RETIREMENT INCOME INSTITUTE
Alliance for Lifetime Income

Who Should Read This Insight:
Consumers, policymakers, financial professionals, retirement investors, annuity manufacturers

Institute Research Agenda Topic:
Optimizing annuities in a retirement portfolio

Definitions of **bold key terms** are at the end of this article.

LINDA S. JAMISON
is an author, public speaker, and consultant who has served in senior executive positions in the US government, including in the White House. She has worked at the United Nations and was a senior leader with the Center for Strategic and International Studies, where she was the founding dean of an international leadership academy. Jamison has trained and advised policymakers and political leaders in the art and practice of leadership both in the United States and abroad. She has a master's degree from American University in Washington, DC, and a bachelor's degree from the University of Denver.

Authors, Titles and Publication Dates of the Articles Addressed in the Insight
Vanya Horneff, Raimond Maurer, and Olivia S. Mitchell. 2019. "Automatic Enrollment in 401(k) Annuities: Boosting Retiree Lifetime Income." Brookings Institution, Washington, DC.

__Vanya Horneff__ is a postdoctoral researcher in investment and pension finance in the Finance Department of the Goethe University Frankfurt. She is also a researcher at the institute for Sustainable Architecture for Finance in Europe (SAFE).

Insight: HOW DEFAULT INCOME ANNUITIES CAN HELP PROTECT AGAINST RUNNING OUT OF RETIREMENT INCOME

IDEAS IN THIS INSIGHT YOU CAN PUT INTO ACTION

Automatically investing a small amount of retirees' employer-provided retirement assets into annuities can enhance retirees' well-being as they age. This study shows that both men and women over the age of 65, of all educational levels, can improve their buying power and overall welfare when employers invest as little as 10% of retiree assets into deferred income annuities. This type of program can help protect retirees from depleting their retirement savings before the end of their lives.

PRINCIPAL INSIGHTS

Today, there are few privately managed retirement plans that provide an income to **retirees** through the end of life. To protect retirees from running out of money in old age their employers could automatically invest a modest amount of retirees' 401(k) earnings in **deferred income annuities** (DIAs) that would guarantee an income for life. Horneff, Maurer, and Mitchell's study shows that both men and women, regardless of educational level, would benefit from this type of default investment by their employer. The result would be more retirement income and improvements to overall well-being for retirees as they age. The authors discuss the uncertainty of retirement, present their research findings, and describe the ways that their idea would be beneficial to retirees.

First, the researchers discuss the uncertainty around aging and retirees' increasing concern about having enough retirement savings to last until the end of life. Since they do not know how long they will live, retirees have no choice but to plan how to spend down their savings as they age. The uncertainty of how long retirees' lives will last can lead to belt-tightening and conservative spending habits that negatively impact their well-being and sense of security. Policymakers are also concerned with the pace at which retirement savings is depleted and the real-life consequences if retirees have to rely solely on Social Security and Medicare until the end of life. To further complicate decisions about retirement investments, officials and others are uneasy about entrusting complex financial decisions to an aging demographic in which cognitive decline is possible.

As a backdrop to this study, the researchers use the term **"longevity risk"** to describe the chance that retirees might live longer than their income will last. Current population data show that a 65-year-old woman today should expect to live for 20 more years; half of women at that age will live to 85 or longer and 15% will live to be 95 or older. The risks inherent in aging are complicated. Uncertainty over health-care issues and when and how to begin to rely on Social Security and Medicare are major concerns among retirees, especially since

Continued

Authors, Titles and Publication Dates of the Articles Addressed in the Insight

Raimond Maurer *is professor of investment, portfolio management, and pension finance in the Finance Department of the Goethe University Frankfurt. He is a research associate for Sustainable Architecture for Finance in Europe (SAFE) and advisory committee member for the Pension Research Council at the Wharton School of the University of Pennsylvania.*

Olivia S. Mitchell *is professor at the International Foundation of Employee Benefit Plans. She is also professor of insurance, risk management, business economics, and policy; and director of the Pension Research Council/ Boettner Center for Pensions and Retirement Security at the Wharton School of the University of Pennsylvania.*

most retirement plans do not offer full lifetime benefits coverage. In addition, retirees want to have control over their assets as they age so they can leave money to their children and/or other heirs. The prospect of living a long life presents challenges to retirees about how to invest; uncertainties about the end of life complicate their planning and can overwhelm retirees.

Next, the researchers describe their proposal. The plan they outline alleviates the stress of longevity risk; under their plan, aging retirees benefit from income from a DIA invested by their employer. The details of the default plan call for employers to automatically invest a modest amount of each retiree's 401(k) savings into a DIA at age 66; the retiree would be able to draw down that income starting at age 85. The authors' study shows that, by age 85, if just 10% of 401(k) retirement savings were to be automatically invested into an **annuity** at age 66, those retirees, regardless of education and gender, would experience more prosperity by having income from a DIA to use until the end of life.

Two factors make the authors' proposal distinctive. The first is that retirees' assets would be automatically invested at age 66. The term used in the study is a **"default plan,"** meaning the employer rolls a specific percentage of 401(k) retirement savings into a DIA. The second unique factor is that the annuity benefit is deferred until age 85, so that retirees accumulate nearly two decades of investment value before the payout begins.

The results of this study are positive for the **retirement investor** and show that if a modest amount of employer-managed 401(k) savings are automatically invested in DIAs for 66-year-olds, there would be measurable improvements in **welfare gains** after retirees reach age 85, when they can start to draw on the annuity. Welfare gains—extra dollars that can be spent on lifestyle improvements—are illustrated in two ways: first, as consumption by both men and women together; and second, by education and gender. A striking finding is that college-educated women have a gain of 6.1% over regular retirement growth. For college-educated men the positive increases are even higher (11%). Although not as elevated, the study shows positive increases in retirement savings for all educational levels for both men and women, even those without a high school diploma.

Horneff and colleagues extract several pieces of advice from the study. First, even though both men and women would see gains in retirement income if more of their 401(k) assets were invested into DIAs, investing just 10% of 401(k) savings is the bottom-line recommendation. Another suggestion is that retirees should avoid an all-or-nothing approach to retirement decisions, where they either roll over all of their savings into annuities or are barred completely from converting any savings into annuities.

The authors characterize their work as a practical approach so retirees will have a steady income in later life instead of relying only on Social Security and traditional 401(k) retirement plans. They recommend that employers who adopt this plan ease into any changes, especially given concerns over managing new financial risks and fulfilling existing obligations to retirees. In addition, employers and retirees alike will need government guidance on the regulatory consequences, tax obligations, and practical adjustments if they adopt default plans going forward.

Finally, despite the need for more discussion on this topic, defaulting a portion of retirement savings into annuity income to be drawn down later in life has positive effects. Offering a way to help retirees manage their finances better in old age and provide additional income through to the end of life helps alleviate the stress of worrying about longevity risk. With more certainty, retirees may choose to make sounder financial decisions and so experience a higher standard of living.

To learn more, visit the Retirement Income Institute at
www.allianceforlifetimeincome.org/retirement-income-institute

KEY TERMS ARE SOURCED FROM THE ALLIANCE FOR LIFETIME INCOME'S ANNUITIES LANGUAGE GLOSSARY AND INVESTOPEDIA

Annuity: *A financial product that can offer protected lifetime income and even potentially grow your money.*
Default plan: *A plan where the employer rolls a specific percentage of retirement savings into a deferred income annuity (DIA).*
Deferred income annuity (DIA): *A type of annuity that delays payments until you choose to receive them, while providing an opportunity for growth or income during the deferral period. Payments can be installment or lump-sum.*
Longevity risk: *The chance that you may live longer than your income will last.*
Retiree: *Someone who has retired, regardless of age or investments.*
Retirement investor: *Someone who invests his or her own retirement savings, regardless of type.*
Welfare gains: *Extra dollars that can be spent on health-care and lifestyle improvements.*

For industry use only.