JULY 2019 | Policy Brief

Managed payout funds and other features:

A proposal to convert retirement account balances into automatic and flexible income

David John
Brookings Institution; AARP Public Policy Institute

William Gale
Brookings Institution

J. Mark Iwry
Brookings Institution; Wharton School, University of Pennsylvania

Aaron Krupkin
Brookings Institution

This report is available online at: https://www.brookings.edu

B | Retirement Security Project
at BROOKINGS

The Retirement Security Project is dedicated to promoting common sense solutions to improve the retirement income prospects of millions of American workers. Nearly half of all workers do not have access to an employer-sponsored retirement savings plan or a traditional pension. Among workers who do have access to such a plan, the shift from defined benefit pension plans to defined contribution plans makes it even more important for individuals to save for their own retirement. To address these trends, RSP proposes research-based policy solutions aimed at helping middle- and low-income Americans to better prepare for a financially

Contents

About the Authors ii
Disclosure ii
Acknowledgements ii
I. Introduction 1
II. Annuities and the Need for Guaranteed Income 1
III. Managed Payout Funds: A Brief Overview 2
IV. An Automatic Retirement Income Option for American Savers 3
V. Conclusion 4
References 5

ABOUT THE AUTHORS

David John is nonresident senior fellow in Economic Studies at Brookings and a senior policy advisor at the AARP Public Policy Institute.

William Gale is senior fellow in Economic Studies at Brookings.

J. Mark Iwry is a nonresident senior fellow in Economic Studies at Brookings and Visiting Scholar at the Wharton School.

Aaron Krupkin is a senior research analyst in Economic Studies at Brookings.

DISCLOSURE

Iwry provides, through J. Mark Iwry, PLLC, policy and legal advice to plan sponsors and other corporations, private equity, fintech, and other investment firms, trade associations, and nonprofit organizations regarding retirement and savings policy, pension and retirement plans, and related issues. Iwry is a member of the American Benefits Institute Board of Advisors, the Board of Advisors of the Pension Research Council at the Wharton School, the Council of Scholar Advisors of the Georgetown University Center for Retirement Initiatives, the Panel of Outside Scholars of the Boston College Center for Retirement Research, the CUNA Mutual Safety Net Independent Advisory Board, and the Aspen Leadership Forum Advisory Board. He also is currently serving as an expert witness in federal court litigation relating to retirement plans. The authors did not receive any financial support from any firm or person for any views or positions expressed or advocated in this policy brief. They are currently not an officer, director, or board member of any organization that has compensated or otherwise influenced them to write this brief or to express or advocate any views or positions in this brief. Accordingly, the views and positions expressed in this policy brief are solely those of the authors and should not be attributed to any other person or organization.

ACKNOWLEDGEMENTS

The authors thank the Laura and John Arnold Foundation for research support. For helpful comments, the authors thank Fredrick Axsater, Michael Davis, Josh Gotbaum, Melissa Kahn, Elizabeth Kelly, Anne Lester, Emily Merola, Moshe Milevsky, David Morse, Bob Toth, Bruce Wolfe, and participants at a breakout session at the Aspen Leadership Forum on Retirement Savings.

I. Introduction

Converting retirement savings balances into a stream of retirement income creates difficult choices. The necessary decisions – made in the presence of uncertainty about investment returns, future healthcare expenses, lifespan, and other factors – must balance the twin desires to boost current living standards and to avoid outliving one's assets. In a recent nationwide poll, 73 percent of Americans said they do not have the financial skills to manage their money in retirement.[1]

New financial products, however, offer people alternative ways to receive retirement income. We propose a default decumulation solution that could be added to retirement plans to simplify decumulation choices in much the same way that automatic choices have simplified enrollment, contribution, and investment allocation decisions for millions of savers. Our proposal centers on pooled investment accounts known as managed payout funds that deliver monthly income that is likely, though not guaranteed, to last a lifetime. Coupled with longevity annuities that begin to make payments when the owner reaches an advanced age and a separate fund for emergencies and extraordinary payments, managed payout funds could help protect retirees from longevity risk without unduly reducing their current living standards.

Retirement systems across the world are dealing with the same issues and coming to many of the same conclusions. While still in its early stages, this growing international consensus is similar to the one that has prompted the spread of automatic enrollment and similar features to many countries.

II. Annuities and the Need for Guaranteed Income

Social Security is the primary source of retirement income in the United States. Yet, it is widely agreed that most U.S. households need additional sources of income to maintain pre-retirement living standards. Until relatively recently, many retirees also received income from employer-sponsored DB pension plans. However, the plans have covered fewer workers over time.

For many private sector employers, retirement savings plans – predominantly 401(k)-type plan for employer-sponsored retirement benefits and the Individual Retirement Account (IRA) for individual savers – have replaced DB plans. Without structured payout options, these plans create dual risks for workers: if they consume too little, they reduce their living standards unnecessarily; if they consume too much, they risk running out of assets in old age.

. . .

[1] Oakley and Kenneally (2019). In the same poll, 79 percent said that retirees don't have the investment skills to ensure their retirement savings last throughout retirement.

In principle, the guaranteed income stream provided by an annuity resolves this dilemma. Benartzi, Previtero, and Thaler (2011) show that many savers are interested in and value annuities. But, for a variety of reasons, the private annuity market is quite small.

III. Managed Payout Funds: A Brief Overview

A major alternative to an annuity is a managed payout fund, a diversified pool of investments that is designed to produce a relatively consistent level of annual income but that does not guarantee that outcome.

Managed payout funds are similar in some respects to Target Date Funds (TDFs), but they have a different objective. TDFs typically invest in a mix of asset classes, including diversified equities, bonds, etc., designed to build retirement assets. While some TDFs are actively managed, TDFs increasingly use some level of passive index funds to reduce costs. As the investor ages, the fund generally continues to seek maximum growth, but the proportion of the balance held in risky assets falls. Distributing income is not necessarily an objective.

In contrast, managed payout funds serve as decumulation vehicles, paying monthly or quarterly cash distributions to retirees. Their investment strategy generally is designed to generate regular investment earnings and gains for income with carefully managed risk to reduce losses. The goal is stable income payouts stemming from consistent investment returns, and possibly growth, over time rather than maximum gains. The annual income amounts are calculated using both investment performance and, in the case of many managed payout funds, a gradual distribution of the principal amount invested in the fund. Certain other managed payout funds seek to preserve capital, though they have authority to distribute it if needed to maintain targeted payments, and therefore try to fund their targeted payments solely with investment returns.

Typically, managed payout funds are actively managed investment vehicles with at least initially a fairly high allocation to equities combined with countercyclical alternative investments or strategies intended to reduce losses when the markets are down. Although the investments are actively traded, the size of the pool and a legal structure that imposes a fiduciary requirement on management help keep administrative costs low. The funds could also use other investment strategies to achieve these goals, including gradually de-risking the portfolio and combining the phased withdrawal fund with other types of retirement income products.

While these funds are designed to produce level monthly income throughout a given year, that income is likely to vary somewhat from year to year, increasing when markets rise and dropping when they decline. To limit variation in income amounts, managed payout funds can use smoothing mechanisms such as reserve funds that spread investment gains and losses over several years.

The largest managed payout fund in the United States, the Vanguard Managed Payout Fund, holds a portfolio that is about 55 percent in stocks, 6 percent in bonds, 21 percent in commodities, and 18 percent in alternatives such as hedge funds, private equity, etc. Over time, the fund expects to pay investors an annual amount equal to about four percent of

their assets, but this may vary depending on the returns on its investments. The fund sets a target level of income every year and then pays that amount in 12 equal monthly payments, while charging a fee of 34 basis points on a minimum investment of $25,000.[2]

IV. An Automatic Retirement Income Option for American Savers

As first shown in research by Madrian and Shea (2001) and Thaler and Benartzi (2004), automatic enrollment and automatic escalation in 401(k) plans have proven to be effective and popular ways to guide people to appropriate retirement saving decisions. The same kind of automatic guidance that has helped millions to build retirement assets could plausibly have a similar dramatic effect helping them to use those savings effectively.

Because it is not mandatory, an automatic income mechanism does not need to – and could not – provide a perfect solution to every retiree. It should, however, provide significant value to the largest number of retirees possible. To meet this goal, we believe that the mechanism should meet several standards:

- It should be simple, transparent, and inexpensive.
- It should protect against the risk of outliving one's savings and provide regular lifetime income that is reasonably stable over time.[3]
- It should be reasonably protected against sequence of returns, market, and inflation risks.
- It should be flexible enough to allow the retiree to change course and pursue a different income strategy without causing undue adverse selection.
- It should provide sufficient liquidity and flexibility to permit a separate fund that allows retirees to make lump sum withdrawals for emergencies or other purposes without unduly disrupting their regular retirement income.

We propose that the automatic retirement income mechanism contain three features:

- A pooled managed payout fund;
- A fund from which retirees could withdraw partial lump sums for emergencies or other special purposes; and
- A QLAC-type longevity annuity.[4]

This structure is similar to proposals in the U.K. and Australia. At the time of the transition from savings to income, retirement assets would be divided into the three components. Most of the money would go into a managed payout fund. Approximately 10 percent would be set aside for emergencies or other lump sum withdrawals and placed in a liquid

. . .

[2] Vanguard (2019).

[3] Another goal of the default would be to include spousal protections.

[4] In addition, we urge employers to assist participants with the timing of their Social Security benefits. This will help participants optimize their total retirement income.

investment or even a bank account. The remainder would be earmarked for the purchase of a QLAC-style longevity annuity that would begin payments at about age 85.

The managed payout fund would be designed to produce a regular stream of retirement income equal to roughly a set percentage of the individual retiree's fund balance based on both investment performance and a gradual distribution of the initial investment, although this amount would not be guaranteed. Because the fund would include significant investments in equities and other growth investments, it should be able to pay out a higher income level on average than if it was invested solely in bonds or safer assets. Once payments begin, the retiree would receive a regular monthly check. Payments would be designed to also satisfy any federal required minimum distributions that apply to the retiree.

The separate emergency fund is an essential part of the package. Having a separate fund for these emergencies and other occasional necessary withdrawals will make it easier to meet these eventualities.

The QLAC (which could be a joint and survivor annuity for the retiree and a spouse or other beneficiary, or a single life annuity) would continue payments for life and would serve as a safety net to ensure that retirees cannot outlive their savings.

In addition, we recommend that retirement savings plans offer lifetime annuities as an optional choice – including annuities that are limited to a portion of the account balance intended roughly to fund essential expenses – as well as other retirement income options that participants could use instead.

This structure meets all the standards proposed above, and it is simple to explain. Appropriately managed and regulated, the plan would generate low costs. The proposal is structured to provide income for life through the longevity annuity as well as predictable, regular income and money available for emergencies. Investments through the managed payout fund will also help to protect retirees against inflation, while the separate fund could be drawn upon to help protect against sequence of returns risk. It is also flexible enough to allow for both different circumstances and different retirement income choices. If some participants wish to use a different retirement income strategy, they only need to opt out of the default in much the same way that someone whose savings are automatically enrolled into a TDF can opt out and choose another investment.

V. Conclusion

Choosing the best way to convert retirement savings into a stream of income is one of the most complex financial decisions individuals have to make. We recommend that plans offer a pooled managed payout fund, a QLAC longevity annuity, and an amount for emergencies and special expenditures. This structure is flexible enough to allow participants to make changes during retirement as their circumstances evolve. In addition, we recommend that plans offer lifetime income annuities as an optional choice. For many people, acquiring an appropriately consumer protective and reasonably priced income annuity with at least a portion of their savings will still be the best choice for retirement income, and for many others it will play a key role in a broader post-retirement financial strategy. While there are many specifics to work out, we believe that the combination of

features discussed above offers a new, sensible, and sound approach to providing income security in retirement.

REFERENCES

Benartzi, Shlomo, Alessandro Previtero, and Richard H. Thaler. 2011. "Annuitization Puzzles." *Journal of Economic Perspectives* 25 (4): 143-64.

Madrian, Brigitte, and Dennis F. Shea. 2001. "The Power of Suggestion: Inertia in 401(k) Participation and Savings Behavior." *The Quarterly Journal of Economics* 116 (4): 1149-87.

Oakley, Diane, and Kelly Kenneally. 2019. "Retirement Insecurity 2019: Americans' Views of the Retirement Crisis." National Institute on Retirement Security, Washington, DC.

Thaler, Richard H., and Shlomo Benartzi. 2004. "Save More Tomorrow: Using Behavioral Economics to Increase Employee Saving." *Journal of Political Economy* 112 (1): 164-87.

Vanguard. 2019. "Vanguard Managed Payout Fund." https://investor.vanguard.com/mutual-funds/managed-payout/#/mini/fees/1498.

B | Economic Studies
at BROOKINGS

The Brookings Economic Studies program analyzes current and emerging economic issues facing the United States and the world, focusing on ideas to achieve broad-based economic growth, a strong labor market, sound fiscal and monetary policy, and economic opportunity and social mobility. The research aims to increase understanding of how the economy works and what can be done to make it work better.

© 2019 The Brookings Institution | 1775 Massachusetts Ave., NW, Washington, DC 20036 | 202.797.6000