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A Perspective on Evaluating Annuities for In-Plan Solutions

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This article describes principles for analysis of income-generating solutions within retirement plans without focusing on fees. It also explains the need for sponsors examining QDIA applications to consider participants that will ultimately opt out of income at retirement, as well as those who will use that income.

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In defined contribution plans, investment costs are the humming third rail of fiduciary concern, or are they? Three little menacing words (excessive fee suit) cause sponsors to stop in their tracks. So how can they seriously consider adding guaranteed lifetime income solutions (read: annuities) to their plans?

The answer is simple, if counterintuitive: you are probably using the wrong metrics to understand the value of annuities and the role they play in improving outcomes for participants.

I argue the following:

1. Fees are not central for proper analysis of income-generating solutions; and
2. The analysis must simultaneously consider that participants will elect income or a lump sum at retirement.

In the interest of full disclosure, my company provides information on the value of annuities for

the retail and defined contribution markets and this work informs my viewpoint here. We do not perform fiduciary analysis and I do not pretend to comment on that realm. However, I do have clear visibility into the design of annuities and how that value manifests for the end user.

Reasons for Annuities

The high-level rationale for implementing income within defined contribution plans is well-established: one leg of retirement's three-legged stool is vanishing while the boon of longer lives carries with it the risk of outliving savings. The health and sustainability of American retirement security depends on greater access to retirement income, particularly among workers with lower wages and wealth who are ill-equipped to fill that gap.

Despite this, real progress has proven lethargic to the point of mimicking death, leading doubters to believe that in-plan income will survive only as a curiosity. Yet there are real reasons that lifetime income concerns are a serious issue that is finally moving into the field of vision of various stakeholders.

Why Is Income Important to Participants?

This is a trick question. Of course, income is critical to participants, even if they don't realize it and don't appreciate the magnitude of the risk that they assume when they lack adequate guaranteed income in retirement. Many, if not most, participants receive no formal financial or planning advice, so workplace savings defaults may be the best or only source of retirement income outside of Social Security.

Why Is Income Important to Plan Sponsors?

A key piece of advice to those who fear they have under-saved: work longer. This may be great for the worker, but is not ideal for the company. A retirement delay serves both to maximize Social Security payments and increase retirement savings. Workplace savings programs that fail to give employees the tools to retire confidently actually end up encouraging workers to hang on longer than they would otherwise choose.

Don't get me wrong. Older workers bring valuable experience, skills, and knowledge to the table, but unnatural delays in retirement are a workforce management concern with ramifications for earlier career stage employees. In 2014, Stephen Miller wrote about this for the Society of Human Resources Management. {"When Workers Won't Retire, Workforce Challenges Arise," Miller, Stephen, at *https://www.shrm.org/resourcesandtools/hr-topics/benefits/pages/workers-not-retiring.aspx*} We hear more about offering workers a glide path out of full-time work and into partial retirement, a solution that helps keep older employees who are motivated to work engaged and able to pass on their knowledge. However, this practice does not support those who are sticking around due to fear, a fear that looms larger for many in the aftermath of the pandemic.

This is not the only reason that sponsors are taking a harder look at integrating income within their plans, but it illustrates a lurking issue that has only gotten more urgent in the last year. Frankly put, altruism and social good do not have to be the primary motivations for sponsors to enhance retirement security.

Why Income Is Important to Advisors and Consultants

The income train has not left the defined contribution station, but no advisor or consultant wants to be left alone on the platform waving a DCIO (defined contribution investment only) booster flag. It's that simple. Those who embrace lifetime income solutions will have a competitive advantage today that will devolve into table stakes down the road.

Regardless of whether or when we see widespread adoption of income solutions, advisors who are not fluent in the language of income will be unable to address sponsors' questions and concerns. This creates an intense need to close the knowledge gap and help them understand how they can bring additional value to their clients.

Now back to the two main points of this piece.

A Contrarian View on Fees

In the context of annuities, fees are a red herring. It is a natural reflex to respond to the fee of Product A being greater than Product B by saying that Product A is more expensive. Yes, this is true on an absolute fee basis, but it does not speak to the underlying value of the two products. After all, target date funds are more expensive than stable value or money market funds but serve participants in a way that is meaningful.

When you go the grocery store, there is a price differential between regular produce and certified organic produce. We know that the organic product has a higher fee, but how much more is the organic over non-organic broccoli worth to you as a consumer? This answer depends on a plethora of factors, the point

Exhibit 1—Sample Evaluation Grid: Participant Value from $100 Contribution

Participant Age	Income Start Age	Income Value	Death Benefit Value	Lapse/Surrender Value	Total Economic Value
60	65	$53	$23	$40	**$116**
60	66	$55	$22	$38	**$115**
…	…	…	…	…	…
61	65	$52	$22	$39	**$113**
61	66	$54	$21	$37	**$112**
Note: All values are fabricated for illustration purposes and are not related to any real product. Total Economic Value is the total of the Income, Death Benefit, and Lapse/Surrender Values.					

being that this is a personal calculus by the individual consumer.

The same is true for income-generating annuities in a way that is very different from accumulation-oriented vehicles; unsurprisingly, this is where our intuition about fees fails. I am acutely concerned about annuities that play a role in qualified default investment alternatives (QDIAs), where they are also most likely to increase workers' retirement security.

Background on Annuities Associated with QDIAs Today

My aim is not to get into the weeds on the design of solutions that are currently marketed for 401(k) plans, but it is helpful to understand differences in the annuities and how we can think of the value they provide. Today, we see a range of annuities integrated into solutions, some offering specific guarantees for future income and others serving more as fixed income-like accumulation vehicles.

Here, I address any annuity that assures income at retirement that is either fixed, in the form of a deferred payout annuity, or has a guarantee with a minimum future income level. The latter category involves withdrawal benefits that guarantee minimum income from day one but also respond to increases in the market value of the account.

How to Think of the Value of Annuities

With this background, I can paint the picture of how we can think of the value that these products provide. There are three fundamental aspects to this value: (1) income, (2) liquid account value, and (3) death benefit. In all cases, we need to assess the value net of fees. This means that we can look at annuities that have explicit fees on a level playing field with ones that do not.

A grid format such as the sample in Exhibit 1 can show the value for all participant demographics and then form the basis for comparison among different products or competing insurer rates in a multi-insurer product. Using this framework, a plan sponsor can make an assessment based on weighted values that reflect anticipated use of income.

As far as income is concerned, the participant characteristics (age, gender, and income deferral) are crucial to understanding the present value of future payments; after all, the longer a person collects income, the more value they get from the product. In the case of fixed benefit products, this is a straightforward exercise. However, benefits that may increase due to market performance and provide income protection in the event of account depletion require more nuance to understand the range of results. Both are valuable but work differently and the income analytics can help illustrate these differences.

The same principles apply to liquid account value and death benefit. All of these factors play a role in the overall design and there is no obvious best choice. For example, there are solutions that offer a qualified longevity annuity contract (QLAC) as an optional investment option alongside a QDIA with a target date design. A QLAC famously offers no liquidity but does have a death benefit before income starts in late old age. The purchase of a QLAC with a relatively small amount of assets establishes a concrete timeframe within which the asset manager has to sustain income from the portfolio. The participant can receive higher payouts earlier in retirement knowing that a guaranteed income stream will begin in late old age.

Income or Lump Sum? Both.

The physicist Schrodinger posed a famous thought experiment involving a box that contains a

cat that we can't see; this creates uncertainty about the cat. If we cannot see the cat, how do we know whether it is alive or dead? When we open the box, we know exactly what is going on with the cat. But before then, it simultaneously exists in multiple states.

Though Schrodinger was helping people grasp an aspect of quantum physics that seems physically impossible, this puzzle also serves as a useful analogy to think about unknown outcomes in many realms of life. In defined contribution plans, the cat is the participant and the box is the QDIA. In this case, the two states at retirement, which is when the cat leaves the box and we know what it chooses, are electing either income or a lump sum.

While the cat is inside the box, we know that the cat can exit in one direction and start income or take the other route and take the accumulated assets, but we don't know which path the cat will take. The plan sponsor places all cats inside the box, but they are free to wander out or back into the box before retirement.

In the interest of increasing the welfare of the cats, the sponsor picks and designs a box that provides more retirement security (that is, the annuity option) than a box that doesn't have an income guarantee (that is, the lump sum distribution). The cats are free to leave the box if they don't have a strong need or desire for the future income. Therefore, it is reasonable for the sponsor to anticipate that most cats will take advantage of the income guarantee.

Nonetheless, the binary nature of the cats demands that the annuity option not be the sole choice. The sponsor also knows that, despite education efforts, some cats will still elect the lump sum at retirement for many reasons, including: a change in circumstances; poor understanding of the value of the income compared to the lump sum; or bad advice.

Knowing that some cats will end up taking a lump sum at retirement, the sponsor must consider both the accumulation value and the income value of any in-plan solution. In other words, the totality of the design matters to the plan sponsor, not one factor or the other.

Conclusion: Income Is a New Paradigm

My purpose here is to open the door to better understand income for those who are unfamiliar with the analytical possibilities around annuities to the fact that they are in fact possible. And, more importantly, necessary.

There are many firms and groups of firms introducing solutions into the market. While this represents an exciting expansion of choice, it also presents daunting (yet manageable) challenges for those making a decision. This is the case both when considering multiple options and when determining whether one is the right fit for the plan.

It is clear that quantitative analysis of annuities can and should play a role as they become more important for employer-sponsored retirement plans. Just as we see among retail sales, it is equally clear that there are non-quantitative elements that factor into those decisions. Nevertheless, the ability to have a clear-eyed view of the benefit of any solution will be an important part of the adoption of in-plan income. ■

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