Annuity in 401(k) Clothing

Next best thing to a pension, or just another tired solution in a box?

Janet Aschkenasy – 09/21/2007

Baby Boomers, it has been said, are redefining all aspects of their working lives: They have more jobs during their total careers than did their predecessors, they work later in life, and they have different notions of what retirement will be. Now, the investment community is under pressure to redefine the notion of achieving retirement income security, even as the 401(k) has been tasked with accomplishing what traditional pension plans once offered, or at least seemed to offer: a guarantee.

Genworth Financial calls its solution "the insured DC plan"—a product combining the lifetime income benefits of a traditional defined benefit plan with the participant election features of a 401(k). With the ClearCourse product, contributions are invested in a GE Investment Funds Total Return Fund (although the GE Total Return Fund is being utilized as the underlying investment vehicle at Genworth's first clients, the firm also has other balanced funds available), benchmarked roughly 60% to the S&P 500 and 40% to the Lehman Aggregate Bond Index.

Driving Interest

What often drives an interest in such products, says Fred Conley, President of Genworth Financial's Institutional Retirement Income Group, is participants' growing awareness that the 401(k) is their primary, if not sole, retirement vehicle. All the same, at a time when many companies have frozen their defined benefit plans, participants are eager for a pension-like benefit, Conley explains.

"Research has shown the product has wide appeal across various age and demographic groups," adds Ken McCullum, Senior Vice President for Institutional Investment Products at The Hartford in Simsbury, Connecticut.

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Genworth has gone so far as to apply for a patent for the processes and methods it is using with ClearCourse. Other providers also are keen on offering a similar "in-plan" retirement income replacement approach. For example, the Hartford offers an annuity program packaged within the 401(k) that can be treated like any other plan investment option. Participants can purchase shares or exchange out at any time while in the plan and prior to beginning their guaranteed income payments.

Participants buy shares of The Hartford Lifetime Income (the price varies based on current long-term interest rates and the age of the participant) that all have an end value of $10 of income for the rest of their lives begin at 65—regardless of the ups and downs of financial markets (however, participants can elect to begin receiving the benefit at 62 or defer distributions until age 70).

Shares are less expensive for younger participants and increase in cost as the participant nears age 65. Hartford offers a projection tool that allows participants to compare the rate of return (which increases the longer a participant lives) they would realize from the purchase of a share and income payments from 65 to 85 or longer. There is even a guaranteed protection benefit for beneficiaries, who may choose to receive every cent the participant has contributed, less benefits paid to the participant, upon the participant's death. The value of the product is backed by Hartford Life Insurance Company's general account, which invests primarily in long-term, high-quality fixed-income investments, matching the duration of the asset to that of the underlying liability.

However, just as with any retirement saving decision, starting earlier provides an advantage because the shares are priced lower at a younger age; therefore, the participant can buy more shares (each of which has a set income value) for less money. More time also means larger accumulations, of course. Moreover, while Hartford's product is meant to provide stability, it also is designed to complement other 401(k) asset classes. Hartford expects that employees will use the product as one of various defined contribution plan investments, allocating between 15% and 30% of their deferrals to the option, saying participants should consider allocating a portion of their fixed-income allocation to guaranteed lifetime income. The firm says that Hartford Lifetime Income can be built into lifecycle funds or be a separate allocation alongside the lifecycle allocation.

Involving Advisers

Officials at both the Hartford and Genworth expect they'll be working with more and more advisers as they target products to smaller employers, and some advisers, including Todd Rustman, President of GR Capital Asset Management, LLC, of Newport Beach, California, say they should have no problem

embracing a product-focused, in-plan approach to the retirement income question alongside their customized, advice-driven programs.

Bolstering that effort, the Hartford's wholesaling arm, known as PLANCO, has built a team of "product-agnostic" specialists to help advisers—and their clients—understand retirement planning concepts, including guaranteed income. This team consists of 20 financial planning specialists across the country who conduct broker and client seminars on topics such as retirement income planning, IRA distribution planning, and Social Security strategies.

Genworth, meanwhile, plans to educate the adviser marketplace by developing its relationships with recordkeepers serving that market. Recordkeepers offering ClearCourse on their platforms will receive all of the tools and counseling they require to help advisers get up to speed on ClearCourse, says Genworth's Conley.

In addition to Genworth and The Hartford, other companies marketing annuities as 401(k) options as of August included Merrill Lynch Retirement Group (which developed its product through an alliance with MetLife) and Prudential Financial Inc.

Rustman derives 15% to 20% of his firm's $100 million or so in assets under management from the 20 retirement plans he advises, but he observes that a large part of his practice is devoted to investing the assets of retiring or soon-to-retire individuals using a series of five-year tranches that start out very safe for the first five years and become more aggressive as the person ages. From age 65 to 70, for instance, he might put a retiree into CDs or a single premium immediate annuity (SPIA). From age 70 to 75, he would reach for a little more return by adding some Treasury bills, and—as long as the desired retirement income stream was being consistently generated at the end of that phase—he envisions pursuing a 50/50 equity/bond split using noncorrelated asset classes for the next five years, from age 75 to 80. Whereas there would not be much principal gain to start with, Rustman says, the client should end up with 8% to 12% returns over a 20-year period.

On the other hand, says Rustman, if his customers really are keen on just having an income guarantee and a big name to back it up, he is only too happy to oblige. "If that gives them some comfort, great!" he says.

Bedda D'Angelo, President of Fiduciary Solutions Inc., a registered investment adviser (RIA) in Durham, North Carolina, says that in-plan retirement income programs are a very inexpensive way to go and often can meet 80% of a client's needs. Take the question of health-related costs for retiring Boomers: Currently, it is estimated that the average 65-year-old couple needs an estimated $215,000 to cover health-care costs in retirement, according to a recent study by Fidelity. An employer-sponsored program will be much cheaper if it is purchased in-plan, she says.

In examining the cost advantage of in-plan programs, D'Angelo compares it to that of purchasing long-term care insurance (LTI). When she recently went to look at a long-term care policy for herself and her husband, she realized that the premiums for some of her clients for similar policies were some 50% cheaper because their company was leveraging its size. "I see significant discounts, though, when people purchase LTI through employers that are listed as large-cap stocks. In other words, large groups have significant negotiating clout," she says.

In addition to allowing workers the ability to effectively dollar-cost average their annuity purchases, the approach also mitigates the exposure to interest rates for the parti-cipant who, having reached retirement, then seeks to buy an annuity. Traditionally, saving for retirement focused on accumulation up until the point of retirement, at which point an investor could make an annuity purchase. Unfortunately, the vicissitudes of the interest rate environment at a single point in time could have a significant—and negative—impact on that purchase.

Downsides

Yet, the latest wave of retirement income replacement remedies from large financial services companies is raising an eyebrow or two among advisers. Aside from advisers' contention that insurers and other financial services giants are driving the phrase "retirement income planning" in order to push their own agenda, it seems almost certain that a growing population of inert, if not unengaged, participants is sure to be confounded by the literature companies are distributing on the new annuity packages. It seems likely that, however intriguing the notion of investing in an annuity prior to retirement may be, widespread adoption will require real counseling, ideally on an individual basis.

That kind of individual counseling is offered by Kevin Waldron, First Vice President, Investments, Senior Resident Director at Merrill Lynch in Bala Cynwyd, Pennsylvania. When offering educational meetings at his retirement plan clients, he often encourages pre-retirees to stay to talk to him about their savings and lifestyle in retirement, and they can hire him to do personal planning.

Although annuities have had a negative connotation for some in the marketplace, that reputation is not entirely correct, Waldron says. In the last few years, he explains, annuities have seen a decline in overall administrative expenses as well as in the cost of the various options available, as the companies offering the products prepare for the influx of Baby Boomers planning to retire. "It is almost like what we have seen with electronics, computers, and cars. Given the features and performance capabilities, they actually cost less now than they did in the past," Waldron comments. Also, options that were once add-ons (such as guaranteed income benefits, guaranteed withdrawal options, death benefits, principal guarantees) have become standard equipment and are offered at a lower cost.

Likening the development of annuities to the growth of computers and electronics, Waldron says that each generation of products has more performance and costs less. "In the past five to seven years, we've seen a reduction in prices of approximately 10% to 15%, and the new products have more features or benefits," he

explains.

When looking at their possibilities for success or failure in reaching a lifestyle in retirement, people are willing to live with different levels of risk, Waldron comments. Some are willing to take the risk proscribed by seeking higher returns, while others are reassured by the guarantees promised by an annuity design. If those guarantees help people to invest when they otherwise might not, and they are willing to accept higher costs for that assurance, that can be an acceptable tradeoff, Waldron says.

More significantly, questions are being raised about the portability of these new annuity/401(k) product pairings. If an employer changes recordkeepers and the new provider cannot support the platform, will those guarantees be in jeopardy? Genworth's Conley thinks not. He expects to have ClearCourse integrated with as many as 10 recordkeepers in the near future, and claims that recordkeepers have been amenable to the requests of interested sponsors to include the capability. The Hartford is in the process of working with more than 30 recordkeepers to have its fund available on their platforms. However, those efforts may pose something of a Catch-22 dilemma for advisers. According to Joseph Eck, Vice President, Institutional Solutions Group, before the recordkeepers are willing to put in the effort to build out their systems, they want their clients to sign on.

Concerns remain about individual participants who leave an employer—and a recordkeeping platform—that sponsors the option. Rick Amering, Retirement Benefits Manager in charge of the ClearCourse rollout at Paychex, Inc., one of a handful of plan sponsors that had signed up for the Genworth program as of this writing, believes that Genworth has dealt with the employee portability issue by establishing an out-of-plan IRA. The rollover version is called MyClearCourse, and is designed to allow departing or terminated employees to transfer their balances and preserve their accumulated guarantee via a rollover. Future investment would be permitted, but only up to current IRA limits.

As for the Hartford Lifetime Income approach, a Hartford spokesman says employees are free either to leave their balances inside the employer's plan, or let the money be held at the Hartford. Of course, that means no more payroll deduction contributions or new monies being contributed of any kind. Participants can roll the money into a deferred annuity in an IRA. When they transfer out of the product, participants get back 96% of their current purchase price (remembering that each share is more costly as participants age).

How an adviser gets paid for these investment options is another concern. The Hartford envisions being able to offer multiple share classes of the Lifetime Income product and says that, once it is being sold through advisers, the firm anticipates offering a revenue share to the adviser.

What Lies Ahead

Only time will tell how the complications will pan out for sponsors and participants. As of mid-July, a total of seven plan sponsors with an average of $500 million in defined contribution assets had rolled ClearCourse out to their defined contribution plan participants. The Hartford, while having spoken with hundreds of plan sponsors about the concept, only had one sponsor in the process of rolling its Lifetime Income product out to its employees. The firm hopes to sign up between six and eight clients this year. Further, none of the advisers PLANADVISER interviewed had a working knowledge of either of these programs as of July, although all wanted to hear more.

Therefore, although these products may offer a solution to help Americans create their own pension-type plan in retirement, the question remains whether or not these products will catch on long term and with all plan sizes.

SIDEBAR:

Retirement Replacement

Four in-plan annuity options

ClearCourse: ClearCourse is a group variable annuity issued by Genworth Life and Annuity Insurance Company. If someone earning $60,000 a year made a 6% deferral and received a 4% match consistently from age 40 through 65, with annual salary increases of 4%, he or she would receive a guaranteed $24,332 per year, assuming no growth in the underlying balanced portfolio. However, assuming an 8% net portfolio growth while the employee is contributing to the program, that individual would earn a guaranteed $32,657 annually in retirement. Should the market continue to grow at 8% year over year when the individual is no longer contributing, at age 85, the person's income level would hit $93,999. The cost of the ClearCourse floor guarantee and lifetime income guarantee is 85 bps, while the cost of the underlying balanced portfolio can vary.

Hartford Lifetime Income (HLI): Each contribution to The Hartford's HLI (a fixed deferred group annuity) works toward the purchase of shares that become more expensive as one ages, with each HLI share providing $10 per month for life, starting at age 65. For instance, a participant accumulating 50 shares of lifetime income would receive $500 of monthly income for life beginning at age 65. As with a defined benefit program, participants do not participate in investment returns above the guarantee.

IncomeFlex: With Prudential's IncomeFlex product, participants can elect to transfer all or a portion of their account into one of five investment funds ranging from conservative to aggressive. The feature offers a guaran-teed yearly paycheck for life. Beginning at age 50—and continuing to the time a lifetime paycheck amount is locked in (up to age 70)—participants are guaranteed their income base will grow at an annualized minimum of 5%. If the participant's account balance exceeds the income base, the future payout could increase. Participants have the ability to transfer out at any time without withdrawal fees, and can pass along any remaining value to their beneficiaries.

Personal Pension Builder: Offered through 401(k) plans managed by The Retirement Group at Merrill Lynch, MetLife's Personal Pension Builder is a deferred fixed annuity that converts into an immediate fixed

annuity upon retirement. The accumulation phase offers a specific future income benefit amount purchased at current prices; guaranteed income for life or a period based on the annuity purchase rate on the date a contribution is made; or a death benefit equal to the current commuted value of the annuity if the employee dies during the accumulation period. Participants can select options that provide continuing income to a beneficiary, as well as the ability to take some or all of the accumulated benefit in cash within 60 days following the start date.