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401(k) Guarantee Products: Current and Future

March 15, 2009

The purpose of this article is to draw the reader's attention to this relatively new product in the marketplace and to briefly discuss its general characteristics.

The transformation from Defined Benefit to Defined Contribution plans as the main retirement savings vehicle has hit an inflection point. Recent studies have revealed the greatest concern among participants is one of longevity risk. Responding to their concerns, asset managers and insurance companies have recently developed the first generation of 401(k) Guarantee plans that will provide the "safety net" lacked in current programs.

Like most new innovations, there are still many questions regarding these products. Issues of portability, cost and complexity are hurdles these products must overcome. As a result, the advisor community has not totally accepted this option. What is often overlooked is the value these riders provide to participants during the accumulation phase of retirement planning, especially in the later working years. There are several different versions of these products in the marketplace and while the acceptance rate has been relatively low, many feel that interest will skyrocket when Participants can move the product from one employer to another or from a 401(k) plan to an IRA. Insurance companies like Prudential, John Hancock, MetLife, and Hartford have implemented a version of these products within their 401(k) platforms. Another version of the product comes from asset managers in conjunction with insurance companies.

It has been shown that many investors make predictably poor decisions when left to their own devices. They become more aggressive when the market tops and sell at market bottoms. Guaranteed products allow participants to stay invested through market cycles, even in the later years of employment when they are more prone to panic. This paper will describe several types of such products, their pros and cons, and what potential impact they may have on the thought process on designing 401(k) investment platforms.

401(k) Guarantee products first came about in the opening years of this decade. Market volatility ignited a near frenzy of activity in the financial planning world. Consultants knew they had to come up with something to manage significant risks for their clients. As a result, the 401(k) Guarantee was born. Over the past ten years, there have been many other new features designed to help participants prepare for retirement. Examples include auto-enrollment, auto rebalancing, lifecycle funds and online advice.

In the future, plan sponsors will need to design 401(k) plans that have the income security of a defined benefit plan. A plan that alleviates the risk of retirement account losses due to market declines and ensures against the possibility of outliving one's retirement savings is very compelling.

The fact that 13 million baby boomers are now between the ages of 57 and 60 reinforces the importance of giving employees a more secure option to transfer into during the retirement phase of their career. Those who set out to design this new feature need to take a few basic concepts into consideration:

- ☐ If participants are to adopt these new plans, they must be easy to understand.
- ☐ Participants who sign up for a 401(k) Guarantee must be able to retain their current investment profile, that is, they will not need to make dramatic changes in their investment selections.
- ☐ For most products, participants will continue to have liquidity and control over how they invest their assets.
- ☐ Once a participant elects a 401(k) Guarantee, all of the money in their accounts is included in the Guarantee. The only requirement for the participant is that they cannot have more than 70% of the account balance invested in equities, since guarantees require a certain level of diversification. The Guarantee is funded through an added fee the participant pays, generally around 75 basis points. The annual fee covers the cost of purchasing the protective hedges and all costs of administering the Guarantee program.

After a participant elects the Guarantee option nothing else has to be done. The participant's withdrawal balance grows alongside the account balance every time a contribution is made. As the market advances, the withdrawal balance also increases annually, thus locking in market returns. If the market declines during the year, the Guarantee withdrawal balance remains the same, thanks to a hedge, which automatically goes up as the market declines.

Participants can withdraw money in two ways. First is to take a stream of money up to 10% per year of the total withdrawal balance. Withdrawals continue until the Guarantee withdrawal balance is exhausted. The second method is to receive lifetime withdrawals or a certain percentage of the guaranteed balance for the rest of the participant's life. The amount of this withdrawal is calculated based on a single-life or joint and survivor calculation.

There are fiduciary considerations surrounding the 401(k) Guarantee. Plan sponsors will need to study the Guarantee model carefully and determine if it is appropriate for their organization. One key question that will arise is, "Do plan sponsors want to make the Guarantee available as an option or as a default"?

There are currently two products available to plan sponsors:

The first is the Target Date Solutions with a guaranteed income piece included. This product is offered through asset managers like Genworth Financial, Alliance Bernstein and Russell Investments and uses the same Target Date funds offered in 401(k) plans by these asset managers. The benefit is available for enrollment by 401(k) participants usually at age 50 (not all have this as a starting age). The minimum value of the income-for-life guarantee is based on the account balance at the time of enrollment. Contributions and positive market value increase the guaranteed withdrawal amount. Market declines will not affect the level of guarantee.

Withdrawals usually start at age 65 and are up to 5% of the account balance. If a participant dies before the balance is depleted, the remaining balance will pass to his/her beneficiaries.

The second product comes from insurance providers like Prudential, John Hancock and Hartford Life. These products are available on the provider's proprietary 401(k) platform. Unlike the first approach, these have premixed asset allocation portfolios. They provide a guaranteed withdrawal percentage at retirement age regardless of how the portfolio performs. Participants can receive higher growth percentages due to market advances (usually 5% for most products). Fees for the guarantee portion are higher than the first option, but as more participants utilize this product and critical mass is achieved, the fees should begin to decrease.

With more providers designing 401(k) Guarantee programs, products will increase in number and become more diverse, but acceptance will only occur for programs that are easy to understand. While education is no cure-all, it has long been the watchword of plan sponsors. Many employees remain skeptical in the wake of market losses over the past year or more. That mindset underscores the need for comprehensive features that are understandable and can empower employees to achieve growth and security in their retirement. Following a decade of turbulent market performance, the 401(k) Guarantee may just be that product.

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Marc provides clients with comprehensive advisory services on overall strategic planning, retirement program design, investment selection, client fiduciary obligations and compliance requirements.

ABSTRACT

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