HYBRID ANNUITY TDFS – A NEW BREED OF TDFS

BY ANKUL DAGA

The last 20 years have witnessed a shift from defined benefits ("DB") to defined contributions ("DC") plans accompanied by an increase in the number of workers covered by retirement plans. This is a result of both direct engagement with plan sponsors regarding plan design and welcome policy changes, including the Pension Protection Act, the SECURE Act, and the SECURE Act 2.0. It has shifted responsibilities in both the accumulation and decumulation phases.

a) In the accumulation phase – Guidance from policymakers and actions from plan sponsors and consultants has proven effective. Defaults have helped improve coverage and account balances. The momentum remains strong.

b) In the decumulation phase – Many industry surveys indicate that the participant's demand for personalized retirement income guidance is high. Participants want help estimating how much to save for retirement, when to retire, and how to create a retirement income stream from their lifelong savings. The variety of income generating instruments, each with different attributes, available in the marketplace complicates this analysis. Further, only a small percentage of people have a financial advisor.

This paper discusses how our industry can better help the millions of Americans seeking a more secure retirement. While challenges on portability and low participant adoption of annuities within qualified default investment alternatives ("QDIA") persist, the underlying need to help participants convert their retirement savings into income has only increased. This has motivated additional research and engagement in meaningful dialogue with plan sponsors, consultants, and participants. This Institute Note highlights insights gained in this pursuit, which are described in more detail in the full research paper.[1]

VANGUARD RESEARCH PAPER

Drawing on the insights from the research on hybrid annuity target date funds ("TDFs"). We see hybrid annuity TDFs as a part of a broader ecosystem and consider how they work alongside financial wellness, advice, and other non-guaranteed income solutions.

The value of annuities in supporting retirement income needs has been well established conceptually. Annuities provide investors with a predictable income stream. The research reviews common forms of hybrid annuity TDF structures available in the marketplace. We consider a range of annuities that could be combined with a TDF while minimizing hurdles

1. From theory to practice: Guaranteed income and hybrid annuity target-date funds (vanguard.com)

such as higher cost/fees, lack of transparency, and irrevocability post-investment. We evaluate the outcomes that participants can potentially achieve using these products over their retirement lifetime. Vanguard does not currently offer a hybrid annuity product as we continue to research and assess the market.

We have quantified the investment value of these options to enable a DC financial professional – providers, plan sponsors, consultants, or policymakers – to understand the pros and cons of different design features. The research covers three foundational design questions:

a. How to invest? *Using SPIA, DIA, or QLAC.*[2]

b. When to invest? *Including a consideration of a prefunding period for the annuity.*

c. How much to invest? *Portfolio completion around the income annuity resulting in an optimal hybrid annuity TDF solution.*

We used the proprietary Vanguard Life-Cycle Investing Model ("VLCM")[3] to quantify the benefits participants could receive from blending annuities with a traditional TDF. Using VLCM, we can measure the degree of improvement in (1) a participant's ability to generate income throughout retirement, (2) to reduce the risk of outliving one's wealth, and (3) to mitigate market risk when using a hybrid annuity TDF versus a traditional TDF.

We find that inclusion of income annuity solutions in a hybrid annuity TDF structure can create value[4] for retirees equivalent[5] to between 20 and 60 basis points of certainty equivalent ("CE") portfolio returns. To put the compounding impact of this CE return into perspective, a 20 to 60 basis points return improvement when translated to dollar value would mean a lifetime improvement of $1,200 to $4,300 for every $10,000 saved at the age of 25 years, when participants typically start saving for retirement in 401(k) plans. This is not limited to any one annuity type, but we see value in a range of annuity options. The analysis shows that there is value in planning by systematically allocating to an income funding sleeve within the retirement portfolio which can be used to purchase annuities closer to retirement. But it is also noteworthy that most of the value for hybrid annuity TDFs comes from the longevity hedge offered by an annuity income stream. We find that there is more value in deferred annuities compared to an immediate start annuity. Participants are typically spending from their portfolio when in retirement, which limits their ability to recover from market downturns and hence increases their exposure to market risk compared to the accumulation phase. This combined with higher mortality credits makes deferred annuities more attractive. There is no one-size-fits-all annuity recommendation, depending on participants' risk profiles, income and saving levels, marital status, and bequest motive we find optimal annuitization may range between 10% and 30% of the retirement portfolio.

VOICE OF CLIENT

Realistically delivering the perceived value from hybrid annuity TDFs to the plan participant would require addressing the challenges around suitability assessment, complexity, and potential costs. To better understand the perceived benefits and hurdles in the adoption of hybrid annuity TDFs, we conducted a Voice of Client study in March 2023 across two key segments in the DC space: plan sponsors and consultants. The intention was to understand the participant need for retirement income and how DC plan sponsors and consultants are assessing different retirement income products.

The insights gained from this study has further informed Vanguard's viewpoint on retirement income needs and the role hybrid annuity TDFs can potentially play to solve them. We share the findings across the DC distribution pipeline in more detail.

2. Single Premium Immediate Annuity ("SPIA") – Starts providing income as soon as its bought. Differed Income Annuity ("DIA") – Starts providing income at a future date. Qualified Longevity Annuity Contract ("QLAC") – A type of DIA that is exempt from required minimum distributions ("RMDs"). Income from QLAC starts at a later stage of retirement (age 78+).
3. The VLCM is a proprietary model for glide-path construction that can assist in the creation of custom investment portfolios for retirement as well as nonretirement goals. For a more detailed explanation, read [Vanguard's Life-Cycle Investing Model (VLCM): A general portfolio framework for goals-based investing](#).
4. We use annuities with survivor benefits; Social Security is claimed at the point of retirement.
5. We use certainty equivalent ("CE") as a key metric to assess participant outcomes in terms of improvement in their living standard against any additional risks of falling short of those levels due to market or longevity risks. CE incorporates participant's preferences while evaluating participant outcomes and associated risks. It can be thought of as an additional return a participant would get from an improved investment strategy (e.g., hybrid annuity TDF) relative to a reference strategy (e.g., traditional TDF).

Defined Contribution distribution pipeline

PARTICIPANTS

During the accumulation phase, participants have benefited from features introduced under the Pension Protection Act (i.e., automatic features such as automatic enrollment and automatic escalation). Data from Vanguard's How America Saves 2024[6] report indicates participation rates, saving rates, and asset allocation has improved in the last two decades. Yet a recent survey[7] finds that a majority of participants worry that they will outlive their retirement savings. Another survey[8] indicates that there is a disconnect between worker's expectations and retiree's expectations. This disconnect is observed across Social Security claiming age, retirement age, and the ability to work during retirement. For instance, workers expect to claim Social Security and retire at a median age of 65. But most retirees (70%) report retiring before 65, with a median age of 62; half of retirees retired earlier than planned, often for reasons out of their control; and only 40% retired early by choice. 75% of workers think they will work for pay in retirement, but only 30% of retirees actually have. For most participants, in the absence of DB income, Social Security is a major expected and actual income source. 88% of workers expect Social Security to be an income source in retirement, and 91% of retirees report it as an actual income source. Most participants do not have access to a DB pension and need support while navigating the decumulation phase.

Additional insights came from the digital interaction plan participants have with the Financial Wellness hub[9]. Participants nearing or in retirement are interested in making the most of their savings. 61% of participants who said they were already retired said that "making the most of my savings" is one of the topics they want to know more about. Participants would like direction on preparing for retirement, including knowing when they have enough money to retire. Based on the [Guided Assessment], 76% of participants who indicated they were one to five years away from retirement said that "having enough money to retire" is one of the most important financial topics to them.

We also surveyed participants on other topics and found that participants may be underestimating how much they need in retirement. For example, 72% of [Retirement Withdrawal Coach remodels] result in an increase in the estimated monthly retirement payment (average monthly increase is $2,895). We found that participants may also expect to retire earlier than they should to cover their estimated expenses. 65% of Retirement Withdrawal Coach remodels increase a participant's estimated retirement age by an average age of two years.

PLAN SPONSORS

"401(k)s have become the main source of retirement income… We are trying to pension-ize 401(k) plans."

– CIO/SVP, Healthcare – Vanguard Voice of Client study

Plan sponsors care about participants' financial well-being during the accumulation and decumulation

6. How America Saves Report 2024 | Vanguard Institutional
7. Transamerica Centre for Retirement Studies (TCRS): Life in Retirement: Pre-retiree expectations and retiree realities.
8. EBRI 2024 Retirement Confidence Survey: covering 1,255 workers and 1,266 retirees.
9. Financial Wellness | Vanguard Institutional

phase. In fact, 99% of plan sponsors who participated in industry surveys,[10] feel responsible for helping their employees generate income in retirement. Many plan sponsors are trying to address the decumulation challenge by offering or considering more guaranteed income solutions for their participants.

Plan sponsors also recognize that retirement income is complicated, and one solution would not be able to solve for varied income needs of participants.

"There is no retirement income silver bullet yet."

– CFO, Retail – Vanguard Voice of Client study

Plan sponsors also recognize the need for education (both for plan sponsors and participants) given the complexity and higher costs associated with guaranteed income products. Complexity gives birth to nuance. In some cases, participants could end up paying for coverage that they don't use. This raises the risk of litigation associated with the suitability of such solutions for all plan participants, given that there is often incomplete information available about participants' finances.

CONSULTANTS

Consultants and advisors have a big role in addressing the decumulation challenge. Many consultants recognize the need to evaluate guaranteed income products. One industry survey indicates that in the next 12 months, approximately one-third of the consultant community anticipates offering formal ratings for in-plan retirement income solutions.[11] Another survey[12] cited the evaluation of retirement income products as the DC service with the highest growth, showcasing continued focus on the decumulation challenge. There is also a recognition that retirement income solutions embedded within TDFs have the best chance of being utilized and sticking around.

"It's less scary and easier when it's part of an existing product, like a TDF, than adding something new to the lineup."

– Sr. Associate, Consultant – Vanguard Voice of Client study

PROVIDERS

Providers are offering a range of hybrid annuity TDFs[13] covering different annuity types (SPIA, DIA, QLAC, Variable) and withdrawal strategies. The dialogue with industry partners revealed that there has been traction from large plans and leading consultants have started offering coverage for many hybrid annuity TDFs.

Despite the widespread recognition of the investment merits of annuities, their adoption has been very low.[14] So much so that it has been coined as the "Annuity puzzle"[15] by the industry. The irrevocability of annuities, combined with the desire to maintain financial flexibility in the face of contingency risks and the goal of leaving a legacy for heirs, presents a significant barrier to widespread annuitization, as individuals are often reluctant to lock up large portions of their wealth in products that cannot be easily modified or liquidated to address unforeseen circumstances or estate planning objectives.

Hybrid annuity TDFs attempt to balance this "puzzle" by offering to solve multiple retirement goals (such as retirement income, precautionary savings, and bequest) through provisioning for an annuity purchase in the default solution. Therein lies a tradeoff between income security and control over accumulated assets used for an annuity purchase. This tradeoff is exacerbated for low-income participants. For such participants the risk of balance depletion due to emergency withdrawals goes up, especially when they are disengaged. Therefore, it is critical that each participant considers their individual circumstances and balances the tradeoffs of investing in a hybrid annuity TDF.

10. BlackRock read on retirement report; T. Rowe Price Defined Contribution Consultant Research Study – Meaningful increase in the percent of clients that consultants categorize as currently offering or planning to add a retirement income solution: 8% of clients in 2021 compared with 19% in 2023; and PIMCO Defined Contribution Consulting Study – Institutional consultants state evaluating retirement income solutions and navigating new regulations are top priorities for most clients.
11. T. Rowe Price Defined Contribution Consultant Research Study.
12. PIMCO Defined Contribution Consulting Study.
13. DCIIA's report on Choice and Evolution in Defaults as of August 2023.
14. RII-Insight-What-Factors-Can-Explain-Low-Annuity-Market-Participation-Rate-Among-U.S.-Retirees-Pashchenko-2.pdf (protectedincome.org).
15. Modigliani, F. (1986). Life cycle, individual thrift, and the wealth of nations. The American Economic Review, 76(3), 297-313.

HYBRID ANNUITY TDF AS PART OF AN ECOSYSTEM

The dialogue with industry partners and the Voice of Client study have revealed that much more value for participants could potentially be unlocked if hybrid annuity TDFs were part of the existing options in the DC ecosystem, rather than offering a hybrid annuity TDF as a standalone product. A standalone product would have to meet evolving guaranteed income needs of certain participants, which poses a suitability challenge when implemented at scale. Unless the annuity contracts are standardized and product familiarity achieved, the portability, liquidity, and complexity hurdles remain.

It is worth stepping back and considering the DC ecosystem in its entirety. Recordkeepers are increasingly investing in financial wellness solutions that participants can use to help with retirement income needs. In general, financial wellness solutions provide education and guidance delivered digitally leveraging behavioral finance techniques. For example, Vanguard launched its Financial Wellness hub in 2022 and subsequently launched a “Living Well in Retirement” hub in 2023. The online hub provides financial assessments, guides, action plans, and digital tools at no additional charge to participants. In fact, there have been 1.8 million visits to the Financial Wellness hub since 2022. Participants most often use this hub to manage debt, build emergency savings, and prepare for retirement.

For participants interested in more support, recordkeepers, asset managers, and consultants increasingly offer Managed Account options in plan that also address retirement income needs. There are a variety of solutions available that deliver both guaranteed as well as non-guaranteed retirement income. Today, 77% of participants are offered a Managed Account program with 7% of participants taking advantage of the offer. Those figures have grown since 2019 when they were 60% and 5%, respectively.[16]

And yet, there still may be a gap. Non-guaranteed income solutions generally help participants develop an income stream with the assets they have accumulated. But in select instances, there may still be a need for ‘downside protection’ or ‘guarantee’ to fill the gap. One can imagine the DC ecosystem evolving to include annuity options, which work in concert with other solutions in the ecosystem to inform and educate plan participants and develop seamless solutions to support their needs. One where employees/participants have access to life insurance (with coverage for long-term care), along with emergency savings support, guidance on prudent strategies like Social Security delay, and access to advice services and financial guidance. Many of these products and services exist today as part of an employee benefits program offered by the employer and are typically offered to plan participants for support when they enter retirement. We believe participants would be better served if these benefits are brought together alongside annuity options under a holistic DC ecosystem. In the current system, this support would likely be orchestrated by plan sponsors, who share the responsibility and support their workers through their retirement (or DC) plan to and through retirement. This rich ecosystem would be reinforced by personalization based on individual circumstances, employee financial education, and employee assistance programs. Participants could get enhanced support during the decumulation phase with this ecosystem. The extent to which we enable such an ecosystem is ultimately a judgement call for policymakers and individual plan sponsors.

CONCLUSION

The need to support retirement income and the accompanying complexities to solve it are widely recognized across the retirement industry. Over the last 20 years, there has been a shift from DB to DC plans, which has shifted responsibilities. Employees are more frequently requesting help to convert their accumulated nest eggs to an income stream to support their retirement. We believe a DC ecosystem that supports participants through all stages of retirement, up to and through the decumulation phase, could help.

Research shows value in helping certain retirees convert their retirement savings into income using hybrid annuity TDFs, but also points to several impediments in participants realizing this value. We seek to continue working with our partners to solve this persistent need.

16. How America Saves Report 2024 | Vanguard Institutional

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