The Future of Retirement Income: Views from Thought Leaders

Considerations for plan sponsors in thinking about an income-oriented approach to retirement savings.

By Jody Strakosch

When we think about retirement in today's defined contribution-centric world, it conjures images of "nest eggs" or "pots of gold" that have been accumulated during one's working years. The central question for many workers, though, is what exactly should one do with what is often one's total life savings? Workers are concerned with how to manage these assets, from the time they start investing to when they begin using this money to fund their retirement. To answer this question, I interviewed three leading experts about their thoughts on the issues facing today's defined contribution participants and the role of the employer in helping to provide solutions.

Q. Professor Bodie, from an academic perspective, can you explain what 401(k) participants should be considering when they are investing over their lifetimes?

Bodie: I think it's very important that individuals recognize that the ultimate objective is to save enough during one's working years to maintain a standard of living in old age after human capital (the present value of lifetime earnings) is exhausted. Secondly, the optimal fraction of one's retirement portfolio allocated to equities depends on the amount of remaining human capital (age) and equity exposure through one's job. For example, the ability to adjust one's retirement age is a key factor in the optimal allocation to equities: consider the difference between a tenured professor and a worker in a cyclical industry.

This framework of thinking about consumption of income (or spending) and investing during one's lifetime is called life cycle finance. It's also important to think about risk management, which encompasses factors such as asset allocation, market risk, interest rate risk, and inflation risk. If we think the goal of the defined contribution plan is to provide an inflation-protected lifetime income that allows the individual to sustain their standard of living, then we need to reevaluate our current investment approaches, which focus primarily on wealth accumulation. The goal of income replacement is not the same as the goal of targeting wealth.

Q. Mike Sasso, are there specific risks facing participants in retirement that plan sponsors should be aware of? And, do you have any suggestions for plan sponsors to help their participants?

Sasso: Participants face a new set of investment risks as they plan for their retirements in the defined contribution paradigm; most of these risks were previously borne by defined benefit plan sponsors. These risks include:

- Longevity risk: outliving retirement savings
- "Buy the new boat" risk: spending lump sum assets prematurely
- Shortfall risk: the lack of adequate savings and sequence of return risk (suffering an investment loss with too short a time horizon to recoup that loss)
- Inflation risk: the erosion of the purchasing power of retirement savings

- Cognitive risk: the potential to make poor investment and financial decisions as one ages, as well as being more prone to being victimized by fraud

Plan sponsors have the opportunity to consider implementing a retirement income solution within the employer-sponsored contribution plan. The benefits of fostering retirement readiness among participants may help with workforce management, enhance the brand of the employer, and potentially lower overall plan expenses. There is a range of solutions that could be offered to participants, which includes: investment-based solutions, such as managed payout and retirement income funds or managed accounts; annuity-based solutions, such as traditional immediate or deferred fixed income annuities, variable annuities, longevity annuities; and blended solutions, such as guaranteed lifetime withdrawal benefits. Each plan sponsor may have different goals for its retirees as well as for its different demographic populations; it is important to evaluate the program that would be most appropriate for your workforce.

Q: Jodie Gunzberg, plan sponsors have generally selected target date funds as the Qualified Default Investment Alternative (QDIA). What if the sponsor chooses a fund that is focused on income generation rather than asset accumulation? Are there ways to measure the effectiveness of these funds?

Gunzberg: As an industry, we have many tools to measure the performance of target-date funds to appropriate benchmark indices. While target-date funds are sometimes compared to asset class benchmarks (such as the S&P 500 and the S&P U.S. Aggregate Bond Index), there is also a representative target-date benchmark that can measure "through" and "to" glidepaths.

As we move toward funds that focus on income, there is an index that helps evaluate the success of these programs. Selection of these types of funds requires a shift in thinking about the goal of the plan, which is now designed to produce income. That, in turn, requires evaluating the income fund strategies differently. The risks that must be considered for an income-focused approach are related to the uncertainty of future income rather than volatility of wealth. Thus, the appropriate comparison should be one that incorporates hedging against inflation and interest rate risk, and reduces the uncertainty about how much income can be expected in retirement.

Q. What trends are you seeing that may lead to improved retirement outcomes? Or, phrased differently, what can the industry do to help participants prepare for retirement?

Bodie: We need retirement plans to encourage participants to think in terms of income levels instead of wealth levels. For example, understanding your "must have" versus your "nice to have" needs provides you with a baseline of required income to meet your budget; you may want to consider purchasing an immediate income annuity to cover the "must haves" or a deferred income annuity that would start at age 85 as a tool to hedge the risk of living too long (tail risk). Income annuities also provide an income stream that you can't outlive, which provides peace of mind.

Sasso: Industry groups and public policy makers are working together to find reasonable responses to plan sponsor concerns about the barriers of implementing in-plan solutions. One of the most cited barriers is that of the fiduciary burden of selecting and monitoring insurance-based products. There are a number of legislative proposals that would provide a safe harbor for plan sponsors if ERISA fiduciary standards are satisfied.

Gunzberg: We see that plan sponsors are beginning to focus on offering income-generating strategies to their participants. Changing the conversation from wealth accumulation to income is important because we know that running out of income in retirement is a real risk, one that many people fear. We also know that many individuals have been so focused on a saving mentality that it is psychologically difficult to move into a spending mode. This is also compounded by the wealth illusion effect of the large account balance that one has accumulated by retirement age. Communicating in the right income terms helps with the cultural shift associated with moving from a lifetime of saving to a lifetime of spending. By providing a proper benchmark that is tied to the underlying investment (an income-oriented target-date fund), participants may more easily understand what they can spend in retirement.

Summary

Our experts have described the importance of changing the focus and goal of defined contribution plans from a wealth accumulation orientation to an income-oriented approach. This shift will require all industry participants (investment managers, plan sponsors, recordkeepers, advice providers, benchmarking firms, consultants) to formulate education, product, and advice strategies that will encourage participants to ask, "How much monthly income will I need to live comfortably through my retirement?" Incorporating an income orientation into the plan design will necessitate a focus on the decumulation phase, and the various distribution options necessary, to enable participants to withdraw their funds in a reasonable and systematic way. Put another way, the guiding principle should be, "income is the outcome."

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Zvi Bodie is a Professor Emeritus, at Boston University.

Jodie Gunzberg, CFA, was the former Managing Director, Head of U.S. Equities at S&P Dow Jones Indices, at the time of the interview.

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