White Paper

TIAA

Reducing Plan Costs while Preserving Retirement Benefits

Savings for Sponsors, Lifetime Income for Participants

Guaranteed income for life

Annuities can provide income that is guaranteed for as long as you live.[1]

Plan contributions are a significant budget item for institutions that offer retirement benefits to employees. So, in our current economic and employment environment, sponsors are looking for ways to lessen the cost of delivering defined contribution (DC) benefits while still keeping participants satisfied.

Some cost-cutting approaches favored by sponsors can be more drastic—and less employee friendly—than others. Satisfying all parties, of course, is ideal.

Traditional approaches to cost saving

Contribution holidays, long-term contribution reductions and plan terminations cut the sponsor's matching costs in the short term or long term or in the case of outright plan termination, forever. Of course, these approaches will negatively impact the financial well-being and morale of employees in escalating degrees.

An innovative solution

There is an innovative way to lower costs for sponsors while simultaneously preserving retirement income for those participants who are auto enrolled by default. This alternative approach uses annuities as a core element in plan default vehicles such as target-date strategies.

Consider the three simplified, hypothetical examples shown in the accompanying graphics. The first strategy uses mutual funds and the latter two include annuities. All three approaches generate the same level of initial retirement income (we assume all have similar investments and those investments have the same net returns), but the cost (matching contributions) of creating these outcomes is substantially lower when using annuities.

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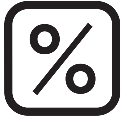


Fixed annuities.

The money that is invested is guaranteed to earn a fixed rate of return for DC plan participants while they're saving for retirement and can be converted to a stream of income when they retire.

Wealth and income at retirement for hypothetical plan default strategies with identical allocations and net asset class returns in accumulation.

Plan Default Strategy #1:

This is a traditional target-date approach commonly used in retirement plans. Here, a plan sponsor contributes $508 per month over 30 years, and that accumulates $1 million by retirement. The participant takes an initial 4% withdrawal from their at-retirement balance–following the 4% "rule of thumb"–and continues along that path through retirement with their withdrawal adjusted annually for inflation while their wealth remains invested.

Plan Default Strategy #1		
Monthly contribution in accumulation:		**$508**
Wealth at retirement:		**$1,000,000**
Bond mutual funds	**40%**	
Stock mutual funds	**60%**	
Bond mutual fund withdrawal:		**4%**
Stock mutual fund withdrawal:		**4%**
Initial retirement income:		**$40,000**

Plan Default Strategy #2 (includes fixed annuity):

Similar in every way to Strategy #1 except that this approach uses a fixed annuity (in accumulation) in place of the bond mutual funds. When that is annuitized in retirement, we can assume a higher pay-out rate of 6% on the annuitized assets.[2] As a result of this higher payout rate, a participant is able to achieve the same overall income amount, but with less reduced contributions from the plan sponsor and a lower account value. In fact; the contribution amount would be only $423 per month, a 16.7% reduction in cost compared to Strategy #1.

Plan Default Strategy #2		
Monthly contribution in accumulation:		**$423**
Contributions vs. Strategy #1	**-16.7%**	
Wealth at retirement		**$833,329**
Fixed annuity	**40%**	
Stock mutual funds	**60%**	
Fixed annuity payout rate:		**6%**
Bond mutual fund withdrawal:		**4%**
Variable annuity payout rate:		**6%**
Stock mutual fund withdrawal:		**4%**
Initial retirement income:		**$40,000**

6%

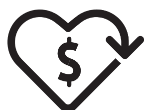
payout

The 6% pay-out example achieves the same retirement income for participants but with less contribution by plan sponsors.

Plan Default Strategy #3 (includes fixed and variable annuities):

This offering is made up of fixed annuities in the fixed-income component (instead of bonds) while the equity component is split between stock mutual funds and equity-oriented variable annuities. We assume a 6% pay-out rate for the fixed annuity and 6% for the variable annuities, if they're annuitized at retirement.[2] That higher, combined pay-out rate means contributions can be reduced to $376, a 25.9% cost savings over Strategy #1 while still delivering the same income amount.

Plan Default Strategy #3		
Monthly contribution in accumulation:		**$376**
Contributions vs. Strategy #1	**-25.9%**	
Wealth at retirement		**$740,741**
Fixed annuity	**40%**	
Equity variable annuities	**30%**	
Stock mutual funds	**30%**	
Fixed annuity payout rate:	**6%**	
Variable annuity payout rate:		**6%**
Stock mutual fund withdrawal:		**4%**
Initial retirement income:		**$40,000**



Managing longevity risk.

An annuity provider pools the life expectancies of potentially millions of annuitants across the annuity pool (the annuity dollars of someone who dies young, for example, fund the income of another annuitant who lives a very long life). As a result, all of the benefits from annuities are paid as income during the life of the participants (or guaranteed periods, if longer).

Retirement savings versus retirement spending

Also in Strategy #1, once in retirement, participants are then tasked with managing the mutual fund assets in their plans. In that example, they take a 4% withdrawal per year for retirement income. However, retirees have no idea how long they will live. So, a healthy financial cushion–or contingency reserve–will need to be incorporated into their planning in case they live much longer than expected. This reserve, if unused, is passed to the estate, which also means the retirees don't use their full retirement income.

So, since employers fund the plans in the first place, in Strategy #1 they are also indirectly funding participants' estates at the expense of participants' income.

That's good for the heirs but can be a source of worry as well as unrealized spending power for retirees who have saved their entire careers to enjoy this time of life.

In fact, the chart below illustrates the magnitude of those potential estates relative to retirement income payouts. Using an analysis of historic data, we can see the sum of the dollars spent on retirement income, on average, is only about one-third of the total wealth accumulated up to and beyond retirement. Or, on a net-present value basis, the retirement income is only slightly more than half of accumulated wealth.

Disposition of accumulated wealth* in retirement following "the 4% rule"**

Historical median results from 65, hypothetical 30-year retirement time periods
Data beginning 1926 through 2019 for 30-year periods beginning 1955 through 2019 for a 50% stock, 50% bond portfolio.
Data Source: Morningstar

	Spent as retirement income	Bequeathed to estate
Actual dollar flows:	**33.7%**	**66.3%**
Net present value of dollar flows discounted at 6%:	**53.8%**	**46.2%**

*Accumulated wealth equals wealth at retirement plus new post-retirement investment gains or losses.

** Spending 4% of at-retirement wealth, adjusted annually for inflation.

In contrast, an annuity-based approach (Strategy #2 or #3) aligns closely with the employer's goal–lowering costs while precisely funding retirement income for life–with the need for a contingency reserve reduced proportionately by the amount annuitized. From a retiree's standpoint, it removes worry of the unknown, simplifies management of funds and maximizes their post-career income. In this scenario, each party's goals are realized.

Conclusion–something old is new again

While these hypothetical strategies may inspire an innovative shift in retirement planning for some, the concepts are actually very time-tested for others. Using annuities within retirement plans is an approach pursued by participants at TIAA for more than 100 years. In fact, the combination of fixed and variable annuities remains one of the most popular investment strategies among our participant base.

For more information about these strategies or how they can be incorporated into the plan's default option, please contact your TIAA representative.

Disclosures

1 All guarantees are subject to the claims-paying ability of the issuing company.

2 The 6% hypothetical payout rate is an approximation based on current payout rates and market conditions. Actual payout rates which are higher or lower payout than 6.0% would impact the amount of assets needed to reach the targeted income illustrated. Variable annuity payments are not guaranteed and can fluctuate with market returns. But, they have the potential to hedge rising costs.

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A variable annuity is an insurance contract and includes underlying investments whose value, similar to a mutual fund, is tied to market performance. When markets are up, you can capture the gains, but you may also experience losses when markets are down. When you retire, you can choose to receive income for life and/or other income options. Example includes the CREF Stock Account.

Annuities are designed for retirement and other long-term goals. They offer several payment options, including lifetime income. When you contribute to an annuity, your money must remain in it until you reach age 59½. If you withdraw earnings before then, you may be subject to a 10% early withdrawal penalty. You may also pay ordinary income tax on other withdrawals from a qualified annuity. Depending on the issuing company, product and available options, the income may be fixed or variable. Guarantees and fixed-income payments are based on the claims-paying ability of the issuer. Variable annuity income varies based on the performance of the sub-accounts. Please note that with variable annuities, your money will be subject to the risks associated with investing in securities, including loss of principal.

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