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Financial Services

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Recipe for Success

Lifetime retirement income is the key ingredient for an effective 401(k) plan

The definition of "success" is constantly changing. Plan sponsors who want to offer successful 401(k) plans need to participate in that evolution ... rather than being anchored to historical measurements.

In the 1990s, 401(k) plans were largely measured by features and funds, the success of the plans often determined by whether they offered brand-name mutual funds and "extras" such as a website, investment education or advice, and/or brokerage accounts.

Beginning in the early 2000s, and continuing to date, success has been based on current results. By "current," I refer to measurements of where a plan stands today. Perhaps the most commonly accepted current yardstick is level of participation. If a plan has high participation, it's a successful plan. Similar thinking applied to deferral rates and participants investing in portfolios of balanced funds, target-date funds, asset allocation models or managed accounts.

We are now evolving into the next generation of success standards. The new measurement will be based on back-end results. Rather than: "What is the plan doing?" the question will be: "What is the plan producing—will it yield adequate benefits for participants to live on in retirement?" Success will be measured not by account balances but retirement income. After all, the need for benefits in retirement is month-to-month and not lump-sum.

How will plan sponsors know if they are evolving to this new standard? The first test will be whether the plan offers gap analysis to its participants. Simply stated, gap analysis tells participants whether they are on course to having adequate retirement income and, if not, what they need to do. To calculate benefit adequacy, a participant would need to perform relatively complicated actuarial calculations. And a participant would need to have information about income replacement ratios, Social Security benefits, life expectancy and probabilities of exceeding life expectancy, and so on. For example, does the typical participant know that one member of a 65-year-old couple has a 25% chance of living at least 30 more years? Probably not.

Participants also need information about sustainable withdrawal rates in retirement. For instance, based on authoritative research, many experts believe that participants should withdraw no more than 4% a year (inflation adjusted) if they want their retirement savings to have at least a 90% probability of lasting for 30 years.

While gap analysis is based on a plan's typical participant, additional website resources could be offered for those wanting to customize their retirement planning. For example, a website calculator could permit a participant to evaluate the impact of deferring retirement to an older age.

The next step is to examine the services and investments the plan provides for retirement income. For example, does the plan include focused investment education for participants aged 55 or older? Does it supply distribution alternatives, such as annuities, retirement income guarantees, accounts that are managed for retirement income or managed payout mutual funds, to support participants in retirement?

My concern is that if participants do not receive those services or investments, they may fail—for two reasons. First, this "decumulation" phase is much more difficult than the accumulation phase; to properly manage and withdraw money to make it last for 25 or 30 years or more is a complex business. Second, retirement plans can get institutional pricing of annuities and mutual funds, but when participants purchase those investments on their own, they undoubtedly will pay retail prices. The differences between institutional and retail rates can be substantial. They can be the difference between success and failure.

These are developing issues. Plan sponsors concerned about successful outcomes for their employees should focus on providing gap analysis, along with the investments and services that support lifetime income in retirement.

Fred Reish is chair, Financial Services ERISA practice, at the law firm of Drinker, Biddle & Reath. A nationally recognized expert in employee benefits law, he has written four books and many articles on ERISA, IRS and DOL audits, and pension plan disputes. Fred has been awarded the Institutional Investor Lifetime Achievement Award and the PLANSPONSOR Lifetime Achievement Award. He is one of the 15 individuals named by *PLANSPONSOR* magazine as Legends of the Retirement Industry, and also one of five individuals acknowledged as Retirement Plan Adviser Legends by *PLANADVISER* magazine.