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How Employers Can Benefit from Recent Retirement Research Analyzing Income Options: A Perspective by David Manuszak

INTRODUCTION BY ANNA RAPPAPORT

The Society of Actuaries, working with the Stanford Center on Longevity, recently completed a new study: Optimal Retirement Income Solutions in DC Retirement Plans. *In four parts, the study defines efficient frontiers for retirement income and provides analysis of the trade-offs between different options which were not previously available. The study examines a number of income options available at retirement, delaying Social Security and integrating Social Security and plan income options, the use of qualified longevity annuity contracts(QLACs), and options for purchasing income prior to retirement age. The researchers are Steve Vernon, Joe Tomlinson and Wade Pfau. David Manuszak, a member of the Project Oversight Group, has spent many years in employee benefit management. Before retiring, he was executive director of National Employee Benefits Administration, a division of the Blue Cross and Blue Shield Association that provides benefits and benefit management to employees of Blue Cross and Blue Shield plans nationwide. We have asked him to draw on his experience and to represent the plan sponsor point of view.*

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Reviewing the four parts of the study sponsored by the Society of Actuaries Committee on Post-Retirement Needs and Risks has been rewarding to me both from a personal standpoint and from the standpoint of a plan sponsor. I have been privileged to participate in a small way in shaping the studies as part of the project oversight group. Moreover, the work has made me aware of some of the most forward thinking available today on the subject of how to best protect oneself from outliving one's assets. All of this is in light of key unknowns: how long one will live, how one will fare during that lifespan, and how one will avoid outliving one's funds. I have witnessed the shift from DB to DC, and I share a concern about a rational method of payout of benefits with others on the project team.

This study defines the retirement wealth portfolio to include regular income, and the portfolio's asset mix includes the value of regular income provided through an annuity. The parts state clearly that it is very important to cover basic living expenses with a combination of Social Security, pensions and annuities. They then look at investment choices for people who have a portfolio generating secure income plus additional assets to invest. They use analytical techniques comparable to those used to compare investment classes to provide new measures and insights about the differences between options.

The study focusses on how annuities and other forms of regular income can be used to build a post-retirement income plan. Annuities show up very well when amount of life income is the goal because of the mortality dividend. With immediate life annuities, the asset pool is divided among the survivors. The assets contributed by the individuals who die are redistributed to the survivors. As actuaries and mathematicians look at the landscape and run the numbers, it seems obvious to them that having an asset that provides guaranteed annual income as a base is a sine qua non. The studies examine different types of annuities with comments about their pluses and minuses. In much of this, I am reminded of an old Metropolitan Life survey of retirees that found the happiest retirees to be those who had reasonably good health, had a regular source of guaranteed income, and had additional assets that enabled them to do special things. Well, yes. That survey was taken toward the end of an era in which retirees might be expected to have a pension as well as Social Security and personal savings. Currently, however, annuities have fallen out of favor, and many retirees are not yet fully involved in longer-term planning. It will take a major effort to focus people on the long term—to help the populace at large understand the options and their pros and cons. That may well be a future effort where the actuarial community can add a lot of value.

The work brings to the forefront the best thinking on Social Security, namely, that if possible one should delay taking Social

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Security until the latest point at which it makes economic sense. This point is age 70. The delaying approach, which has been gaining wider publicity lately, contradicts the formerly favored approach, which was to take Social Security as early as possible in order to take more funds from the system. With the current 8 percent percent annual increase in monthly income between normal retirement age and age 70, this is a very attractive reward for delaying taking Social Security to age 70. If one is able to delay taking Social Security to age 70, this is a good deal.

Perhaps most surprising to me is the proposition that the best option for investing the additional assets after all basic needs have been covered through Social Security and annuities or pensions is to invest 100 percent percent of one's remaining assets in equities.

Comments from Anna Rappaport: *"Best" here focuses on the greatest expected value. Stocks have the highest expected return over the long term, but they are more volatile. While stocks have the highest expected return in the end, they can also lose money and have much lower returns in the interim.The study does not shift away from an approach that is safe to cover basic needs. It does shift away from using bonds as the investment to accomplish this and toward employing greater use of annuities.*

This proposition is particularly surprising in light of the heretofore prevailing wisdom that a major portion of assets in retirement should be invested in bonds. Earlier advice sought to assist retirees in avoiding risk of loss. However, the new thinking is that there is ultimately more probability that such an approach will actually promote a greater risk of outliving one's assets. Two current factors come to mind here. The first is that individuals, in general, are living longer than their parents or grandparents. Secondly, the poor returns available from bonds in the current environment lead one to explore alternative low risk investments and make annuities more attractive as a low risk investment. This also means that someone invested wholly or in major part in bonds is actually falling behind with respect to inflation. Desirable strategies may need to rethought as there are the future changes in markets and living conditions.

The authors show that investing 100 percent of the residual in equities after protecting income needs must be considered a tenable solution. This is a different way to think about asset mix. The safe part is viewed as a match to income needs and the remainder is then invested differently. This suggests to me that, at the least, retirees should consider much higher equity components in their portfolios than they had once thought appropriate.

From the point of view of a plan sponsor, these studies are rich with suggestions. Yet a plan sponsor is always cautious not to undertake either unwanted costs or undue fiduciary responsibility. In the background are the pension liabilities that, when ill-managed, burdened or sank many companies and that are currently bedeviling the public sector. No one wants to go back. The move to defined contribution pulled plan sponsors from the brink. If a defined contribution plan is designed and set up well, sponsors were told, and the investment elections evidenced sufficient procedural prudence and due diligence, the sponsor´s responsibilities were a quantum leap back from those incurred in the days of pensions. Liability was on the front end, and lifelong connection and financial commitment was gone.

Some of what the studies show will have an uphill battle among plan sponsors. The ability to purchase annuities is offered currently by a growing number of defined contribution plans. The takers among plan participants are, as I understand it, few. For those retirees and pre-retirees with long memories, the recollection of the effect of double-digit inflation in the 70s on retirees who were receiving fixed monthly benefits is all too vivid. In addition, bankruptcies of annuity providers such as Mutual Benefit and Executive Life and of other insurance companies are a continuing caution. Perhaps most of all, pre-retirees and investors have grown wary of handing over large sums of money on the basis of a promise to pay in the future. If one were going to embrace annuities, the best and most cost-efficient way to obtain an annuity benefit, as many actuaries have pointed out, is through a defined benefit plan, and that ship has sailed. Moreover, movement of the funding of retirement over time from insurance companies, who once did it all, to investment companies has caused the annuity muscle to, as it were, atrophy. Innovative companies, such as United Technologies, that now offer an annuity piece as a possible outcome of their 401k plans are rare. The instances are characterized by a well-paid, well-educated, longstanding workforce in a large company in an industry that has been remarkably stable. Even with all that, it may be that some fiduciary risk for the company remains as the scheme plays out over time. Smaller companies, or companies that do not have that kind of workforce or stability, are more reluctant to take that gamble on their own. Moreover, plan sponsors would likely be more inclined these days, in a risk-averse posture, to "enable" a suitable retirement rather than to "provide" one.

The actuarial community has a significant task ahead of it: to rehabilitate the annuity and its providers in the minds of pre-retirees, retirees, and plan sponsors. Simply put, there is a lack of trust. Explaining in simple terms what annuities do and how best

to choose an annuity provider would be a useful point at which to begin. In addition, creating matrices that explore in detail the pluses and minuses of the various types of annuities available in the market today and the companies that provide them would be a valuable service.

Investment advisors are critical to the process, but few would be so bold as to advise a retiree to invest 100 percent of residual assets in equities. Especially now at a time when advisors are being asked to take on additional fiduciary responsibility, the tendency will be to go with what has been perceived in the prevailing wisdom to be the more conservative route in recommending an investment strategy. No one wants to be sued by disgruntled advisees during a market correction, as we have experienced recently, or even a long-term bear market. So, there is a need to educate advisors as well.

Certain innovations, such as the recently approved Qualified Longevity Annuity Contract, or QLAC, show much promise by reintroducing the annuity in a context that has a regulatory seal of approval. But there is an uphill struggle to make this approach understandable. One of the most positive aspects of the QLAC is that their establishment shows that regulators are receiving quality advice from retirement practitioners on products that will enhance the lives of retirees and are acting on that advice. That alone is an indication that the tide may be moving in a good direction.

In a final segment, the authors discuss how pre-retirees might begin to position themselves as they approach retirement. Given the robust discussions of options in the preceding sections, this section provides food for thought for the pre-retiree, plan sponsor, and advisor communities alike. Its inclusion draws the implications of the first three sections back to the preparatory stage for retirement and makes the entire effort a whole-cloth of how to find optimal retirement income solutions through defined contribution plans.

In summary, these studies have provided an enormous service by bringing together some of the best thinking available on the slippery problem of how to live a lengthy retirement in a prosperous way, given the regulatory and investing landscape as it now presents itself. The authors have incorporated the best forward-looking thinking with current investment vocabulary, and they have provided mathematical and statistical underpinnings for expert readers. In a textual summary, the studies have significant merit and provide food for thought, both for individuals and for plan sponsors.

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Comment from Anna Rappaport: *I want to thank David for this interesting perspective. As one of the actuaries who David expects to have an uphill struggle, I am seeking ways to increase understanding and interest in more organized longer-term planning, and more planned lifetime income solutions. Other research from the CPRNR shows that many people want to hold on to their assets, and that Required Minimum Distributions become the default method of withdrawing money from tax-protected retirement savings. My view is that many of these people do not have a good understanding of alternatives for generating retirement income, and some of them do not focus on the fact that RMD is a method of drawing down assets. This paper is exciting to me because it opens up the way to much stronger analytical comparisons of a range of options, and provides new ways to think about the comparison. My hope is that while employers will generally not want to guide people to a particular option, they may be willing to encourage longer-term planning that supports better comparisons of the options.* ■

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