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BENEFITS PERSPECTIVES
Current Issues in Employee Benefits

# Helping employees in their retirement: 401(k) decisions, decisions, decisions!

**Jinnie Olson**, CPC

As a plan sponsor, you've worked hard to help your employees save for retirement. You've designed a savings plan to best fit their needs and guided them on their way to building a nest egg. You've spent countless hours walking them through account statements, helping with contribution or investment changes, and explaining the meaning and benefits of diversification. These efforts have not been in vain: Your participants *have* saved for retirement!

But what's in store for them? Well, it depends. Although factors such as performance of the economy and individual life expectancy are beyond your control, you can consider 401(k) plan design features and educational efforts as key components in helping employees make the right choices for their specific situations. These considerations, examined in this article, may also apply to workers (at retirement age or not) leaving with a vested balance for other jobs or to new-hires who become your plan participants, but the focus here is on issues aimed at your employees at the retirement threshold.

## 401(k) plan design: Options at retirement

Plan design plays an enormous role in effectively helping your employees accumulate savings, but you should also consider features that provide retiring employees convenient methods to access their retirement savings. Every participant should have access to information about the distribution options that the plan offers. If you cannot explain an option, someone who doesn't regularly work with the plan will not likely understand the option. So what happens when employees leave the company with a vested balance in their savings account and are preparing for retirement, with their goals changing from accumulating funds to retention and drawdown? For plan sponsors, the starting point begins with "Leave the money where it is." Retiring plan participants may need time to consider the best options for a future drawdown or rollover. (A plan may require that small balances, i.e., $1,000 or $5,000, be automatically rolled over to a financial institution.) Plan design options can then provide what happens to the funds, allowing participants to determine an appropriate course of action, such as any or all of the following:

1. taking periodic distributions;
2. electing installment payments—a payout stream over a predetermined period of time (e.g., quarterly for the next 10 years);
3. purchasing an annuity to generate a lifetime income stream; or
4. receiving the full amount (as discussed further under "Contemplating plan designs for one-time distribution options") under the following scenarios:
    - Roll over the balance to a new employer's 401(k) plan. Moving the account balance may be a good option for employees who continue working in retirement, as they may view combining accounts less stressful than tracking multiple accounts.
    - Roll over the balance to the retiree's individual retirement account (IRA). An IRA may offer retirees a larger array of investment options and could provide the vehicle for the former participant to consolidate multiple accounts in one place.
    - Distribute the money in a lump sum to the retiree, who then faces the tax implications. If a participant is not of the plan's retirement age, this can be detrimental for their financial planning. A lump sum could raise a recipient's taxable income for the year and may include a penalty tax for early distribution.

## Maintaining accounts

Many employers look at retired (or terminated) employees' account balances as a burden, when in fact they may benefit from allowing those participants to stay in the plan. Having the sums in the individual accounts could give the plan sponsor greater bargaining power when negotiating fees with the investment service provider and thereby may also benefit other employees in the plan. While a participant may have fewer investment options by leaving his or her retirement account where it is, sometimes less is better. Qualified plans provide careful oversight by the plan sponsor and recordkeeper, bankruptcy protection, and generally a low-cost environment. If you, as a plan sponsor, have taken a fairly paternalistic approach to helping your employees save for retirement, why not continue to assist them straight through retirement?

- *Investment options* – Individual retirement account (IRA) providers and brokers tend to argue that plan participants should want to move their 401(k) funds into an IRA as soon as possible because of the additional investment options that are available. But how many people are knowledgeable enough to invest on an investment platform with unlimited options? Most qualified plans offer a reasonable number of investment options that typically have been scrutinized by the plan's investment adviser and retirement committee and evaluated based on the fund's performance. Qualified plan investments are typically institutionally priced (i.e., lower cost) and may include investment options (such as employer stock) that may not be available within an IRA.

- *ERISA protection* – Employees who contribute to your qualified retirement plan are protected by ERISA. This law protects qualified plan accounts from creditors in bankruptcy, requires that participants be provided plan information, and allows participants to sue for benefits and breaches of fiduciary duty, features that are not provided for IRAs.

- *Fees* – Help your participants determine what they're paying in fees. No matter what type of retirement savings accounts they have, fees should play a large factor in participants' decisions to consolidate or move accounts. Some plan sponsors pay the complete operating costs of the plan, while others pay a portion of the costs. Fees that are assessed back to the participants can be offset by revenue sharing, charged pro rata (larger account balance = larger portion of fees), or charged per capita (flat fee for every participant). If participants have multiple accounts and each plan charges a flat annual fee, consolidating accounts into the employer-sponsored plan could save them money. When considering an IRA, participants should pay particular attention to embedded fees, who benefits from any applicable revenue sharing generated by their accounts, and the expense ratios on the funds that are available. The Fee Analysis Worksheet on page 3 is a sample that sponsors could provide to employees (with plan level information/fees on Table 1 optionally completed by the plan sponsor or administrator) to make sure they are thinking through the potential costs of staying in the plan versus moving to another qualified plan or IRA.

## Ad hoc, installment payments, or partial distributions

It is often said that a person's 401(k) isn't meant to operate like a checking account, which is very true while an employee is actively saving for retirement. But allowing for a terminated or retired participant to access his or her account when needed could help avoid adverse tax consequences or rash spending decisions. Offering an installment option may allow participants to set up their future distributions to pay out a steady monthly or annual income and continue to budget as they had while still employed. Alternatively, ad hoc distributions allow for participants to accommodate those unpredictable events that fall outside their regular expenses. Plan sponsors could encourage retirees to use a retirement income calculator to estimate how these distributions might affect their finances to make sure that employees don't outlive their retirement savings.

## Required distributions

If retirement savings are left in a qualified plan, participants eventually must begin taking a minimum distribution. Required minimum distributions (RMDs) must be withdrawn by a qualified plan participant on an annual basis, beginning in the year in which he or she reaches the later of age 70½ or retirement. IRA account owners or those who are 5% owners of the business sponsoring the qualified retirement plan must begin receiving RMD payments once the account holder reaches age 70½ regardless of employment status, while qualified plan account holders may defer their RMD payments if they continue to work past age 70½. The IRS places the onus on individuals to take their RMDs on time, and the penalties for those who fail to take their RMDs are assessed directly on the participant.

Qualified plan participants should be monitored by the plan sponsor and notified as they reach their required beginning dates for RMDs, whereas an IRA owner may need to monitor each IRA individually and consult with a tax adviser each year.

## Contemplating plan designs for one-time distribution options

Plan designs typically provide the following for one-time distributions of participants' accounts:

- *Force-out distributions* – There can't be a more stressful feeling than logging into a previous employer's account and seeing "Account Balance = $0.00." If your plan requires force-out distributions for participants with a balance under $1,000 or forced rollovers to IRAs for those with a balance between $1,000 and $5,000, make sure you communicate this feature. This will prevent distraught former employees from contacting you. Helpful information might include the timing on these distributions if participants do not take a distribution on their own, where an IRA will be established for balances between $1,000 and $5,000, and how to access the new account. As a responsible plan sponsor, you should choose a rollover IRA solution for the plan with reasonable fees. Remember that forcing people with a balance less than $1,000 out of the plan might save them from seeing

## Fee Analysis Worksheet

### Step 1- Calculating the Cost of the Investments and Any Additional Expenses

Since the cost of an investment is deducted by the investment provider at the fund level, participants usually don't realize the impact of these fees. Remember, all fees, including investment fees, reduce the growth of your account.

The first column in Table 1 lists your investments in the ABC Company, Inc. 401(k) Savings Plan, their expense ratios (netted with any revenue sharing/fee credits provided to this plan) and any other expenses. After the investments, we included any additional expense charged to your account, other than the investment fees. In Table 2, you can fill in and calculate the cost of your current investments with an alternative plan or IRA.

**TABLE 1: CURRENT PLAN INVESTMENTS AND FEES**

| INVESTMENT OPTION | AMOUNT INVESTED | EXPENSE RATIO | ANNUAL COST $ |
|---|---|---|---|
| Bond Fund 401K | $20,000 | 0.32% | $64 |
| Index Fund 401K | $15,000 | 0.15% | $23 |
| Large-cap Fund 401K | $30,000 | 0.46% | $138 |
| PLAN SPONSOR MAY SUPPLY INFORMATION | | | |
| Total | $65,000 | | $225 |
| | | Fees as % | Fees as $ |
| Investment Expense Ratio Fees | | 0.35% | $224.50 |
| Account Fees (fixed*) | | 0.09% | $60.00 |
| Account Fees (asset-based*) | | 0.05% | $32.50 |

**TABLE 2: ALTERNATIVE PLAN OR IRA INVESTMENTS AND FEES**

| INVESTMENT OPTION | AMOUNT INVESTED | EXPENSE RATIO | ANNUAL COST $ |
|---|---|---|---|
| Bond Fund IRA | $20,000 | 0.85% | $170 |
| Index Fund IRA | $15,000 | 0.40% | $60 |
| Large-cap Index Fund IRA | $30,000 | 0.86% | $258 |
| PARTICIPANT COMPLETES THIS AREA | | | |
| Total | $65,000 | | $488 |
| | | Fees as % | Fees as $ |
| Investment Expense Ratio Fees | | 0.35% | $224.50 |
| Account Fees (fixed*) | | 0.09% | $60.00 |
| Account Fees (asset-based*) | | 0.05% | $32.50 |

* Fixed fees are dollar amounts, usually expressed as an annual fee.
** Asset-based fees are expenses outside the investment expense ratios. Often, qualified plans or IRAs have an asset-based fee in addition to the expense ratios. IRAs or annuity products may have a "wrap fee," which is an additional asset-based fee.

### Step 2- Are There Any Penalties or Surrender Charges?

Fees alone may not be the deciding factor in making your decision about what you want to do about your ABC 401(k) account. Some investments have higher expense ratios, but when you look at their performance over the last 3, 5, and 10 years, they may have outperformed investments in their peer group. Keep in mind the additional fees that may apply if you change your mind in the future, because it's not uncommon for participants to be surprised by their account closure fees. Be sure to ask if there will be any surrender charges or penalties if you choose to close out your account in the future. This is usually true for insurance products when you elect to change or close your account. Following are possible costs you should also consider when making your decision about whether to leave your account here or roll it over.

| CURRENT PLAN INVESTMENTS AND FEES | |
|---|---|
| Account Closing Fees | $35* |
| Surrender Charges | None |
| Market Value Adjustment Fees | None |
| Other Fees | None |

| ALTERNATIVE PLAN OR IRA INVESTMENTS AND FEES | |
|---|---|
| Account Closing Fees | ________ |
| Surrender Charges | ________ |
| Market Value Adjustment Fees | ________ |
| Other Fees | ________ |

* Distribution transaction fee.

their retirement savings depleted by plan fees, but you should try to give employees plenty of notice before forcing them out so they can roll over the balance to an IRA if they wish.

- *Rollover distributions* – Some participants may have no interest in leaving their money in the plan. Most plans allow for rollover distributions to an IRA or a qualified plan sponsored by another employer. But the U.S. Government Accountability Office (GAO) has found that assisting former participants with rollovers is an area that most employers fail to give enough attention to, potentially allowing IRA companies and brokers to prey upon retired investors without attention to the person's specific financial interest. The Department of Labor has released its final fiduciary/conflict-of-interest rule that generally requires these investment advisers to act in the "best interest" of their clients.

- *Lump sums* – Many plans only allow for a lump-sum distribution. This may give participants fewer options, encourage luxury or unnecessary purchases, and lead to a large tax burden. Plan sponsors may avoid this sort of outcome by adding a variety of distribution options to best suit each individual's financial planning.

## Design consideration: in-plan Roth conversions

One plan design feature that might benefit some employees is to allow for 401(k) designated Roth accounts. Having this feature can further help participants as they contemplate managing their finances going into retirement. Allowing in-plan Roth conversions can be a great benefit for those who are well educated and/or are willing to put in the time to analyze and research the tax effects.

Simply put, a Roth conversion takes previously contributed pretax dollars and converts them to Roth dollars within the participant's qualified plan account. In effect, participants pay taxes on the converted amounts at their current tax rates so that the future distributions are tax-free, unlike 401(k) pretax contributions that are distributed on a tax-deferred basis.

Roth conversions can be beneficial for:

- individuals in a low tax bracket who can take advantage of the tax-free compounding interest;

- individuals who would like to spread out the tax implications over multiple tax years at their current income tax rates rather than face the entire balance as taxable income at retirement and paying those taxes at a higher tax rate;

- an individual who wishes to pass along the retirement savings to beneficiaries and doesn't want them to face tax consequences when the money is distributed; or

- individuals who know they have tax deductions that could offset the tax costs of converting to Roth.

Roth dollars and applicable future earnings will grow tax-free as long as the money remains in the Roth account for five years following the Roth conversion and the participant is age 59½ or older when withdrawing the Roth dollars from the plan.

Roth conversions are absolutely not reversible; if the participant receives an end-of-year bonus and the combination of the bonus and taxable Roth conversion amount bumps him or her into a higher tax bracket, he or she cannot ask to reverse the decision and convert the Roth money back into pretax funds.

## Importance of communications

Does your plan offer additional services and tools to assist participants in their transitions from working to retirement? Typically, employer-sponsored retirement plans offer a wealth of tools and avenues for advice of which most participants are unaware. Make sure your participants know whether the plan offers an investment adviser that can sit down one-on-one with participants, and assist them in determining the appropriate investment makeup for their retirement savings.

Have you hired a third-party service provider or does your recordkeeper offer retirement transition advisers who can assist participants plan their retirement? Do they offer tools that project a current account balance to future monthly income after retirement? These are often underutilized benefits that should be advertised or strongly communicated. Quick access to investment advisers, the plan website or call center number, or a local annuity provider can be essential to those trying to make decisions about their retirement accounts.

The method and timing of retirement plan distributions also can have a giant effect on a participant's taxable income for the year. Plan sponsors may wish to consider referring participants to a tax adviser in some cases. Say a participant has a $50,000 balance in his 401(k), will be age 59½ in two months, and is debating immediate retirement:

- If he terminates and cashes out now, the actual cash that he would receive in hand is $50,000 less 20% federal withholding, an additional 10% early withdrawal penalty, and a tax "true-up" at the end of the year when he files his taxes.

- If he waits until he's 59½, the 10% early withdrawal penalty would not apply.

- If he cashes out now and then decides to roll the money into an IRA or qualified plan within 60 days, he is responsible for paying back the 20% tax withheld out-of-pocket or it becomes taxable income for the year.

- If he opts for a direct rollover, no tax withholding or penalty would apply.

There are far too many situations and variables that can affect the taxability of a participant's account. Rather than place yourself in a position of liability, do not give tax advice to participants and instead refer them to an accountant or other tax expert who can assess the situation and is certified to give advice.

### Is your plan helping?

From healthcare to monthly income to maintaining a certain lifestyle, retirement decisions put pressure on participants to make a quick selection. Every month, more than a quarter-million Americans turn 65 and by 2030, the over-65 crowd will reach 20% of the population. Are you helping your employees in their retirement planning and in making educated decisions regarding their retirement nest egg? Designing the plan with effective savings options, quality post-retirement distribution options, and appropriate education during a participant's active employment years may be the three key pieces for a plan sponsor to successfully ease employees into a comfortable retirement.

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# Helping 401(k) plan participants calculate withdrawal rates in retirement

**Matt Kaufman**

In the spring of 2007 I took my son to watch his grandfather play in a charity golf tournament. While at the tournament we ran into a family friend. He was in his late 50s and had just retired from 30 years of work in the bond markets. His children were grown and he had accumulated enough wealth in his 401(k) plan to retire comfortably with his wife. He even started a small business selling coffee beans. The coffee beans made great coffee, but the heart of the business was even better. This friend employed former convicts to grind and package the company's coffee beans, in an effort to help each convict successfully reenter society–a noble cause.

Three years later, in 2010, while on a morning commuter train into the city I noticed the same friend sitting a few rows ahead of me. I saw him on the train the next day too, and again the next. After inquiring, he informed me that the global financial crisis had wiped out approximately 50% of his retirement savings, forcing him to sell the coffee bean business and reenter the workforce.

Like many investors, this friend (a typical conservative investor) was exposed to more market risk than he thought he was, and his withdrawal rate could not sustain a severe sustained downturn in the market. Many readers know of similar stories, some of which hit close to home.

Out of these narratives, however, comes an opportunity for plan sponsors, who are poised to help retiring participants provide for themselves when they no longer work. One way plan sponsors can tackle this retirement income challenge is by providing intelligent, reliable withdrawal-rate calculation models that lay out threats that may disrupt the sustainability of a retired participant's portfolio. Current withdrawal-rate calculations often fail to accurately account for two major risk factors facing retirees: the impact of adverse market environments and the toxic combination of portfolio withdrawals and broad market declines.

### Implications of informed decisions

Of course, the bulk of a plan sponsor's work is to be done at the accumulation level: setting plan guidelines, establishing appropriate asset allocation techniques, determining investment options, etc. But once the participant has accumulated enough wealth to retire, it's clear that more work can be done to empower retiring employees in making informed decisions regarding their 401(k) plan withdrawal rates.

Such an effort by plan sponsors could give participants greater certainty in determining an appropriate withdrawal rate, reducing risk of portfolio depletion, and potentially creating longer 401(k) portfolio lives (for those planning to a high probability that they will not outlive their savings). Plan sponsors may benefit from efficient, continuous communication with plan participants across all stages of planning (accumulation and decumulation), increased participation, better intelligence regarding plan drawdowns, and ultimately "stickier" plan assets.

### Traditional withdrawal-rate models

Traditionally, moving assets from equities to fixed income has been the modus for plan participants in retirement. The purpose is twofold: to generate income and to manage risk.

In the 1980s and 1990s, this approach was generally successful. Yields on fixed-income assets were attractive relative to the risk levels that accompanied them. Today, however, relatively low yields, higher taxes, and market volatility have made generating income without taking on too much risk difficult for many withdrawing plan participants.

Along these lines, the traditional approach to calculating a portfolio withdrawal rate has relied heavily on allocations to fixed-income assets. This approach was popularized in 1994 by William P. Bengen in his paper, "Determining Withdrawal Rates Using Historical Data." Bengen analyzed over 75 years of market returns and found that if retirees had invested their retirement savings in 50% stocks and 50% bonds and withdrew no more than 4% of their initial account value per year (adjusted for inflation), they had a high probability that their money would last 30 years or longer. Not surprisingly, the probability decreased as the withdrawal rate increased. For example, a 5% portfolio withdrawal rate achieved success (30 years or longer) only 70% of the time.

To summarize, the traditional approach to calculating a withdrawal rate is derived by setting an asset allocation mix (e.g., 50% stocks/50% bonds), along with a withdrawal rate assumption (e.g., 4% annually), and then testing the assumptions along various paths of a single historical return stream (i.e., market returns). However, this approach does not accurately account for adverse market environments or the sequence-of-returns effect.

## A sustainable withdrawal-rate model for plan participants

To properly address the threats facing a retired participant's 401(k) assets, a plan sponsor may employ a more mathematical approach to help a participant calculate a sustainable withdrawal rate that can be achieved with a high degree of success. From here on out, this approach is referred to as the "sustainable withdrawal rate model" (SWM).

Rather than setting a withdrawal rate and testing it for success, the SWM is rooted in a retiree's confidence level. In other words, how certain would a retiree like to be that he or she will not run out of money in retirement? For retired participants, this certainty is likely very high. In the traditional approach, the *withdrawal rate* is the assumption that is tested for validity. In the SWM approach, the *confidence level* is the assumption and the withdrawal rate is the calculated outcome. In this analysis, planning to a confidence level helps generate an accurate withdrawal rate that also aligns with a participant's expectations.

The ability to model long-term average returns of a portfolio and account for short-term market variations (such as adverse market events and the impact of portfolio withdrawals) gives plan sponsors and plan participants greater insight into how these factors interact with each other, and therefore, greater control and confidence over the output.

## Calculating a sustainable withdrawal rate

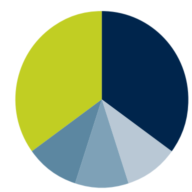
This section delves into the manufacturing of a sustainable withdrawal rate for participants. Plan sponsors may elect to tackle these types of methodologies themselves or refer to a consultant or third-party administrator for assistance in bringing these types of tools to the plan.

To illustrate the SWM, let's use the example of a 65-year-old male participant who has just entered retirement. He looks to his plan sponsor to help him calculate a sustainable withdrawal rate from his retirement savings. The results of this process are illustrated in Figure 1. (A link to the full paper, including a reference table that includes profile inputs, probabilities, capital markets assumptions, and other assumptions, is available at http://us.milliman.com/uploadedfiles/insight/2014/frm-the-six-percent-rule.pdf.)

**FIGURE 1: 65/35 ASSET ALLOCATION ANALYSIS**

Stochastic Analysis: 65-year-old male, moderate high confidence, adjusted for inflation

| Asset Class | Weight |
|---|---|
| U.S. Large-Cap Equity | 35% |
| U.S. Small-/Mid-Cap Equity | 10% |
| Developed International Equities | 10% |
| Emerging Market Equities | 10% |
| U.S. Bonds | 35% |



### Results

| | |
|---|---|
| Sustainable Withdrawal Rate | 4.1% |
| Probability of Success | 94% |

### Sustainable Withdrawal Rate Breakdown

| | |
|---|---|
| Average Compounded Annual Growth Rate | 7.8% |
| Impact of Adverse Market Environments | -3.4% |
| Sequence-of-Returns Effect | -1.4% |
| Return for Planning Purposes | 3.0% |
| Planning Horizon | 27 years |

Source: Milliman Financial Risk Management LLC, 2015.

### Step 1: Identify the retiree's confidence level

The development of the retiree's sustainable withdrawal rate is anchored in his confidence level. In other words, how confident does the retiree want to be that his portfolio will last the length of his planned horizon? This approach is well aligned with the traditional financial planning model in which a financial advisor works with individual clients to identify their specific risk tolerance levels. A retired participant's risk tolerance level may easily be translated into a confidence level for withdrawal purposes. For example, a retiree with a conservative risk tolerance would likely maintain a high confidence level for withdrawal purposes (e.g., 96% to 99% probability). "Success" is defined as the ability to take portfolio withdrawals throughout the planned horizon without depleting the portfolio's value.

### Step 2: Set the asset allocation

Once the participant's confidence level is established, the next step is to set the portfolio asset allocation to align with the retiree's confidence level. For illustration purposes, the portfolio of this moderately conservative retiree is diversified 65% among equities and 35% fixed income.

### Step 3: Calculate the return for planning purposes

Once the appropriate portfolio asset allocation is established, the inputs are in place to calculate a return for retirement planning purposes. This is the average compounded annual growth rate, less the impact of adverse market environments, less the sequence-of-returns effect.

- *Average compounded annual growth rate*: From the stochastic analysis, SWM derives the average compounded annual growth rate of the portfolio—the average year-over-year growth rate over a specified period of time. In Figure 1, this value is 7.8%. However, participants may not simply use this return for planning purposes, because adverse market environments will likely affect their ability to consistently withdraw 7.8% each year.

- *Account for the impact of adverse market environments*: Providing sustainability in retirement means planning for an adverse-case scenario (i.e., the "black swan," or "tail risk" event). During these adverse market events, asset classes tend to become highly correlated and decline together. These events are often overlooked in traditional approaches and can be devastating to a retirement savings portfolio. SWM accounts for the negative impact of adverse market environments by measuring the standard deviation of the cumulative returns over the planning horizon, annualizing it, and scaling it up by a factor associated with the confidence level (moderate, moderate high, or high). In Figure 1, this means reducing the average compounded annual growth rate by 3.4%.

- *Account for the sequence-of-returns effect*: This metric accounts for the additional impact of portfolio withdrawals on wealth accumulation. For retirees, market downturns combine with portfolio withdrawals in a toxic way, especially if those declines come near the beginning of one's retirement years.

  To account for this, the difference between the internal rate of return (IRR) over the planning horizon with and without withdrawals is calculated for each stochastic scenario. The average IRR over a subset of the worst-case scenarios is then used to generate the sequence-of-returns impact. This subset (also known as the "conditional tail expectation") is selected based on the predetermined confidence level of the retiree. For the retiree with a moderately high confidence level, the average of the worst 50% of scenarios from the stochastic analysis is used. In Figure 1, this means a further reduction of the average compounded annual growth rate of -1.4% (to 3.0%).

### Step 4: Determine the planning horizon

Once the return for planning purposes is calculated, the planning horizon—that is, the time over which the participants have to take withdrawals—must be identified. Generally, the greater the confidence level, the longer the planning horizon.

For each confidence level, the SWM calculates an estimated death probability specified at the end of the planning horizon. This approach attaches a confidence level, or probability, that the retiree will be deceased upon the completion of his planned horizon. Using the retiree's current age and a mortality table, the SWM can derive the age at which the death probability matches that of the retiree's confidence level. The planning horizon is then calculated via the difference between the retiree's current age and the age of probable death (which varies depending on the confidence level of the retiree).

For this 65-year-old male with a moderately high confidence level, SWM figures there is an 80% chance he will have died by the end of his planning horizon (27 years, or age 92).

### Step 5: Calculate the sustainable withdrawal rate

Once the planning horizon has been determined, SWM calculates the withdrawal rate through a simple drawdown over the planning horizon, assuming an annual return for planning purposes of 3.0%, adjusted for inflation.

To recap, the resulting sustainable withdrawal rate in Figure 1 is 4.1%, with a 94% probability of success. The 4.1% withdrawal rate is taken in the first year of retirement. This figure (as a dollar amount) is then increased in subsequent years, assuming a 2.5% annual inflation rate. Note that this figure begins at age 65, when the required minimum annual distribution from many types of retirement accounts is zero. The 4.1% rate is higher than the required minimum distribution mandated by law (i.e., age 70½ for most participants), which equates to about 3.6% (for a 70½-year-old male, with an estimated rate of return of 4%, an account balance of $500,000, and the age 65 spouse as a sole beneficiary). One other point to note is that federal tax implications must be taken into account when withdrawing from tax-deferred retirement plans.

## Other key related issues

Plan sponsors also may provide solutions to help participants increase their withdrawal rates by not only accounting for risks facing retirees, but also seeking to address them head-on. Two possible options are discussed below.

- *Managed risk equities*: In an effort to address market risk and generate growth, many investors have turned to the "managed risk equities," which are an asset class that combines equities with a risk management overlay that seeks to stabilize portfolio volatility and reduce downside risk over the long term. Prior to 2008, this type of risk management was generally available only at the institutional level; today, the managed risk equities asset class can be accessed through various investment vehicles (e.g., mutual funds, exchange-traded funds, collective investment trusts, target-date funds, variable annuities). By considering managed risk equities, a plan sponsor could help retirees potentially reduce their overall exposure to fixed income assets and participate in the growth potential of stocks to a greater degree.

Managed risk equities also may allow for increased investments in stocks, thereby providing a reasonable approach to account for the erosion of real purchasing power that is due to inflation. Because equities share a positive correlation to inflation over time, moving into managed risk equities may provide more natural protection against inflation than a static adjustment. By relying on managed risk equities to manage market risk and generate income, the retiree may gain a degree of insulation against adverse changes in interest rates, as well as the opportunity to generate a more sustainable retirement income than under other approaches.

- *Deferred income annuity (DIA)*: To overcome longevity risk (that is, the uncertainty of a person's potentially long lifespan), plan sponsors could consider DIAs, an insurance product that provides lifetime income payments, beginning (or deferred) 13 months to 50 years from the purchase date. Income payments may be designated for the lifetime of the annuitant and the policy has no traditional cash value.

  DIAs became available in 2014, when the Departments of Treasury and Labor allowed 401(k) participants to use the lesser of $125,000 or 25% of their account balances to purchase them. The amounts used for DIAs are not taken into account for the age-70½ minimum distribution requirements. For example, a 65-year-old plan participant may use a portion of his or her 401(k) savings to purchase a DIA that will replace the income stream (e.g., 5% of the participant's plan assets) at a given point in the future, say age 80. By doing this, the retiree has created a defined planning horizon (15 years–age 65 to 80), and thus eliminated longevity risk. Beginning at age 80, the income payments from the DIA will replace the income payments from the retiree's portfolio.

## Can your plan participants weather the storm?

For several decades, plan sponsors have been offering tried-and-true advice: "stay invested in the market; continue saving and investing in your portfolio through all market conditions; when the market goes down, ride out the storm–eventually growth will return and the damage to your portfolio will be repaired." This advice may have been correct when participants were contributing to their portfolios. However, this approach simply may not work for participants who are currently in or nearing retirement. When a participant must use a portfolio to meet current income needs, riding out the storm may not always be possible.

Plan sponsors have a tremendous opportunity to serve retiring 401(k) participants by providing them with intelligent tools to help them safely provide for themselves when they no longer work, and solutions that seek to address major risks faced by this group.

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