A better target date strategy with lifetime income

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Target date funds (TDFs) have become the preferred default investment strategy for defined contribution (DC) plans due to a combination of regulatory changes and product features. While the target date structure offers sound accumulation investment advantages, it was not designed to deliver sustainable retirement income because it has not historically been able to provide a lifetime income solution—until now.

A newer approach has the potential to lead the market by incorporating lifetime income options within the target date structure. This concept embraces TDFs and custom model portfolios (including those in managed accounts), as both leverage the same investment concepts to shift the asset allocation as participants reach retirement. Retirement outcome modeling illustrates the improvement to both risk and return compared to typical target date designs that don't include lifetime income protection.

The time is right to consider a new approach

The SECURE Act spotlights the fact that increased participant access to lifetime income within their DC plans is a matter of public policy. This clear mandate should encourage plan sponsors to adopt the newest generation of target date structures that offers participants guaranteed lifetime income by including an annuity within the target date design. The annuities available within TDFs offer liquidity and flexibility to allow participants to change their strategies and make a decision at retirement how they want to receive income.

A brief history of the evolution of TDFs provides context for the need for this approach and demonstrates how the industry can expand beyond the concentrated focus of current TDF strategies:

First generation: offering investors the convenience of putting their investing activities on autopilot in one vehicle for a predetermined timeframe. The original TDFs, most familiar to plans and participants, simplify accumulation. An investment adviser manages them, freeing participants from the burden of overseeing their portfolios and providing broad portfolio diversification. A fund's glidepath becomes more conservative as participants get closer to retirement, using periodic rebalancing to keep participants on target based upon participant age cohort.

Second generation: allowing for more customization. The next step in target date design strategies that is now gaining traction incorporates customization of the target date structure. The ability to customize offers the latitude to adjust key factors—such as asset allocation, fund offerings and glidepath—to better align the target date strategy with the specific needs of a plan and its participants. Many managed accounts today offer powerful tools for customization of the target date structure and guidance to help participants.

Generation Now: emphasizing retirement outcomes. The latest development moves beyond the traditional accumulation-centric approach to incorporate the opportunity for retirement income. Any annuity used within a default strategy must offer liquidity before retirement and the choice for income at retirement. Expanding the mandate of the target date strategy to include lifetime income provides a holistic solution for participants that improves retirement security and builds confidence. Furthermore, adding lifetime income to a customized solution does so while providing access to multiple asset managers and investments, flexibility in glidepath construction, and the ability for the plan to amend the strategy as needed.

An approach with many advantages

- Introducing annuities earlier reinforces the idea that retirement planning is more than accumulating wealth—it's also about creating lifetime retirement income.
- Plan sponsors and advisors may do a better overall job of selecting the right annuity strategies compared to individual participants.
- Participants can benefit from institutional design and pricing for in-plan annuities that builds future lifetime income while protecting savings—rather than waiting until retirement.
- Full liquidity in the annuity component gives each participant the option, *but not the obligation*, to retire with lifetime income.

Lifetime income can improve outcomes—before and during retirement

Lifetime income solutions within plans can take different forms based on the type of annuity and the structure of the guarantee. Our analysis focuses the role of a deferred fixed annuity as a replacement for the fixed income allocation in the target date structure, which is common among in-plan solutions and offers benefits both during accumulation and in retirement.

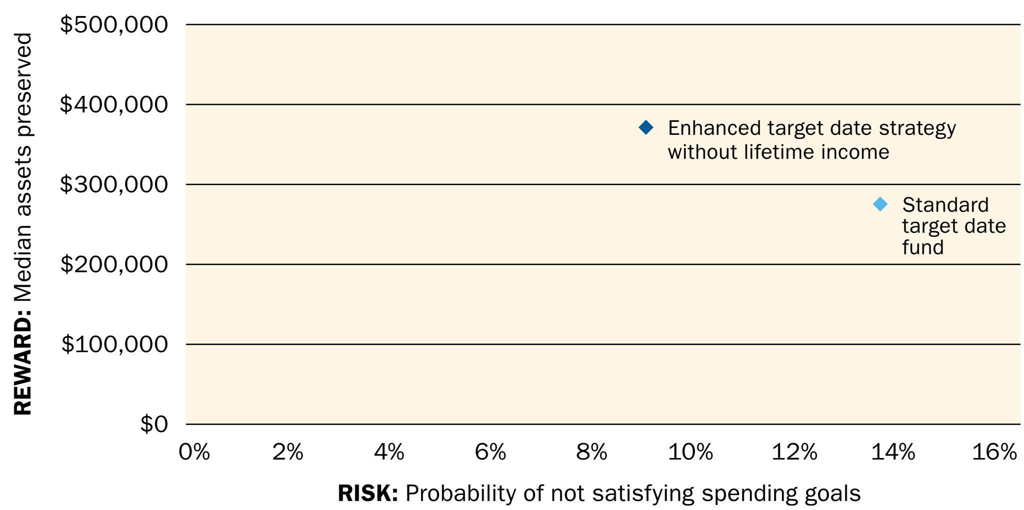
Here, we are able to compare the outcomes of a traditional target date strategy and one that incorporates the deferred fixed annuity. To understand the role of lifetime income within a target date strategy, we evaluate outcomes that represent participants who do not annuitize and those who do.

When participants take withdrawals in retirement

We use independent, third-party capital market assumptions supplied by Morningstar for different asset classes as well as the TIAA Traditional annuity, a flexible premium deferred fixed annuity. The following scenarios are the result of thousands of Monte Carlo simulations run through our financial planning software:

The fixed annuity offers stable investment performance with low volatility and high risk-adjusted returns—compared to bond investments over the long term.[1]

Standard target date fund vs. enhanced target date strategy without lifetime income

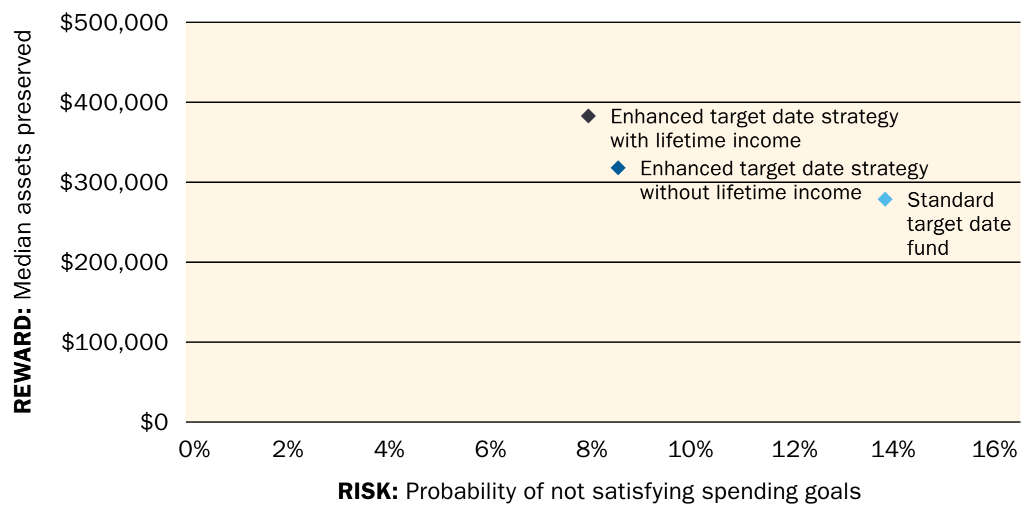


The two strategies are applied to a target date strategy with a typical glidepath that 1) uses traditional investments, and 2) replaces the bond allocations with a liquid flexible premium deferred fixed annuity like the TIAA Traditional annuity. The figure shows that the use of the annuity reasonably stands in the place of the bond allocation.[1] In this scenario, doing so both reduces market risk and increases reward vs. the traditional target date strategy.

When participants take lifetime income in retirement

The next step is to examine whether annuitization will further improve the retirement outcomes for the lifetime income-enabled target date strategy. Using a reasonable assumption for annuity payout rates in the future, the resulting outcomes are shown here.

Standard target date fund vs. enhanced target date strategy



Annuitization can improve risk/reward outcomes: risk is reduced by 41% and reward increased by 34%.

Annuitization improves risk/reward outcomes even more: risk was reduced by 41% and reward increased by 34%. This validates the view that individuals who convert a portion of the wealth inside a target strategy into lifetime income can reduce their risk of running out of money in retirement. Annuitization can also increase assets preserved because the fixed annuity provides a reliable stream of income during both good and bad markets.

These illustrations demonstrate that a target date strategy that includes a deferred fixed annuity can outperform a typical TDF—even when the participant never elects to turn on the lifetime income feature at retirement.

The liquid fixed annuity offers both capital preservation during accumulation and lifetime income during retirement. This structure can help provide even the most unengaged employees with peace of mind and certainty during their retirement years.

The added advantage of customization through a managed account

Plan sponsors may choose to work with an advisor skilled in retirement outcome modeling to build a custom model portfolio that mirrors a target date strategy or use a TDF that incorporates lifetime income as the plan's default investment. Either approach offers the look and feel of a traditional TDF with the added benefit of lifetime retirement income features. With either a managed account-based custom model portfolio or custom TDF, sponsors and advisors can use the investment options already in the plan menu to offer solutions tailored to the plan's demographics. When not available as the default, participants can affirmatively elect to invest in the target date strategy that includes lifetime income through traditional plan enrollment tools or provider-based websites.

Lifetime income in a customized target date strategy can flex to suit the plan

- Multiple glidepaths
- Lower-cost fund choices
- Diversification across fund companies
- A mix of active and passive strategies
- Improved investment stability and lifetime income through an annuity

Fiduciary considerations for a custom solution can include cost, investment control and alignment with plan demographics. The plan sponsor, as fiduciary, can select the investment options to meet the asset allocation requirements on its own or with the counsel of its 3(21) fiduciary advisor. The plan sponsor may also choose to delegate selection to a 3(38) investment manager.

Investment menus with lifetime income options can help improve retirement readiness and deliver better outcomes for both the plan and its participants.

When does a customized solution make sense?

The increasing demands on plan sponsors to design and administer compliant retirement plans is daunting. Constructing investment menus that can provide lifetime income options is a reality with a customized approach. Adopting this strategy enables the retirement industry to enhance and advance the lifetime income imperative while providing tangible value. Plans may be able to reduce costs and simultaneously expand and improve choices available to active participants and retirees. In addition, customization enables participants to choose their own risk tolerance based on their age group. It also provides flexibility to offer more sophisticated paths for some participants and more simplified paths for others.

Retirement outcome is key in any structure

For plan sponsors that prefer an off-the-shelf TDF over customization, there are more options that embed lifetime income. The integration of lifetime income helps improve retirement readiness and can deliver better outcomes for both the plan and its participants. In particular, our analysis supports the inclusion of a liquid, flexible premium deferred fixed annuity that provides the target date structure with stability of returns while participants save for retirement and simultaneously gives participants the option for lifetime income. All of this means that participants have the potential to receive outcomes that exceed those of traditional TDFs, regardless of whether they decide to take guaranteed income at retirement or not.

The continued evolution of target date strategies with annuities broadens the availability of lifetime income vehicles within target date solutions. These advancements make it easier than ever to bring the income promise of a pension to the defined contribution plan and take the next step to modernize a supplemental retirement savings plan to a true retirement income plan.

For more information, contact TIAA.org/contact-tiaa-dcio.

[1] Over the long term, the credited interest rates on TIAA Traditional, a guaranteed annuity, have been similar to long-term average returns of intermediate-term corporate and treasury bonds, with less volatility. TIAA Traditional credited rates include a guaranteed rate stated in the contract, and may include additional amounts which are discretionary. There are other material differences between a guaranteed annuity and a bond.

There can be substantial differences in investment objectives, costs and expenses, liquidity, default risk, guarantees, and fluctuation of principal or return (including the effect of the vintage system on TIAA Traditional returns). The TIAA Traditional guarantee is based upon the claims-paying ability of TIAA, while bonds are typically backed by the credit of the issuer or underlying cash flows from other assets. Treasury bonds are backed by the full faith and credit of the U.S. government. A bond will be more liquid than TIAA Traditional, which, under some TIAA contracts, does not provide any lump sum withdrawal option. TIAA Traditional provides the ability to annuitize and receive guaranteed lifetime income (based upon TIAA's claims-paying ability); bonds don't. There is no assurance that additional amounts above the TIAA Traditional Annuity's guaranteed minimum rate will be declared in the future. Consider differences between investment options to decide which one is suited for your goals.

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The investment returns and principal value of the model portfolios will fluctuate so that the value, when redeemed, may be worth more or less than the original value.

Any annuity guarantees are backed by the claims-paying ability of the issuing company.

A target date fund is a "fund of funds," primarily invested in shares of other mutual funds. The fund's investments are adjusted from more aggressive to more conservative over time as the target retirement date approaches. The principal value of a target date fund isn't guaranteed at any time, including at the target date, and will fluctuate with market changes. The target date represents an approximate date when investors may plan to begin withdrawing from the fund. However, you are not required to withdraw the funds at that target date. After the target date has been reached, some of your money may be merged into a fund with a more stable asset allocation. Also, please note that the target date fund is selected for you based on your projected retirement date (assuming a retirement age of 65). Target date funds share the risks associated with the types of securities held by each of the underlying funds in which they invest. In addition to the fees and expenses associated with the target date funds, there is exposure to the fees and expenses associated with the underlying mutual funds as well.

Please note that no strategy can eliminate or anticipate all market risks and losses can occur.

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