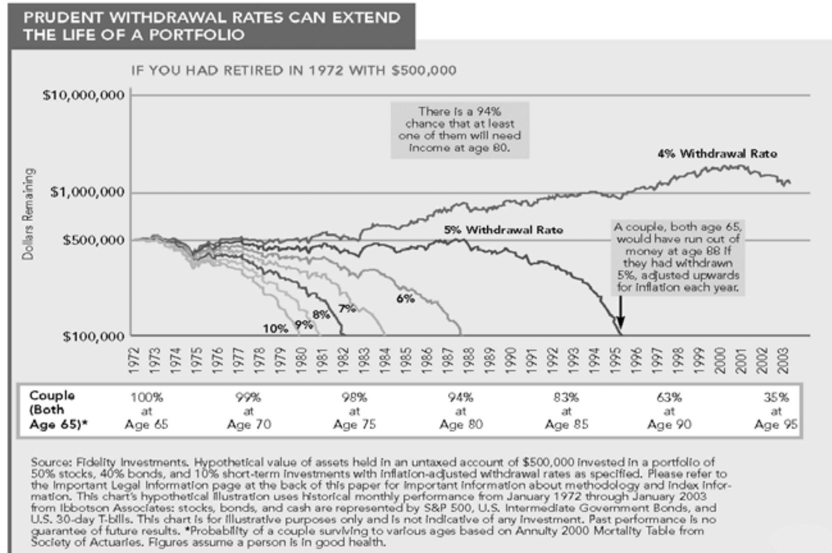

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Chart 5

Product – Needs Map

	Lifestyle	Control	Longevity	Inflation	Emergencies
Mutual Fund Sys Wd	✓	✓	⬭	✓	✓
Traditional Fixed SPIA	✓	⬭	✓	⬭	✗
Variable SPIA with Liquidity	✓	✓	⬭	✓	✓
CD Sys Wd	✓	✓	⬭	✗	✓

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Chart 6

Fixed SPIA – Needs Map

Benefit Option	Benefit Amount	Lifestyle	Control	Longevity	Inflation	Emergencies
Life Only	1,000	✓	✗	✓	✗	✗
Life & 10 yr Certain	800	✓	✗	✓	✗	✓
Life with Cash Refund	900	✓	✓	✓	✗	✓
Life with 3% Increasing Benefit	700 Initial	✓	✗	✓	✓	✗

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