The Distribution Decision

Three experts address how plan participants should convert their savings into income once they retire

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MORE THAN 55 MILLION AMERICANS participate in their employer-sponsored 401(k) plan, and about 6 million of those participants are in their 60s. This segment of the workforce needs to know how best to use their accumulated savings to maintain their preferred standard of living throughout their retirement years.

Upon retirement, participants can decide how to distribute their savings by choosing an option made available by their employer-sponsored plan (see chart, next page). These options commonly include lump sum (e.g., cash out or rollover), installment payment (e.g., systematic withdrawal from the retirement account), or annuity (e.g., guaranteed income stream). The lump sum is the most common choice available to participants planning to retire. The annuity, while gaining in popularity, still lags far behind. A recent study from the Insured Retirement Institute showed that, even though 70% of baby boomers say it’s important for retirement income to be guaranteed for life, only 3% used their balance to purchase a lifetime income annuity in 2018. This raises the question as to why.

What goes into the distribution decision given the options that a plan makes available? Why aren’t annuities used more often? What can the industry do better to help plan participants generate income in retirement? We asked three experts to share their views and offer additional insights about decumulation.

Annuity, Lump Sum, or Installment?

Percent of Plan Participants with Access to Various Distribution Options, 2017

<table>
<thead>
<tr>
<th>Distribution Option</th>
<th>Savings/Thrift</th>
<th>Deferred Profit Sharing</th>
<th>Money Purchase Pension</th>
</tr>
</thead>
<tbody>
<tr>
<td>Annuity</td>
<td>12%</td>
<td>9%</td>
<td>29%</td>
</tr>
<tr>
<td>Lump Sum</td>
<td>86%</td>
<td>81%</td>
<td>75%</td>
</tr>
<tr>
<td>Installment</td>
<td>38%</td>
<td>38%</td>
<td>49%</td>
</tr>
</tbody>
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Note: A savings and thrift plan requires an employee to contribute a portion of earnings into an individual account. In deferred profit-sharing plans, employers usually contribute money to employee accounts based on company profits. A money purchase pension plan provides fixed employer contributions, typically calculated as a percentage of employee earnings.

What is the average DC participant thinking when it comes to funding their future retirement?

WARREN CORMIER: It’s a combination of what individuals value and think about. Proprietary research I conducted at the Boston Research Group shows that individuals primarily value control, choice, and safety. In fact, the same research shows that even protection against the downside is often more important than upside potential. They are vaguely thinking about what percentage of assets can be drawn down each year in retirement and how many years of income they will need in retirement. However, we see in studies that individuals may say they need retirement income for 30 years and then also say they want to draw down 10% of their assets each year in retirement. There is a clear mismatch because most participants are not thinking about how their distribution choices will work in practice. People think in terms of how much it costs to live each month today—but not necessarily that they may have potentially severe expenditures on health care, especially in the final years of life.

ZVI BODIE: The logical starting point for participants is to conduct two exercises. The first is to calculate how much retirement income you need. It is essential you understand your “must-have” needs vs. your “nice-to-have” needs. The second exercise is to calculate the maximum income you could achieve if you annuitized your total retirement savings. If you can cover your “must-have” needs with guaranteed income, you may wish to pull the annuitization trigger. However, if you find you are falling short, you may need to think about delaying retirement or saving more in your employer-sponsored plan. The key is to be honest about your situation as you plan for retirement.

KELLI HUELER: Participants who have successfully saved money for retirement need to shift gears and “think income.” No two participants’ circumstances are exactly alike, but the need for regular monthly income and the uncertainty about how to create it are pretty universal. So at the top of the list of things for participants to consider should be building a foundation of reliable, sustainable lifetime income with a portion of their savings. Take a simple approach by establishing a baseline income amount needed to cover essential expenses as the first step. Then participants can identify the income sources they will have when their employer paycheck stops. By comparing the two, it is pretty easy to see the additional income needed to cover their baseline income need. And this is why access to low-cost lifetime income annuities for a portion of their savings can be important for participants.

Why do you believe the single lump sum distribution option is so prevalent?

HUELER: It is the most commonly presented and easiest option for participants to understand and select in the current recordkeeper service provider models. Unfortunately, there are potentially dangerous consequences. For instance, lump sum options often lead participants to roll their hard-earned savings into a higher cost retail environment rather than keeping their resources in low-cost plan investment options. Our firm encourages plan sponsors to offer greater flexibility than what is typically available. An example would be partial distributions, which allow participants to use a portion of their savings to secure a lifetime income stream while keeping the balance of their resources in the plan to withdraw whenever possible. Participants also need objective advice regarding income alternatives and how best to create a personalized income plan. The value and tradeoffs of guaranteed lifetime income vs. market value payout options need to be considered. Access to easy-to-use tools and unbiased education is also very helpful.

CORMIER: Most plan participants need help to think through the decision to take a lump sum and how to spend it. It’s about what they are doing with it that matters most. It is important for participants to consider other options that can help stretch out income received during retirement. Also, a good way to connect with plan participants while they are still working is to show them what their nest egg can produce monthly. They have spent their whole adult lives thinking in terms of monthly pay and monthly expenses.

BODIE: The lump sum is prevalent because it is usually the default option. I believe more consideration from plan participants should go toward the life annuity. By converting some or all of your accumulated savings, you can purchase a stream of income payments to suit your needs, which can last as long as you live. An advantage of a life annuity is that the income from your payment takes into account the rate of mortality. It offers an additional dividend because you forfeit the income when you and your spouse die—meaning the accumulated savings paid by those who die earlier than expected contribute to gains of the overall mortality pool and allow for a higher yield to be paid to those who live longer than could be achieved otherwise. From an economist’s viewpoint, this is the chief reason to urge plan participants to annuitize.

Why do you think there is still bias against using an annuity to generate an income stream during retirement?

BODIE: It’s unfortunate, but the word annuity sows an adverse reaction. Why? It has been sold as an accumulation vehicle, in which case it is very different from an income annuity and the fees can be quite high. Word has spread to stay away because annuities are deemed a ripoff. A simple solution is to refer to it differently. Let’s call it “guaranteed lifetime income.” That is what it actually is when you reach retirement and annuitize. It becomes a retirement income payout vehicle. If you pose the question this way, I believe you might begin to get a different response and more acceptance from participants.

5. Mortality rate is a measure of the frequency of occurrence of death in a defined population during a specified interval.
CORMIER: If someone doesn’t understand something, they tend to shy away from it. From a behavioral point of view, individuals desire control, safety, and choice—they want an escape hatch. They fear they will get locked into a decision and want to know they are not stuck if their situation changes years from now. It is unfortunate that many are not familiar with all the ways annuities have been redesigned to offer more flexibility so that individuals don’t need to convert all of their accumulated savings to buy an annuity. Today, annuities offer a lot of principal repayment and minimum guarantee payout options, allowing individuals and their advisors greater opportunities when targeting lifetime income.

HUELER: The word “annuity” correlates in most consumers’ minds with expensive, high-commission, complicated variable or indexed annuity options. Presenting an annuity as low-cost lifetime income, as a personal pension to supplement other income sources, allows for a more positive conversation. Given the typical sales tactics (e.g., free steak dinners) and complicated products that people have been sold, it is not a surprise that consumers have a negative opinion of annuities. At the plan level, annuity options have been presented largely as an all-or-nothing decision, and most participants rightfully reject this option in favor of greater flexibility, choice, and ultimately the ability to personalize an income plan that best meets their needs. Refocusing on the utility of the low-cost lifetime income annuity as a complementary personal pension supplement is key to changing the mindset.

What can the industry do better to help participants prepare to annuitize at retirement?

HUELER: Make it easy for plans to allow for partial distributions, and eliminate any all-or-nothing decisions from the distribution process. Foster a “think income” mentality. Improve overall education on the benefits of guaranteed lifetime income streams. Encourage objective consideration of lifetime income alternatives, including guaranteed options. Start providing income annuity projections during the accumulation phase, and present participants with a mix of lifetime income alternatives that can be implemented easily. Consider showing relatable examples of success profiles in retirement. Separately, regulations need to be changed from burdening the plan fiduciary with liability to encouraging them to offer low-cost lifetime income alternatives throughout the savings phase as well as at distribution.

BODIE: A few things may move the needle: First, direct individuals to any of the websites that offer tools demonstrating the benefit of full or partial annuitization. It’s not an all-or-nothing decision. From a regulatory perspective, recordkeepers should be required to give an estimate of the maximum retirement income that plan participants can achieve with their accumulated savings. We need retirement plans to refocus on getting people to think in terms of income levels instead of wealth levels. Further, create a safe harbor for plan sponsors that add an in-plan annuity. Today, they become liable for that decision; I believe regulations should change to make it easier for plan sponsors to offer this option.

CORMIER: Improve education, not only around annuities but also around all distribution options, so plan participants can make informed decisions. The best way is to connect them to a competent advisor, who can walk them through all their options. Those who can’t get an advisor will need to fall back on generalized education provided by their plan provider.

What trends and innovations are you seeing that may lead to improved retirement outcomes?

CORMIER: Increased activity from product manufacturers engineering more creative solutions to retirement income. Simultaneously, there seems to be more willingness among plan sponsors to consider in-plan retirement income products. However, plan sponsors often say they haven’t seen a suitable product or one they are comfortable with just yet. So there is more to do.

HUELER: Dynamic technology will continue to drive innovation, both in terms of lifetime income products and the delivery channels/methods. We are on the cusp of game-changing innovation that will occur in one of two ways. Organizations will engage in creative collaboration with product providers, asset managers, plan sponsors, and other service providers—or technology-based solutions will create constructive disruption to the system.

BODIE: One innovation is the QLAC—Qualified Longevity Annuity Contract. It is great for those who don’t want to give up full control of their accumulated savings. The annuity kicks in at age 85 as a tool to hedge tail risk.

Can you offer one piece of guidance to help plan participants with the transition to retirement?

HUELER: Seek out objective, unconflicted guidance/advice, and as part of the process, consider incorporating a “personal pension” or low-cost lifetime income component to cover your baseline income needs.

CORMIER: The transition to retirement comes with important, difficult decisions. Start the planning process at least five years before retirement.

BODIE: My guidance is directed to plan sponsors. Do a better job of communicating the advantages of life annuities and the benefits of guaranteed lifetime income—whether in-plan or out-of-plan annuities. Additionally, give serious consideration to making annuitization their default distribution option.