Understanding Preretirees' Retirement Income Preferences

Beyond products, plan sponsors and financial professionals can offer an experience to help participants make informed savings drawdown decisions

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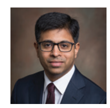

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KEY INSIGHTS

- Confusion about different retirement income products points to an opportunity for traditional advice or advice-embedded retirement income solutions.
- Preference for managed payout solutions and annuities weaken as participants get close to retirement. Willingness to work with a financial professional increases at the same time.
- Participant preferences suggest that retirement income solutions need to evolve beyond products to provide participants with an experience that makes them confident about their choice.

Once upon a time—as the fairy tale goes—defined benefit (DB) pension plans were the norm among employers and generated sufficient retirement income for all.

However, the past frequently appears rosier in collective memory.

Even when DB plans were more commonplace, not every worker had a DB plan, and not every plan provided a livable income. However, DB plans provide a simpler experience for participants in retirement. Money set aside by the DB plan sponsor provides a paycheck for life, and DB plan participants don't need to make complicated decisions about how to arrange for ongoing income.

In recent years, defined contribution (DC) plans like 401(k)s have overtaken DB plans as the most popular workplace savings vehicle for most employees. Recent research from the Employee Benefit Research Institute (EBRI) found that the percentage of private sector wage and salary workers who participated in a DB plan decreased from 28% to 1% between 1979 and 2018. During that same time period, the percentage of individuals participating in DC plans increased from 7% to 40%.[1]

The shift from DB to DC plans has placed shared burdens on the employee and the employer for solving for retirement income. Plan sponsors are expected to offer solutions. Employees then have to decide which solution

[1] "Putting Numbers to the Shifting Retirement Landscape," Plans, EBRI Fast Facts, https://www.ebri.org/docs/default-source/fast-facts/ff-344-retplans-23jan20.pdf?sfvrsn=8063d2f_6, January 23, 2020, #344.

can help them generate a "paycheck" throughout retirement.

The financial services industry has put a lot of energy, education, and communication toward teaching people how to save for retirement, and it has done a lot of good. Perhaps more importantly, plan sponsors have increasingly adopted auto-services (i.e., auto-enrollment, auto-escalation, etc.) to make it easier for plan participants to save for retirement.

A similar "auto income" feature can simplify the participant experience after retirement. However, most DC plans lack a default "auto income" feature.

Because savings decisions in DC plans are often automated, saving for retirement may be an easier proposition for individuals than deciding how to spend down their nest egg. People saving for retirement need to make two crucial decisions: how much to save and how to invest the savings. Workplace retirement plans like 401(k)s have increasingly made these decisions easier by creating defaults that auto-enroll people to save and invest in investments (including target date investments) that are age- and risk-appropriate.

On the other hand, generating retirement income may require a deeper assessment of longevity risk, market risk, and inflation risk, as well as an understanding of tax implications. Yet many people are left to fend for themselves in this critical phase.

It's almost like they've been dropped off in the middle of a bus route with no directions and left to their own devices to navigate the rest of the journey on their own.

While the conversation continues on what can be done to address income needs, the challenge continues to grow. More people saving in DC plans means that more will need to find their own way. DC plans may be well suited to meet this need by incorporating solutions that can help the transition to income so retirees can meet their spending needs.

How to Create the "Best" Retirement Income Strategy?

Part of the complexity in presenting a solution is that there is no such thing as a "best" retirement income strategy or an ideal one-size-fits-all approach. People have different needs and preferences, so their retirement income strategies may include a variety of solutions—such as managed payout solutions, systematic withdrawals, immediate annuities, and deferred annuities, etc.

That's easier said than done.

Even though plan sponsors have tried to educate, research has shown that a large number of Americans still lack basic financial literacy, which affects their retirement planning.[2] So introducing a plethora of complicated financial products and strategies to them at a time when they are most concerned about not making a financial mistake only increases their financial stress, which is counterproductive.

The first step to solving the retirement income needs of workers is to understand their knowledge and preference regarding liquidity, flexibility, and risk tolerance.

T. Rowe Price's most recent Retirement Savings and Spending Study examined these topics for preretirees who are saving for retirement in a 401(k) plan.

[2]Lusardi, Annamaria and Mitchell, Olivia S., "Financial literacy and retirement planning in the United States," *Journal of Pension Economics and Finance*, Cambridge University Press, vol. 10(04), pages 509–525, October 2011.

Aversion to Some Income Solutions Increases Closer to Retirement

Would not invest in a managed payout solution

31%	28%	45%
Age 50–54	Age 55–59	Age 60–64

Would not invest in an immediate annuity

31%	28%	46%
Age 50–54	Age 55–59	Age 60–64

Would not invest in a deferred annuity

43%	47%	62%
Age 50–54	Age 55–59	Age 60–64

What Do People *Really* Want?

In our survey, we posed a question to preretirees age 50 and older about how they would allocate a hypothetical amount of retirement savings ($500,000) at retirement across four options:

- Invest in a managed payout mutual fund
- Invest in an immediate annuity
- Invest in a deferred annuity
- Manage on their own or with a financial professional's help

One number immediately jumped out from the responses: One in four preretirees were not sure if they would invest in **any** of these products or if they should manage their money on their own. In our question, we provided detailed explanations of these investment solutions with relevant examples, but people were still confused. Explaining these products and strategies is part of the challenge.

More than eight in 10 preretirees have a goal to manage a strategy that converts their assets into an income stream in retirement. In simpler terms, they want to create a paycheck from their own savings. But when asked about individual retirement income solutions like a managed payout fund, an immediate annuity, or a deferred annuity that would meet that goal, the majority of preretirees say they are either not sure or won't put any money in these choices.

So while the desire to create a paycheck is there, the appeal of individual retirement solutions is low—this is the gap that needs to be bridged.

There could be other reasons, beyond unfamiliarity, behind the aversion to certain retirement income solutions.

For example, while guaranteed income is an appealing idea in theory, we see that consumers balk at the point of purchasing an annuity. Some aren't sure if it's a fair product for the money,[3] and others might be concerned about liquidity. Also, the lack of knowledge and understanding of these products could be a key barrier toward the adoption of these solutions.

Product Preferences Change as Retirement Approaches

Our research also shows that there is more openness to a managed payout solution or annuity among younger preretirees who are further from retirement. However, when retirement is just around the corner, preferences change.

A few factors may be at play here:

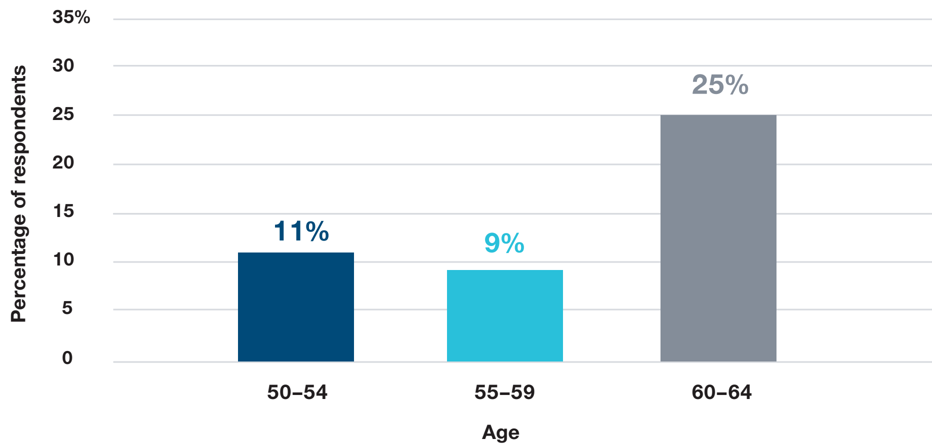
1. The purchase of these products is complicated and, in some ways, a final decision. For example, with annuities, the trade-off is sacrificing liquidity and, in some cases, higher returns for a predictable, guaranteed income stream. While the idea of a guaranteed income stream is appealing, these concerns are more and more manifested as people near the time of decision-making.
2. As people near retirement and amass more wealth, they might become more reluctant to relinquish control of their assets. So, the appeal of standalone retirement income products, which demand some control over their assets, starts to weaken and they lean more toward options that give them a higher degree of control over their assets. That might be the reason why managing it on their own or with the help of a financial professional becomes an appealing option.

[3]"The Pivotal Role of Fairness: Which Consumers Like Annuities?," Shu, Suzanne B.; Zeithammer, Robert; Payne, John W., Dec. 7, 2018. https://onlinelibrary.wiley.com/doi/full/10.1002/cfp2.1019#d21735373

> One in four preretirees were not sure if they would invest in a managed payout solution or a deferred or immediate annuity."
>
> **— Sudipto Banerjee, Ph.D.**
> *Vice President, Retirement Thought Leadership*

Proximity to Retirement Increases Openness to Advice, Managing Own Finances

(Fig. 1) Respondents were asked: "Would you invest 100% of your retirement assets on your own or with a financial professional?"



Source: T. Rowe Price Retirement Savings and Spending Study (2019).

3. There is more to a retirement income solution than just a product. Individuals may want an additional layer of service involving advice or education before they make a decision.

This need for advice is more apparent when we see that the interest in working with a financial professional, or managing one's finances entirely, more than doubled from 11% for the age 50–54 cohort to 25% among those in the age 60–64 cohort (Fig. 1).

As mentioned before, an incomplete understanding of these products could push people away from these products toward managing their own money. Trust issues with financial companies could be a factor as well. On the other hand, familiarity and trust with one's own financial professional could make people more reliant on them. This means that providing people with retirement income products might not be enough. The delivery of these products must provide an experience that people are comfortable with and trust.

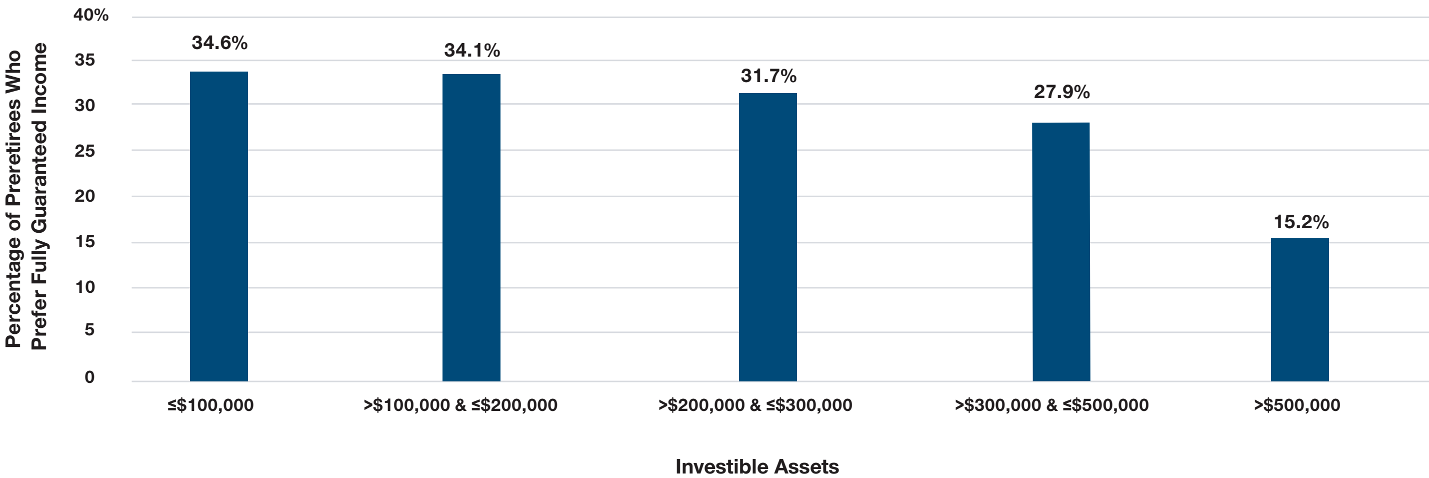
Investible Assets and Preference for Annuities

Preference for guaranteed income has an inverse relationship with the level of assets. As assets increase, preference for guaranteed income decreases. As Fig. 2 shows, households with investible assets over $500,000 have a much weaker preference for guaranteed income than those with below $500,000 in investible assets. This could be due to the following:

- Those with fewer assets face a higher risk of running out of money and have a stronger preference for guaranteed income. They also have less margin for error in managing their monthly cash flow.
- Those with more assets are less concerned about running out of money and more concerned about liquidity and missing out on growth opportunities.

Investible Assets Shape Preference for Guaranteed Income

(Fig. 2) Preretirees with fewer assets have more interest in guaranteed income than those with higher assets



Source: T. Rowe Price Retirement Savings and Spending Study (2019).

83%

of all 401(k) participants want to keep their savings in the employer plan after retirement.

What Do Participants Expect to Do With Retirement Plan Accounts in Retirement?

We know from other research T. Rowe Price has done that plan sponsors are open to retirees leaving their assets in their employer's plan. In fact, half of plans with assets greater than $500 million prefer that participants maintain their balances in DC plans.[4]

But do participants feel the same way?

Eighty-three percent of all 401(k) participants want to keep their savings in the employer plan after retirement. Breaking that down:

- Fifty-three percent would keep their savings in the 401(k) after retirement if a retirement income solution was available, and
- Thirty percent would keep their savings in the 401(k) after retirement regardless if a retirement income solution was available

While the desire to keep the assets in the plans might be known in institutional circles, employers are not necessarily conveying that message successfully to their plan participants. Sixty-one percent of participants say their employers have not communicated the advantages (like lower investment cost or ongoing professional oversight) of leaving the money in the plan.

Interest in keeping assets in the 401(k) plan is strong across all generations, with millennials having the strongest preference about keeping money in the work plan (88%), followed by Generation Xers (83%) and baby boomers (77%).

[4] "What DC Plan Sponsors Prefer Retiring Participants Do and Why It Matters," Latham, Lorie, T. Rowe Price, February 2019.

Opportunities for Plan Sponsors and Financial Professionals

So what does this all mean?

Retirement income products have existed for years, and more are coming to the market every day. In addition, the recent passage of the SECURE Act has provisions that address:

- annual lifetime income disclosures to plan participants,
- a safe harbor provision for annuity selection for plan sponsors, and
- portability for participants who purchase in-plan annuities.

Increased disclosure and regulatory safe harbors will not be enough on their own. More likely, effective solutions will address a wider set of needs. Our research suggests that product alone may not be enough to increase adoption. The solution likely lies beyond product.

Individuals want more than a one-dimensional product. They need help with selection and planning. So how these solutions are delivered to them will be as crucial as the solutions themselves.

Our research also suggests that plan participants may be willing to accept such help from their employers. So plan sponsors and financial professionals have an opportunity to take the lead and help participants make better retirement income choices. That means not only providing participants a variety of retirement income solutions, but also providing them the right tools and education to make the necessary choices.

Financial professionals can engage with plan sponsors with what they feel is appropriate. If plan sponsors don't want to support retirement income options within the plan, financial professionals can engage individuals outside the plan.

Ultimately, solving for retirement income comes down to assessing an individual's personal needs and wants, not designing and selling a particular retirement income product. Retirement income products or solutions can only be successful when participants are comfortable and eventually confident with their choice.

ABOUT THE STUDY

The Retirement Savings and Spending Study was conducted by NMG Consulting and included a sample of 3,016 retirement plan participants, 250 eligible non-plan participants, and 603 individuals without access to workplace savings plans. It also included 1,005 retirees who have retired with a rollover IRA or left-in-plan 401(k) balance. The survey was conducted online from June 13–25, 2019.

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