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INVESTMENT COMMENTARY

## Guaranteed Retirement Income Products: Meeting the Fiduciary Challenge

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## Guaranteed Retirement Income Products: MEETING THE FIDUCIARY CHALLENGE



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Since the advent of target date funds, product innovation in the defined contribution industry has focused on retirement income products. Originally designed for non-qualified investors at or near retirement, insurance products such as Variable Annuities with Guaranteed Withdrawal/Minimum Income Benefits (GLWBs/GMIBs), as well as their fixed annuity cousins, have recently been re-engineered as accumulation vehicles suitable for defined contribution investing. While many plan providers either have adopted or are considering such products, adoption rates by sponsors have been stymied by their relative complexity and the resulting fiduciary uncertainty.

This article outlines the fiduciary challenges associated with Guaranteed Retirement Income (GRI) products, and a proposed framework by which they may be evaluated to help plan sponsors meet the ERISA standard when selecting annuity products.<sup>1</sup>

### Benefits and Costs of Guaranteed Retirement Income Products

GRI products provide a number of compelling benefits for investors. They can help bridge the gap between income needs and traditional sources such as Social Security, and thereby increase the likelihood of meeting overall retirement goals. When used in-plan, some GRI products can also protect retirement account balances near and during retirement. These benefits come with both direct and indirect costs. Fees are associated with the guarantees, and there can be penalties for excess withdrawals. Guaranteed income may imply a lower than desired income level, which can be considered an opportunity cost for not investing in more flexible alternatives. For some products, investors may need to exchange a portion of retirement savings for the promise of future income. This loss of control can be an opportunity cost

significant enough for some investors to eschew any product requiring immediate annuitization. Assessing the balance between the benefits and costs of GRI products is a crucial aspect of the fiduciary challenge addressed below.

### New Dimensions of Retirement Income Planning

Investment planning for accumulation depends on familiar factors such as investor age, retirement horizon, and traditional tolerance for risk. To understand how GRI products fit into an overall portfolio, several additional factors need to be considered: withdrawal rate, longevity expectations, bequest goal, and “income risk tolerance”. We define “income risk tolerance” as a direct measure of the appetite for guarantees, because the desire for/concern about stable income in retirement is not necessarily commensurate with traditional risk tolerance. Table 1 illustrates the impact of each dimension on the allocation to GRI products in an overall portfolio.

Table 1. Dimensions of Retirement Income Planning and Product Allocation

Dimension	Value	Relative Allocation to GRI Products
Withdrawal Rate	Low High	Higher Lower
Longevity Expectations	Above Average Below Average	Higher Lower
Bequest Goal	Low High	Higher Lower
Income Risk Tolerance	Above Average Below Average	Lower Higher

<sup>1</sup> While some manufacturers have carefully designed their products to avoid technical classification as annuities, we assume that plan sponsors will want to meet ERISA fiduciary standards in any case.

The dependence of product allocation on these new dimensions indicates that the balance between the costs and benefits of GRI products should be considered for a range of investor types, rather than for an “average investor”.

### Fiduciary Analysis: Applying Conventional Due Diligence Methods

The ERISA standard for selection of annuity providers, which is set forth in DOL Regulation Section 2550.404a-4 and applies to selection for an “individual account plan” (e.g., a 401(k) plan), is summarized in Table 2.

Table 2. ERISA provisions for the selection of annuity providers

ERISA Safe Harbor Process for Selecting Annuity Providers
Plan Sponsors satisfy ERISA fiduciary obligations if they:
2. consider competing annuity providers;
3. appropriately consider information sufficient to assess the ability of the annuity provider to make all future payments under the annuity contract;
4. appropriately consider the total cost (including fees and commissions) of the annuity relative to the benefits and administrative services to be provided under the contract;
5. appropriately conclude that the annuity provider is financially able to make all benefit payments under the annuity and the cost of the annuity contract is reasonable in relation to the benefits and services under the contract; and
6. if necessary, consult with appropriate experts to determine if your process complies with this regulation.

The provisions of the ERISA standard that lend themselves to a conventional due diligence process to determine suitability for retirement investing are highlighted in blue. We can generalize the set of questions appropriate for the evaluation of stable value or fixed account products to construct an outline for a GRI product Fiduciary Due Diligence questionnaire (Table 3).

Table 3. Outline for a GRI product due diligence questionnaire

Outline for a GRI Product Due Diligence Questionnaire
A. Questions assessing investment policy and product features for products supported by a General Account
B. Questions assessing investment policy and product features for products not supported by a General Account (e.g. Variable Annuities with GLWB/GMIB riders)
C. Questions assessing business and credit risk of product provider
D. Questions assessing product portability

The first sets of questions (A and B) define two broad classes of GRI products based on the role of an insurance company General Account. Much of the required information should be available through product literature and remain static; the purpose is to summarize key product features in a standard format to facilitate comparison. Other questions

*Assessing the balance between the benefits and costs of GRI products is a crucial aspect of the fiduciary challenge addressed below.*

should track changes in important data over time (e.g. underlying investment characteristics; fees; expense ratios). Significant changes could be fiduciary red flags.

The remaining questions (C and D) apply to all GRI products. In addition to the importance of business and credit risk, we have emphasized product portability; participants should understand whether the cumulative fees paid for guarantees are transferable. While portability touches on it, the assessment of costs versus benefits is a complex issue that requires explicit attention.

Specifically, the provisions of the ERISA standard related to the balance between costs and benefits are highlighted in red in Table 2. The variety of benefits and costs, the new dimensions of retirement income planning, and the complexity of typical GRI products present significant challenges for meeting these provisions.

### Principles for a Quantitative Process to Assess Costs vs. Benefits

To answer the critical question of how plan fiduciaries can assess costs versus benefits for GRI products to meet their ERISA obligations, we first establish a set of principles a fiduciary analysis should respect, and then present a paradigm for a quantitative process compatible with the principles.

#### ▶ Comparability Principle

A fiduciary analysis should demonstrate that products perform well relative to “comparable” strategies constructed from ordinary investments. All costs and benefits can then be assessed relative to a viable alternative.

#### ▶ Universal Process Principle

A fiduciary analysis should be general enough to apply to all current products, be flexible enough to accommodate new products, and avoid bias for or against any type of products.

#### ▶ “At or Near Retirement” Principle

A fiduciary analysis should demonstrate that products perform well at or near retirement. Some products offer age-based incentives for contributions throughout accumulation, but these should not preclude good performance near retirement.

#### ▶ Multiple Scenario Principle

A fiduciary analysis should evaluate products across a range of investor scenarios and aggregate the results into a composite measure.

The proposed fiduciary analysis based on these principles is a two-part process, in which the GRI product is evaluated in isolation (“stand-alone” analysis) and in a portfolio. The related principles are identified for each step in the process.

Guaranteed Retirement Income Products:

## MEETING THE FIDUCIARY CHALLENGE

### Part I: Stand-alone Analysis

- 1. Construct a Benchmark Portfolio of ordinary investments that is “comparable” to the underlying portfolio supporting the guarantees (Comparability).** We define “comparable” based on risk level (the volatility of the underlying portfolio) because risk drives return potential, which in turn determines the income and wealth generating potential of a strategy.
- 2. Use the same Benchmark Portfolio and fee assumptions for all GRI products of similar risk level (Universal Process).** The asset class- and portfolio-level fee assumptions for the Benchmark Portfolio should correspond to those of ordinary investments, independent of the GRI product fees. Examples:
  - For GLWB/GMIB products with a balanced underlying portfolio, use a Moderate accumulation portfolio as the Benchmark Portfolio.
  - For products supported by a General Account, use a Conservative accumulation portfolio as the Benchmark Portfolio.
- 3. Choose the scenario of an Age 60 investor retiring at Age 65 (“At or Near Retirement”).**
- 4. Study the Benchmark Portfolio subject to systematic withdrawals that match a sustainable income stream adjusted for inflation (Universal Process).<sup>2</sup>** As for fee assumptions, the withdrawal strategy should be independent of the GRI product features. The concept of sustainability provides a natural way to narrow the possibilities, and it can be defined based on acceptable levels of downside risk.
 

Example: for a Moderate investor with Average Longevity and Moderate Bequest, study the Benchmark Portfolio under sustainable withdrawals of 3.75% adjusted for 3.0% inflation.
- 5. Study the Benchmark Portfolio for a range of investor Longevity and Bequest levels (Multiple Scenario).** The combination of withdrawals and investor scenario for the Benchmark Portfolio defines a specific Benchmark Strategy that can be fairly compared to the GRI product. Studying multiple scenarios probes a range of performance for different investor types.
- 6. Study the GRI product under the same withdrawal and investor scenarios as the Benchmark Portfolio (Multiple Scenario).** Comparing performance metrics under identical scenarios provides a gauge of both direct and indirect costs relative to product benefits.<sup>3</sup> By varying Longevity and Bequest but not Income Risk Tolerance, we maintain a neutral stance toward GRI products, but also include scenarios (such as Above Average Longevity) in which the GRI products should perform well.

- 7. Aggregate performance metrics across scenarios for composite scoring of the GRI product vs. Benchmark Strategy (Comparability).** For three levels each of Bequest and Longevity, the performance metrics for all the scenarios can be displayed in a nine-box scoring grid for side-by-side comparison. These values can be averaged into a single composite measure of absolute performance.

### Part II: Portfolio Analysis

With all the relevant concepts introduced, Part II of the process involves:

- 1. Repeat steps 1-3 of Part I.**
- 2. Consider a Two-Product Portfolio consisting of the Benchmark Portfolio and the GRI product and optimize (find the allocation to each) subject to systematic withdrawals that match a sustainable income stream adjusted for inflation (Universal Process).**
- 3. Repeat the optimization for a range of investor Longevity and Bequest scenarios (Multiple Scenario).**
- 4. Aggregate optimization results across scenarios for composite scoring of the Two-Product Portfolio vs. Benchmark Strategy (Comparability).**

The allocation to the GRI product in an overall portfolio is the simplest and most direct measure of the balance between costs and benefits – it is an unambiguous gauge of the desirability of the product relative to a comparable portfolio of ordinary investments. The impact of any GRI product redemption costs, which do not enter into Part I, is captured through portfolio rebalancing prior to retirement. We also obtain a nine-box scoring grid of performance metrics and sustainable withdrawal rates that capture the impact of the special GRI product features in a portfolio setting. By comparing these to the results for the Benchmark Portfolio alone, we can answer a fundamental question: *does the presence of the GRI product improve a retirement portfolio?*

### Technical Hurdles and Meeting the Fiduciary Challenge

While the steps of the fiduciary analysis are straightforward, in our work for clients, the Investment Strategies Group of Mesirow Financial found that actually executing the process requires overcoming a number of technical hurdles. Among them is the need to define appropriate performance and downside risk metrics, which are in turn required to determine sustainable withdrawal rates and acceptable two-product portfolio solutions. A new optimization methodology capable of producing two-product portfolios is also needed. Without solutions to these technical hurdles, the process is just a fiduciary wish list. To meet these challenges we developed a quantitative framework to analyze GRI products and offer fiduciary coverage. Efforts by other providers to follow a comparable process and offer GRI product coverage as part of broader fiduciary services are fundamental steps toward increasing GRI product adoption in the defined contribution industry. ■

<sup>2</sup> By “study” we mean characterize using some objective performance metrics, which need to be defined.

<sup>3</sup> Since the income level of GRI products is determined by product design, we need to clarify how they can be studied under the Benchmark Portfolio withdrawal scenarios.