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Plan Sponsor News

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The Next Phase in Defined Contribution Plans

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We are now entering the next phase in a massive paradigm shift that began in 1982, the year the first 401(k) plan came into existence. (According to the Center for Retirement Research at Boston College.) In 1980 85% of workers were covered by a traditional Defined Benefit (DB) plan but by 2004 that percentage had dropped to 37% and is still falling. Our elected representatives have “protected” the DB plan into extinction.

The front edge of the baby boom is turning 60. Over the next fifteen years 76 million boomers will retire. They are also living longer; there is an 81% probability that at least one of a couple aged 65 will be alive at 85. There’s a 25% chance that one will live to 96! Social Security will provide less than half of required income and there is a very real chance that many will outlive their savings.

From a behavioral standpoint, a steady income is one of the greatest contributors to a satisfying retirement. DB plans produce monthly pension checks. 401(k) plans produce a lump sum. Plan sponsors and participants now perceive the need to convert 401(k) balances into an income stream.

There are no perfect solutions – in part because participants have conflicting goals:

- Regular income
- Spending flexibility
- The desire to leave something to heirs.

Participants also face various kinds of risk: longevity risk; inflation risk; and investment risk, to name a few.

First generation solutions

Plan sponsors and participants initially had two options:

1. *You’re on your own* – Participants took a lump sum and then sought out banks, brokers, insurance agents etc. to turn their savings into income. The quality of advice was uneven and the embedded “retail” costs were high. Account based investments (mutual funds or managed accounts) are subject to market risk and income is not guaranteed. Annuities offer guaranteed income but the investor turns control of their money over to an insurance company.
2. *An annuity distribution option* – Upon retirement, the participant might elect not to receive a lump sum. Rather the sponsoring company goes into the market place and buys an immediate annuity to provide a stream of income to the participant and spouse. This option is rarely included in plan documents, and was even more rarely chosen by retirees. It also raises fiduciary issues for the sponsor.

The Second Generation

New approaches are being brought to the marketplace on almost a daily basis. These basically fall into two categories: those implemented outside the plan and those that become part of the plan investment menu.

Outside the Plan

○ An Annuity “Mart”

Typically a plan sponsor links to a platform offering institutionally-priced annuities from a number of issuers. The participant uses an IRA rollover to acquire the annuities. The platform may be offered through the record keeper or by an arrangement with the plan itself. Characteristics of these types of programs include:

- Group institutional pricing – resulting in monthly income that is 4-9% higher than retail products.
- Competition among issuers – The difference in quotes can range from 1% to 15% on any given day.
- Standardized and simplified quote requests
- Flexibility – The participant can opt to annuitize only a portion of their lump sum or buy in over a period of time (akin to dollar-cost-averaging).
- Ability to diversify – The participant can choose several different issuers to spread credit risk.
- Plan sponsors do not assume the same level of fiduciary exposure as with a plan distribution option. (They are not a party to the annuity contract.)

Disadvantages of this approach include:

- Negative participant attitudes toward annuities – Some education is required to delineate the distinction between institutional and retail pricing.
- Loss of control – The participant buys an annuity stream and no longer owns the money used for the purchase.
- Inflation risk – An amount of income that seems substantial today might have small purchasing power in 10 or 15 years. Although, the participant can buy annuities that offer a cost-of-living adjustment option...at lower initial payout.
- A limited number of truly independent and transparent platforms.

○ Managed Payout Funds

These are versions of balanced mutual funds. They tend to be allocated more broadly than the average mutual fund ...more like an endowment (which also has a spending requirement). The key is they pay out income on a monthly basis. The investor selects a fund based on the payout target, generally 3%, 5%, or 7%.

Advantages include:

- The participant retains control and can sell the fund at any time. This allows great flexibility in case of emergency.
- The funds typically include some alternative asset classes that provide inflation hedging (i.e. REITS, commodity futures, and TIPS).
- Investors avoid the credit risk of an individual insurance company.
- Investors have a better understanding of mutual funds.

Disadvantages are:

- Accounting issues currently prevent these from being an in-plan option.
- Limited track record.
- The targeted income is not guaranteed.
- They are subject to market risk.

Within the Plan

○ Annuity options

Unlike the old annuity form of distribution, these are accounts within the 401(k) plan. Sometimes these are referred to as “DB within DC”. The participant chooses an allocation to this “guaranteed income option”. Each pay period the participant’s contributions are used to purchase an annuity income stream at the then prevailing rate. Upon retirement, the participant begins to annuitize. Prior to retirement the participant can switch his account balance to another fund just like any other plan option.

Advantages include:

- Guaranteed income.
- Accumulation within the plan.
- Institutional pricing.

Disadvantages are:

- Lack of portability – This is a huge drawback at this time. If a participant switches employers, there is a very good chance that he will have to roll his account balance to a plan that can not support the annuity. In that case, the participant would lose the guaranteed income he had paid for.
- Low demand – Participants have not embraced this option.
- Exposure to single-issuer credit risk.
- Increased fiduciary exposure for the plan sponsor.
- Low traction – If these types of annuities can not attain critical mass, they may cease to exist or may become second class “orphans” with little support from the issuer.

o Guaranteed Minimum Withdrawal Benefit (GMWB)

This is an interesting hybrid structure. Patterned after the “synthetic GIC” now universally used in stable value funds, an insurance company “wraps” a balanced fund with a guarantee. This guarantee specifies a minimum annual income, typically 5%. The income is paid monthly upon retirement. Since the account is still invested in a mix of stocks and bonds, the market value may (should) continue to rise. Each year, on the participant’s birthday, the account is evaluated. If the market value has risen, that becomes a new “*high water mark*” and the GMWB is now pegged to that new higher value. There are unbundled issuers – insurance companies who will wrap funds created by mutual fund companies or even custom designed funds-of-funds. They may charge in the 80-85bp range to provide the guarantee.

There are also bundled issuers – insurance companies who wrap their own proprietary funds. Embedded fees for these seem to be higher, in the 125-150bp range.

Advantages include:

- Ability to integrate into a customized target term fund – This is potentially one of the greatest advantages. Theoretically, a solid asset allocation implemented by “best of breed” managers can be wrapped to produce the GMWB. The guarantee replaces the stability created by large bond allocations in the typical “retirement income” target term fund. This allows potentially greater growth of the assets during retirement.
- Flexibility – The participant can elect to partially “annuitize” the account.
- Preservation of participant control. (The participant may choose to take more than the minimum guarantee, although that reduces the high water mark by the amount of the excess. This eliminates one of the main objections to annuities, “what if I have an emergency?”)
- Minimizes single issuer risk – The insurance company does not take in the money but instead wraps another fund which is not part of their general account.
- Diversification – One can use a program that has multiple insurers.
- Portability – if the participant leaves the company, the fund is rolled into an IRA rollover.
- The balance can be left to heirs.

Disadvantages are:

- The GMWB produces less monthly income than a straight annuity
- There are extra fees to produce the guarantee.
- The guarantee may still be exposed to single issuer credit risk even if the principal is not.

What To Do...We can help!

The answer is probably a suite of the above options to address participants’ diverse needs. This is an important and rapidly evolving area and the clock is ticking. The first baby boomer is already receiving social security distributions. Vendors and participants are rapidly focusing on the need to move from accumulation to distribution. Contact us for a more detailed look at your options.