Evaluation Scorecard for Retirement Income Products

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Over the last several years, there has been a great deal of innovation in the retirement industry. One of the most meaningful changes has been an evolution to thinking about retirement savings in terms of the amount of lifetime income that can be sustained by a given participant's accumulation, rather than the lump-sum amount that can be withdrawn at retirement. Many in the industry have proposed investment solutions to help participants convert their savings into lifetime income.

The benefits of lifetime income strategies are clear. They generally try to eliminate the risk of a participant outliving his/her savings and they protect against diminished benefits associated with a market downturn. They do so, however, with a cost and with restrictions.

We believe that these lifetime income strategies represent a true enhancement to participant-directed retirement plans. However, they must be adopted and monitored by plan sponsors subject to the rigorous demands of the Employee Retirement Income Security Act (ERISA). ERISA charges plan sponsors with selecting and monitoring investment options using a prudent process that would be employed by an expert in the field. While there is a large body of knowledge that has been developed regarding selecting and monitoring traditional investment options within participant directed retirement plans, the new lifetime income options don't easily fit within existing frameworks.

The purpose of this paper is to propose a set of metrics that plan sponsors and their consultants can use in assessing the suitability of a retirement income strategy as an investment option within a participant directed retirement plan. Given our experience as consultants and co-fiduciaries in this field, we believe that following this framework would meet ERISA's procedural due diligence requirements.

We recognize that there are a wide range of retirement income solutions available on the market. They include a broad array of insurance-oriented solutions (e.g., fixed annuities, guaranteed monthly withdrawal benefit, or GMWB, annuities, and guaranteed monthly income benefit, or GMIB, annuities) and non-insurance solutions (e.g. managed payout funds and multi-asset payout funds). It would be beyond the scope of this paper to address the idiosyncrasies of each specific strategy, so instead, we will focus on the major criteria that we believe should be evaluated, regardless of the solution type.

We believe there are five major criteria that must be evaluated and “scored” to document the plan sponsor has followed a “prudent process” in selecting and monitoring a retirement income strategy. These criteria include:

- Efficacy of the underlying investment process
- Nature of the lifetime income guarantee
- Counterparty strength (in the case of an insured product)
- Cost of product (including both investment management and insurance)
- Operational flexibility (at both sponsor and participant levels)

We recommend that each of these criteria be scored on a 1–5 scale (low–high) and that the scores be combined by computing the average, which would represent a composite score that would range between one and five. In order to appropriately score a strategy, a plan sponsor or consultant would need to have a good understanding of the entire universe of available options, as the score would be relative to other available strategies. A score of three would be denoted as satisfactory, with scores of one or two being deemed below par and scores of four or five being above par. A composite score of three or above would place the strategy in good standing, while scores below three would place the strategy on a watch list.

Efficacy of the Underlying Investment Process

With any retirement income product, a participant’s account growth will be a function of the success of the underlying investments. While more critical in products where the participant takes on the investment risk (subject to a guarantee), the astute plan sponsor will want to understand how well the underlying investments have fared relative to an appropriate benchmark. Also important in this category is how much flexibility a participant is given in selecting the risk profile of his/her underlying investments. Higher scores would be reserved for strategies that provide flexibility to invest in seasoned investment strategies that have demonstrated strong quantitative and qualitative standards over substantial time periods and which give the participant the ability to calibrate his/her risk profile and—if desired—take on significant equity risk.

Nature of the Lifetime Income Guarantee

The objective in selecting a lifetime income guarantee strategy for a participant investment menu is to offer the participant an income stream that s/he cannot outlive. That said, there are many variations in how this guarantee is manifested. At the less attractive end are managed payout funds where there is no actual guarantee. At the other end are GMWB strategies with annual step-ups, and even annual guaranteed increases. A popular in-between choice is a deferred annuity which kicks in at age 80 or 85, so that there is a known length of time over which a participant's retirement savings must extend. Higher scores here go to strategies that provide higher lifetime incomes for a given amount of savings and to higher comfort levels for investors.

Counterparty Strength (for insured products)

Currently available products may have either one or multiple insurers backing the guarantee (or selling annuity segments). In cases where multiple insurers are involved, they are not joint and severally liable, meaning each insurer is responsible only for its own segment of the guarantee, but not responsible for backing other insurers' segments if they default. The insurance industry has an extremely sophisticated support system in place. In the event of insurer insolvency, the state of domicile steps up and takes control of the organization and handles the payout of liabilities. The state guarantee association structure has a strong track record but an insurance company failure and a subsequent state takeover still represent a risk with this type of product. As a large proportion of an investor's wealth, frozen retirement assets can be almost as devastating financially as a loss of assets. There is also some question as to what exactly would be recompensed in the event of insurance company insolvency. If a withdrawal rate was guaranteed, would an investor receive the stepped-up account value minus withdrawals, or the actuarial equivalent based on interest rates of the day? Variable annuities and other such products with market-related components have helped in setting some of the precedent, but counterparty failure risks still remain. In addition to default risk, an at-risk insurance company will raise the cost of offering the benefit. We recommend that satisfactory ratings be reserved for counterparties that maintain ratings in the top third of financial strength rankings. For instance, from a rating agency with a range of 21 scores, the insurer should stay within the top seven. Of course, products with multiple insurers will score higher in this criterion provided each insurer has sufficiently high ratings.

Cost of Product

Expenses are a critical component in the evaluation process, since insurance and management fees have a direct impact on performance. The investment management portion of the fee should not exceed typical expense ratios for similar risk asset allocation strategies outside of the retirement income guarantee products arena. Passive and active strategies should be compared to appropriate peers.

The second consideration with regard to expenses is the cost of the guarantee when dealing with insured products. Both current and maximum expenses need to be compared to products with a similar type of guarantee, and the cost must be commensurate with the value. For instance, more than one product offers a guaranteed withdrawal benefit of 5%, with an annual ratchet, and the beneficiaries receive the full account value remaining at death. These products should be priced similarly. If another product has the same withdrawal benefit and annual ratchet, but requires that the participant annuitize, meaning that remaining assets are not passed to beneficiaries, it should be less expensive. A product with similar features, but which also includes a guaranteed 3% annual increase in the account value, has a justification for charging participants a higher fee for the additional inflation protection during retirement. As a guide, the average current benefit cost of the products included in our research is 80 basis points, with a range from 50 to 100 basis points. Don’t overlook the importance of comparing the maximum cost of the benefit to competitors. In an extreme down market, when a large proportion of plan participants are “in the money,” meaning that the guarantee has been triggered and benefit bases are larger than account market values, it’s not unlikely that the insurer will push the cost of the benefit to the maximum allowable level.

A final comment is warranted on fixed annuities that don’t disclose an explicit expense for the guarantee, or for any product that is designed with an expense structure that differs from competitors. In cases such as these, it may be more appropriate to evaluate the dollar amount of retirement income offered for comparably-sized accounts when the account market value is the same as the benefit base. Actual retirement income can be viewed as the 'net performance' of these products, and while performance is driven by other factors besides expenses, comparing the bottom line can be effective.

Operational Flexibility

With regard to portability, two scenarios must be considered. First, if a participant departs the plan, there should be an available vehicle for retaining the product's guarantee. Most insurers offer a rollover product where the guaranteed benefit base is carried over to the new product. The availability of such a rollover product will significantly enhance product acceptance among participants.

The plan sponsor must also consider its ability to relocate to an alternate platform if it becomes dissatisfied with the current recordkeeper. Many of these products are offered exclusively on the insurer's platform, with no intention to expand availability. Some insurers are partnering with external recordkeepers and designing an exclusive offering for each platform. Only a small number of these product issuers are actively pursuing widespread platform availability.

A plan sponsor has a fiduciary responsibility to evaluate its recordkeeper based on service, cost, and investment option availability. If it becomes necessary, the plan sponsor may be forced to move the plan to an alternate platform which doesn't offer the same, or possibly any, retirement income guarantee products. There is a risk that participants could lose the guarantee in this scenario. Although the sponsor has the ability to make this decision if the transition is in the best interest of the majority of the plan participants, this is not an appealing alternative. For these reasons, product flexibility and portability are critical components of a scorecard. A product issuer who is working toward increasing platform availability would score higher in this criterion. One of the newer products is designed to send x% to an annuity carrier over a ten year period while the remainder stays in a diversified unitized portfolio which can be liquidated at any time. Since the annuitized portion of the investment is locked in, and the remainder can be re-invested in any way, this product would score well in operational flexibility.

Conclusion

Retirement income strategies are the most recent innovation to hit the participant directed retirement industry. Just a few years ago, target-date funds were new and untested. Plan sponsors and their consultants needed to develop a framework for evaluating these new strategies. The same creativity must be now be applied to these new products. In this paper, we have attempted to outline the criteria that we believe should be evaluated and offered some guidelines on how the evaluation should be conducted. We recognize that this new frontier is a work in progress and look forward to comments by other practitioners regarding this developing field.

Sample Evaluation Scorecard	Score from 1–5 (1=lowest/5=best)
Efficacy of the Underlying Investment Process	
Does the product include an element of professional investment management, or do the assets remain participant-directed?	
If professionally managed, are the options well diversified portfolios with experienced management, ample resources and access to high quality research, low cost, and with a good track record of risk-adjusted performance?	
Are the participants able (through managed or self-directed accounts) to take an acceptable level of market risk to maximize the benefit of the guarantee?	
Nature of the Lifetime Income Guarantee	
Does the product offer a guarantee?	
What is the value of the guarantee relative to competing offerings?	
Counterparty Strength	
Does the product have a single insurer or multiple insurers backing the guarantee?	
Does the insurer (or insurers) have a financial strength rating in the top third of the range of possible ratings?	
Cost of Product (including both investment management and insurance)	
Are the investment management fees for the underlying diversified investment options less than 100 basis points, and equal to or less than the average for similar strategies?	
Is the cost of the retirement income guarantee commensurate with its value relative to competing offerings?	
Is the maximum guaranteed cost of the insurance benefit acceptable?	
Operational Flexibility (including both sponsor and participant levels)	
Does the insurer offer a rollover product in the event of a participant departure?	
Is the product available on multiple platforms and does the plan sponsor have the ability to migrate the plan to a different platform?	

Scoring	
Add up all scores and divide the total by 12.	
3-5: This product has an acceptable overall score and compares favorably to competitors. However, even one low score may indicate that the product is not suitable for your plan.	**1-2:** This product is not meeting its objective of providing an avenue of retirement income to your plan participants. A broader survey of available products in the marketplace may be necessary.

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