Target-Date and Retirement-Income Product Trends

BY JUDITH K. BENSON

As more-sophisticated retirement-income solutions have made their way into the financial services marketplace, advisors have acquired enhanced tools to solve two key challenges to their clients’ financial well-being in retirement:

1. Sufficient income to enjoy a comfortable retirement
2. Confidence that they will not outlive retirement funds

With the first wave of baby boomers facing retirement and the decumulation of financial assets, product development is shifting from accumulation to distribution vehicles. While the only sure way to have cash flow throughout retirement is via annuities with lifetime benefits, product designers are attacking the retirement-income conundrum more broadly and a number of solutions are utilizing target-date constructs. This article will highlight key retirement-income product trends and, to provide context, also consider overall developments in target-date offerings.

Market Segmentation

Understanding market segments and their unique requirements is a prerequisite to using these new retirement-income products in client portfolios. Using the definitions provided by Tiburon Strategic Advisors, the mass market is defined as $100,000 up to $1 million in investable assets; the affluent fall in the $1-million to $5-million range; and the wealthy are those with more than $5 million. Retirement-income solutions for the mass market will be concentrated on packaged offerings, including annuities, rather than more-tailored interpretations. A key value proposition of the advisor is customized portfolio construction, which will be of great import to the affluent and the wealthy. Retirement-income concerns of the affluent will be addressed through the creation of sophisticated systematic withdrawal plan solutions that in part may use packaged offerings. For the wealthy, the generation of retirement income will take a back seat to estate-planning considerations, and packaged offerings are likely to be de-emphasized.

Product Development:
Overarching Lifecycle Trends

Target-date vehicles are accepted widely as a one-stop solution for the accumulation years. To appreciate the role of these constructs in retirement-income offerings, the following key trends in the target-date/lifecycle space provide the prologue.

Target-date funds soon will dominate the burgeoning lifecycle market, which includes both target-date and target-risk offerings. Target-date products controlled 29 percent of the lifecycle market at year-end 2004. By March 31, 2007, this had increased to 40 percent of market share. As further perspective on the magnitude of this increase, the lifecycle market recorded a 43-percent compound annual-growth rate during the same period.

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Product Innovation in the quickly saturating accumulation lifecycle market is moving to greater customization — whether for the investor, the advisor, or the plan sponsor. Product manufacturers are distinguishing themselves with innovative or customized solutions, including the following:

- **Systematic retirement savings outside qualified retirement plans along with the added benefit of tax management using pre-set portfolio asset allocations or customized allocations and a final target-date selected by the participant**.
- **Customizable target-date retirement portfolios for large defined contribution (DC) plans**, including a choice of the percentage of active or passive management and the inclusion of additional managers.
• Customizable target-date funds that feature third-party funds that allow advisors to choose from independent affiliates in the product design
• Target-date offerings geared to a discrete distribution channel—direct, institutional, and advisor markets

Collective investment funds will go toe-to-toe with mutual funds in garnering lifecycle assets in DC plans. While collective investment funds lost their luster in the early 1990s, there has been a resurgence in popularity due to their lower operational costs, the advent of daily pricing, and the attendant ability of an investor to check prices online and complete transactions at any time. A number of manufacturers are offering the collective investment approach in their new products.

The construct of the glide path, which represents the shift of the allocation in a fund to a more-conservative mix over time, will generate increased scrutiny. Over the past several years glide paths have been tweaked but generally have involved an increased commitment to equities from the outset through (and into) retirement. There have been nascent steps to expand the underlying investments in target-date funds for diversification and risk-adjusted return purposes and to extend the opportunity for capital appreciation when an investor moves to the “in retirement” phase.3

In the white paper “Ready! Fire! Aim? How some target-date fund designs are missing the mark on providing retirement security to those who need it most,” the authors propose a “target-date structure that accommodates both types of volatility (volatility embedded in design and the volatility of participants’ cash flow)—an institutional quality portfolio that is broadly diversified, more efficient, and thus more effective at helping participants to achieve retirement-income security.”4 Whether by using underlying investments with wider-ranging mandates or through vehicles that utilize nontraditional investments and have a liability-driven investing approach, glide paths will be further refined.

Converting Accumulated Assets into Reliable Cash Flow in Retirement

In its 2005 study, “The Retirement Journey, Pathways to success in the new retirement market,” McKinsey & Company noted the “growing disconnect between the accumulation-orientation of most distribution firms and the income, asset preservation and protection needs of retirees.” Against this backdrop, as well as the continued retirement of the early baby boomers and product saturation in target-date accumulation vehicles, the recent shift by investment management firms and insurance companies (and potentially others) to emphasize decumulation strategies is not unexpected.

Funds

Annuities with lifetime benefit features are a sure solution for lifetime cash flow, as noted above. But annuities continue to be perceived as complex, expensive products (more on this later). A competitive response: Marry the income-in-retirement benefit with target-date offerings to create vehicles that provide income over pre-defined periods (but not necessarily one’s lifetime). The following are attributes of such a product.

• Designed solely for the in-retirement years—think of this as an in-retirement glide path that provides greater potential for capital appreciation than the in-retirement option of the typical target-date fund
• Predictable payment stream—designed to convert accumulated assets into a predictable payment stream
• Multiple maturities—allows the investor to determine the appropriate duration by the target-date selected
• Inflation protection—total return is provided through a combination of current income and capital growth
• Asset allocation strategy—designed to achieve a level of total return consistent with the payment strategy and investment duration
• Multiple share classes—to match investor type (direct, financial advisor, institution)

The above description is for a recently introduced series of funds. The boomers achieve predictable income for a pre-defined number of retirement years, and the manufacturer (also a DC plan administrator) retains the accumulated assets and the attendant fees that otherwise may have migrated away at retirement. Caveat: At the final target-date (the terminus of the fund), the investor’s funds are depleted.

Product offerings that expand upon the foregoing design are proliferating. By way of example, we consider several other proposed packaged retirement-income solutions.

• Predictable cash flow and asset preservation. These include a principal-protection feature, while using target-date vehicles as the core. Depending on the fund/class selected, the investor may elect to have a significant portion of his investment remaining at termination. While the investor may experience lower cash flow during the term selected, the residual asset pool can be redeployed to other vehicles, used for daily living expenses, or incorporated into an intergenerational wealth-transfer plan. While a principal-protection feature may not be a per se goal of a retirement-income offering, it satisfies a retiree’s goal of asset preservation.

Whereas predictable cash flow and asset preservation income solutions may, under certain circumstances, dip into principal to cover the regular distributions, another proposed solution is being rolled out—albeit at a higher cost to investors.

• Regular distributions at fixed dollar amounts combined with principal protection, and a financial guarantee that ensures the ongoing cash flow and a lump-sum distribution at maturity.
>> “PRODUCT TRENDS” CONTINUED
And finally

- Melding the accumulation and distribution phases of a target-date structure through a more dynamic asset allocation strategy post-retirement, and the emulation of the asset/liability matching principles from the defined benefit world. It is expected that this product will appeal to the upper two market segments.

Annuities

According to a study conducted by the Wharton Financial Institutions Center at the University of Pennsylvania, income annuities surpassed other options as the most cost-effective and least risky asset class for generating lifetime income. The study was insightful about the following several perceived hurdles with life annuities:

- Once money is put into an annuity, it cannot be tapped for emergencies
- Informal self-insurance appears less risky
- Desire to enter the annuities market often is decreased due to the perceived high price and front-loaded cost
- Consumers seek other products because they think they cannot afford annuities or they think they can get a better return elsewhere
- Imperfect information about the products, features, and availability

As the baby boomers increasingly focus on retirement and their concomitant retirement-income needs, annuity manufacturers are repositioning their offerings to their original purpose—the “paycheck in retirement.” To overcome the sales challenges of complexity and cost and to address consumer needs, the industry is responding with product and pricing innovation. The study addressed ways in which an individual’s cash-flow needs now can be met with annuity product provisions (riders) such as period-certain payout guarantees, increases in monthly payments for inflation protection, monthly payment increases at a stipulated percentage beyond a certain age, or the converse—the reduction of monthly payments beyond a certain age.

A few recent annuity product innovations include:

- An annuitant’s ability to extend the unused portion of a guaranteed minimum-withdrawal benefit to the next contract anniversary year.
- Facilitating the conversion of an IRA rollover to an immediate annuity that provides a guaranteed monthly income for life or a specified period of time, and offers a variety of retirement stream customization options. The platform is provider-agnostic because the customer is able to request bids from many participating insurance providers.
- Substantially reduced mark-ups on annuities or price concessions (For example, a major annuity distributor has demanded price concessions by all its load annuity providers.)

The Wharton authors, Babbel and Merrill, also opined that the combination of immediate annuities with deferred annuities would allow the engineering of a wider range of payout options. The need—and thus the opportunity—is to educate advisors and consumers on the merits of including income annuities as part of an integrated approach to securing income in retirement.

Longevity Insurance

Any discussion of annuity product trends also must address stirrings in the longevity insurance space. The Center for Retirement Research (CRR) at Boston College has considered the attractiveness of an advanced life deferred annuity (ALDA), an offering that would be purchased at retirement or earlier; however, the payment stream would not start until the retiree had achieved a self-selected advanced age. Features of an ALDA are the following:

- Longevity insurance at a relatively low cost because of the extended runway prior to the commencement of distributions,
- Simplification of the decumulation process,
- More effective management of one’s assets in the intervening retirement years,
- Inflation protection, and
- Elimination of the longevity tail risk.

The CRR study estimated that a household seeking a smooth consumption through retirement would need to allocate only 15 percent of its age-60 wealth to an ALDA with payments commencing at age 85; inflation-protected income of $20,000/year starting at age 85 would mean a lump-sum contribution of just $74,000 at age 60. The purchase of an ALDA could overcome a barrier to increased levels of voluntary annuitization and could even be deployed as a default in a 401(k) plan, and it maintains the availability of other retirement assets to cover unexpected major expenses such as health care.

Other Retirement-Income Solutions

Many other retirement-income solutions will evolve over time. It is worthwhile to touch on two—the life-care annuity and reverse mortgages. The life-care annuity would provide regular income and, if needed, would cover long-term care. A tax provision in the Pension Protection Act of 2006 that takes effect in 2010 would address the tax treatment of such an offering. In addition to the income features, the life-care annuity would solve another retiree issue beyond the purview of this article: paying for long-term care in the sunset years.

There has been limited demand to date for reverse mortgages, which allow a retiree to create cash flow from a residence, likely the retiree’s most valuable asset. The opportunity for the retiree to benefit from the significant capital appreciation in property should spur demand for...
respective investments. This will be the case whether the retirement plan is a defined contribution plan (where the employer matches the employee’s contribution) or a defined benefit plan, which includes benefits such as a pension or an DB plan that is funded by the employer. The employee then bears the investment responsibility directly or indirectly (through the employer’s investment policies).

In our experience, the prudent retirement saving is an almost forgotten art. The current focus of retirement planning is to understand that the burden for retirement savings comes from the employer. This view is only supported by a two-thirds retirement income secure from the employer (i.e., defined benefit plans). So, it is not surprising that many people have a low sense of retirement security. The term security here means a sense of assurance that they will be able to meet their retirement needs. Therefore, the prudent retirement saving is not only a responsibility of the individual but also a responsibility of the employer.

In conclusion, we believe that the prudent retirement saving is a concern for both the individual and the employer. The prudent retirement saving requires a financial planning process that is designed to meet the retirement needs of the individual and to ensure that the retirement income is secure. The process should include identifying the retirement needs, assessing the retirement income sources, and determining the retirement income strategy. The process should be repeated at least once every five years to ensure that the retirement income strategy is still appropriate for the individual’s needs.

Acknowledgments

The author thanks three industry experts for the generosity of their time and guidance in developing this article: Chip Roame, managing principal of Tiburon Strategic Advisors LLC; Chris Brown, founder of Sway Research LLC, and Charlie Bevis, strategist and editor-in-chief at Financial Research Corporation.

Endnotes

1. According to Financial Research Corporation, target-risk offerings build their allocations around and rebalance periodically to maintain pre-specified levels of risk (i.e., conservative allocation or moderate allocation).
2. All statistics are from the FRC Lifecycle Funds Quarterly Report, First Quarter 2007, vol. 4, no. 1, Financial Research Corporation.
3. In research conducted by Brigham Young University Associate Professor Craig Israelson on the 170 target-date funds registered at year-end 2006, among his findings were a concentration in large-cap U.S. equities, which disregarded the mid- and small-cap premium, and the equal weighting of the various equity sectors, which disregards performance differences.

Center for Retirement Research at Boston College Reports Trend in Greater Under-preparedness

By Andy Hyer, CMT

According to a report by the Center for Retirement Research at Boston College (2007)* National Retirement Risk Index (NRRI) statistics on retirement assets suggest that many Americans are failing to understand that the burden for retirement planning is falling increasingly on their own shoulders. Consequently there is a need for financial advisors to motivate their clients to take the steps necessary for them to maintain the standard of living to which they have grown accustomed. The analytical tools necessary to determine if clients are saving enough are available at most firms (and if not, many tools are available on the Internet). It is not, however, knowledge alone of the prudent retirement savings plan that will get the job done; execution of that plan is the key. A persuasive financial advisor will be able to move clients to action. That action may entail saving more, working longer, consuming less, investing more wisely, or a combination of some or all of the above. The findings of the Center for Retirement Research report should give the advisor the context in which to begin this discussion with each client.

Andy Hyer, CMT, is marketing coordinator at Dorsey Wright Money Management in Pasadena, CA. He earned a B.S. magna cum laude in finance and economics from Utah State University. Contact him at andyh@dorseywright.com.


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