BLACKROCK®

Decumulation in Defined Contribution

The second act

SEPTEMBER 2017

BLACKROCK **RETIREMENT** INSTITUTE

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EXECUTIVE SUMMARY

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- The soaring number of Baby Boomers entering and approaching retirement is leading to a major shift in focus from accumulation and savings to retirement income.
- Most will want and need assistance to systematically withdraw their retirement assets to create this income – both in terms of managing the investment complexity and embracing behaviors that support retirement income and spending.
- Defined contribution plans are increasingly becoming a logical platform to provide retirement income based on investor familiarity, infrastructure capabilities, and regulatory changes.
- We believe that target date funds – already a popular option – can be an effective in-plan, end-to-end retirement savings and spending solution for many investors.
- Plan sponsors, in close coordination with record-keepers and asset managers, can begin the process towards improving plan flexibility, investment tools and participant education needed to use target date funds as a comprehensive retirement solution.
- BlackRock's leading target date fund – LifePath® – integrates both the retirement savings and retirement spending phases, offering investors a single, familiar, and sophisticated accumulation and decumulation solution in one product.

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INTRODUCTION

DC plans' second act

As a burgeoning number of older Americans shift from retirement saving to retirement spending, the central financial question of "How can I create lasting income in retirement" is gaining urgency.

There are few readily available answers for retirees. Most are uncertain about how to manage their retirement savings and would prefer guidance on how best to receive regular income in retirement.[1] As a result, retirees can be overly conservative, cutting spending and their standard of living or following outdated "rules of thumb" methodologies.

So far, employer-based defined contribution (DC) plans have not been seen as a serious response to this question. Yet, DC plans can deliver on the top reason that plan participants save for retirement[2] – maintaining consistent spending in retirement – while providing a seamless transition from the savings phase.

Extending DC plans as a platform for retirement distributions can address several key issues facing investors and give them greater comfort with a savings system they trust. Just as many DC plans have helped guide employees during their accumulation years, we know that many of them are also unclear on how best to protect their savings as they approach retirement and then which products to use during retirement.[3]

Looking ahead, these concerns will take on greater meaning and complexity. Employees entering retirement in the coming years can expect to live longer, healthier lives, but will do so in an environment characterized by lower investment returns, fewer defined benefit pensions, and a longer period to make those savings last.

From an employer standpoint, plan sponsors can also find business value in promoting better retirement income solutions and DC plan capabilities. Numerous studies show that financial stress can have a debilitating impact on employee productivity and engagement, creating an incentive for employers to help participants plan properly for their retirement goals. Conversely, we see a positive connection between employee health and proper retirement planning behaviors.[4] But much remains to be done to bridge this gap. In one recent study almost 1/3 of employees were somewhat or very stressed about preparing for retirement.[5] This can lead to workers delaying retirement, creating unexpected changes in an employer's overall workforce profile. Lastly, employees who retire and continue to keep their retirement balances within their employer plan contribute to economies of scale helping keep investment fees lower for all participants in the plan.

DC plans, when designed appropriately, are well-positioned to help both investors and plan sponsors capture these benefits and provide straightforward, easy-to-use retirement income solutions. After all, tens of millions of investors have successfully used DC plans to save for retirement. Why not use the same platform to generate retirement income for these same investors? This is the "second act" for DC plans.

1,3,5 https://www.ebri.org/pdf/surveys/rcs/2017/IB.431.Mar17.RCS17..21Mar17.pdf

2 "Inside the minds of 401(k) plans and participants: 2017 BlackRock DC Pulse Survey," BlackRock, 2017, Pg. 34.

4 https://www.aegon.com/siteassets/research/2017-retirement-survey/retirement-readiness-survey-2017.pdf

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The growing focus on retirement distributions

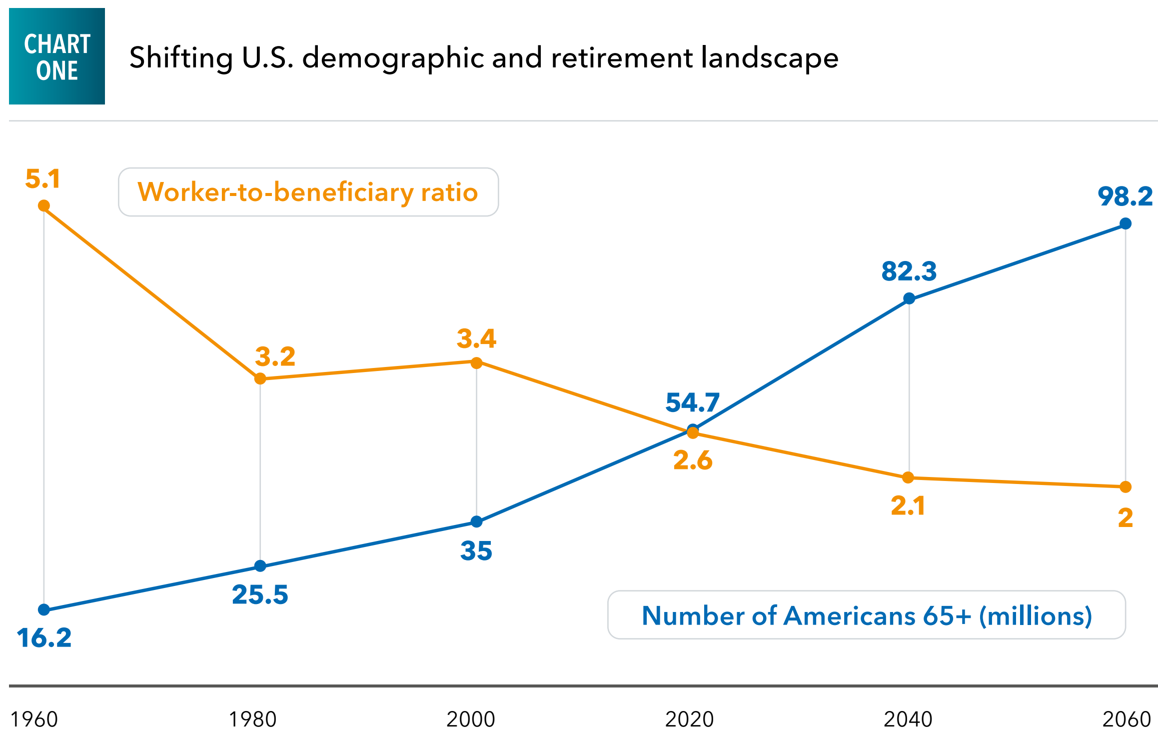
This DC evolution takes place in the wider context of an unprecedented, national demographic shift. The number of Americans over the age of 65 will more than double between 2015 and 2060; from 48 million to 98 million, while the ratio of worker to beneficiary will fall significantly (Chart One).[6]

Most of these individuals have saved and invested during the "401(k) era." In the 38 years since the IRS introduced the 401(k), DC plans have become by far the most common retirement savings platform in the U.S., outpacing traditional pensions with over 77 million participants.[7]

But the 401(k) era is entering a new and expanding phase: the era of retirement income and asset distributions.

Just like the introduction of the 401(k), this shift will transform the retirement landscape.

CHART ONE Shifting U.S. demographic and retirement landscape



Source: Administration on Aging and Social Security Administration reports. See footnote 6 for full citation.

6 A Profile of Older Americans: 2016, Administration on Aging, Administration for Community Learning, and US Department of Health and Human Services, 2016. https://www.acl.gov/sites/default/files/Aging%20and%20Disability%20in%20America/2016-Profile.pdf; Gayle L. Reznik, Dave Shoffner, and David A. Weaver, "Coping with the Demographic Challenge: Fewer Children and Living Longer," Social Security Bulletin, 2006. https://www.ssa.gov/policy/docs/ssb/v66n4/v66n4p37.html; "Social Security History," Social Security Administration, https://www.ssa.gov/history/ratios.html; Social Security worker-to-retiree ratio for 2015 is estimate based on 2013 data.

7 "Private Pension Plan Bulletin Historical Tables and Graphs," U.S. Department of Labor, Employee Benefits Security Administration, September 2015. These figures may double count individuals who have both DB and DC plans. Data exclude one-participant plans.

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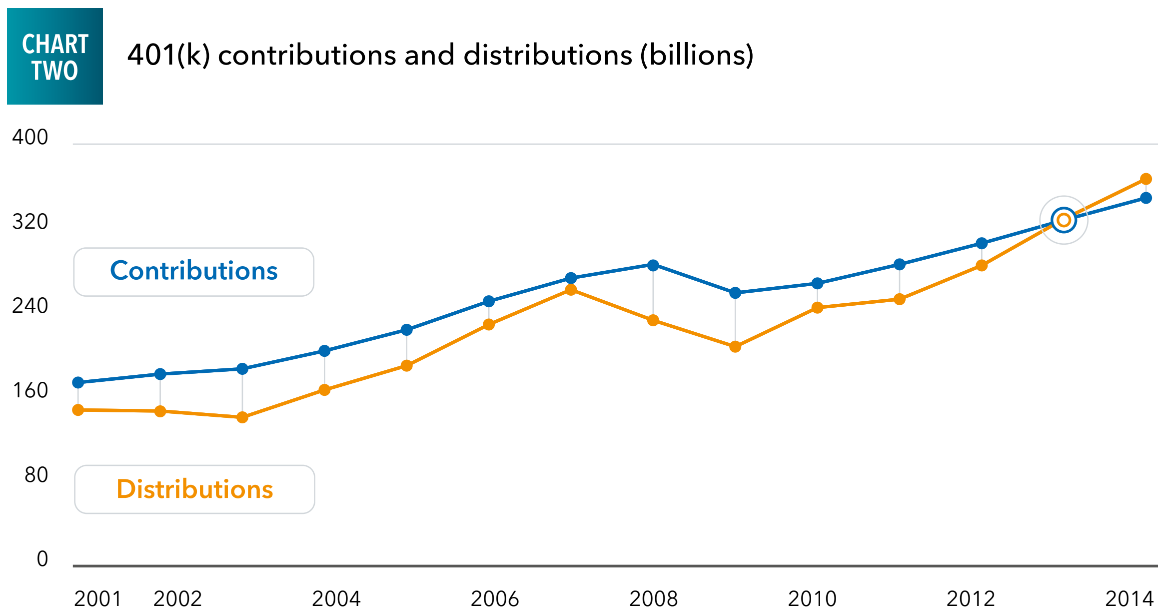
We have already seen a demographic "tipping point" in 2013/2014 with assets leaving 401(k) plans exceeding assets being contributed or entering plans (Chart Two).[8] This trend is expected to remain until 2030, peaking at $40 billion annually in 2019.[9]

This will shift the current focus of DC platforms to include a greater emphasis on retirement distributions, in addition to savings. Traditionally, DC investment menus have focused on accumulation: the phase when people earn, save, and invest during their working years. However, with 10,000 Baby Boomers reaching 65 every day and accelerating,[10] our focus and energies must now be broadened towards decumulation and distributions: the phase when people begin to withdraw their retirement savings.

Investors face a new retirement reality

Most investors and retirees can expect to experience a longer and healthier life, and it should be our goal to make it financially secure, too. They will also face different kinds of spending needs – some desired, such as new small business ventures, travel and leisure on a regular basis; some forced, such as healthcare for oneself, spouses and/or elderly parents who themselves have not saved enough. To do so, investors desire solutions that can convert their assets into steady, regular retirement income. These solutions should help retirees negotiate a future where key, long-held assumptions are



Source: Bloomberg, as of 11/21/16. Nominal GDP is the economic growth rate, while real GDP is that growth rate minus inflation.

8 Private Pension Plan Bulletin Historical Tables and Graphs 1975-2014, U.S. Department of Labor, 2016, Pg. 25, https://www.dol.gov/sites/default/files/ebsa/researchers/statistics/retirement-bulletins/private-pension-plan-bulletin-historical-tables-and-graphs.pdf

9 Kirsten Grind, "Money Flows Out of 401(k) Plans as Baby Boomers Age," The Wall Street Journal, June 15, 2015, https://www.wsj.com/articles/net-outflows-befall-401-k-plans-1434408836

10 Russell Heimlich, "Baby Boomers Retire," Pew Research Center, December 29, 2010, http://www.pewresearch.org/fact-tank/2010/12/29/baby-boomers-retire/

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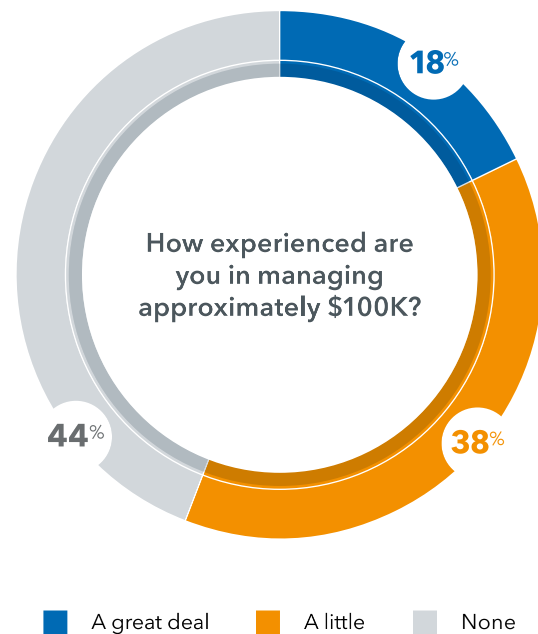
rapidly shifting. This future retirement environment will likely differ significantly from those of previous generations, as a result of lower returns, a lack of Defined Benefit pensions, and longer life expectancy. The combination of all these factors are not insurmountable, but will require sophisticated solutions able to navigate a more challenging environment.

Building investment solutions will not be enough, as the requisite behaviors and skills for plan participants to manage assets during retirement are ones not well honed nor encouraged under today's system. Leading up to retirement, investors only had a single goal in mind – maximize their risk-adjusted returns. Investors were told to "save, save, save" for retirement. When reaching retirement, things shift gears quickly and people must adapt to a new set of behaviors and risks. And the current DC system doesn't really help make that transition easy. For example, as indicated in a BlackRock investor survey (Chart Three),[11] investors need help with the complexity of managing large sums of money over long periods of time. In fact, most people would prefer to receive regular income payments in retirement, yet the lump sum option is the most common distribution today.[12,13]

CHART THREE Plan participant's experience managing large sums of money



Source: BlackRock Investor Attitudes and Behaviors, 2010.

One less prominent hurdle for future retirees is getting comfortable with actually spending their retirement assets and potentially seeing them decline. Past retirees have been fortunate from a retirement income perspective to have the "wind at their sails" with strong investment returns, pension income and shorter lifespans requiring funding. The combined benefits, in many instances, didn't warrant a systematic spending of principal to maintain a reasonable standard of living, relieving retirees from the understandable fear of using their savings too early and not having sufficient resources available near the end of life. But those on the

11,12 "BlackRock Investor Attitudes and Behaviors," BlackRock, 2010.

13 https://www.cerulli.com/publications/us-retirement-markets-2016-preparing-for-a-new-world-post-conflict-of-interest-rule-P0003F1

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cusp of retirement will be experiencing a very different environment: one where pension income is a rarity, investment returns generating reasonable levels of income are much harder to come by, and investors have the potential to live for 25-30 years after retiring.

A BlackRock white paper, "The Changing Equation: Building for retirement in a low return world," examines one of the core challenges facing these future retirees. From 1978-2016, a hypothetical 60/40 portfolio (60% U.S. equities and 40% U.S. bonds) would have generated an annualized average real return of 6.3%. But turning to the next ten years, consensus forecasts predict an annualized average real return of just 2.9%. Assets expected to generate 50% less in investment returns could leave Millennials and Gen Xers with savings balances at retirement 55% and 43% lower, respectively.[14]

The future of DC plans, as shaped by D.C.

Recent regulatory changes indicate that Washington understands the demographic shift in the workforce and the need to provide plan sponsors with greater latitude to help address retirement income solutions for their plan participants. This includes a series of changes that suggest an evolution towards making products like target date funds (TDFs) more robust and appealing vehicles for retirement distributions. These enhancements share a common thread – helping individuals to more simply and cost effectively plan, save, and invest for retirement and lay the foundation for retirement income solutions.

Although this is not a comprehensive set of regulatory changes, they provide sufficient guidance for plan sponsors to take action:

- **Pension Protection Act:** The 2006 Pension Protection Act (PPA) primarily established "safe harbor" provisions to automatically enroll employees into DC plans and clarified investment strategies designated as Qualified Default Investment Alternatives (QDIA). Looking ahead, the QDIA structure could serve as a scaffolding for designing and implementing a retirement income default option or a Qualified Default Retirement Income Alternative.[15]

- **Retirement Income Estimates:** Since 2013, the Department of Labor (DoL) has been considering a requirement that DC plan participant statements provide a projection of retirement income based on a participant's assets. Though the rule has not been issued, we believe that participants would benefit from such information, including projections of total assets at retirement and the resulting annual retirement income.

14 "The Changing Equation: Building for retirement in a low return world," BlackRock, 2016, Pg. 8, https://www.blackrock.com/investing/financial-professionals/defined-contribution/building-for-retirement-in-a-low-return-world

15 Steve Vernon, Foundations in Research for Regulatory Guidelines on the Design & Operation of Retirement Income Solutions in DC Plans, Stanford Center on Longevity, 2014, http://longevity3.stanford.edu/wp-content/uploads/2014/09/Foundations-for-Regulatory-Guidelines-2014-Final-.pdf

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- **Annuities in QDIAs:** Building on the PPA, the U.S. Treasury issued a ruling in 2014 that allowed deferred annuities to be embedded into QDIA products within DC plans.[16] As a result, TDFs and other QDIA solutions can now incorporate certain annuities into their asset allocation, usually in the form of replacing the fixed income allocation as participants close in on retirement. This ruling represents another important step in the ongoing evolution and re-orientation of TDFs towards retirement income.

- **Longevity Annuities:** In 2014, the IRS ruled that retirement assets, up to a certain limit, used to purchase longevity annuities within a Defined Contribution plan could be excluded from the Required Minimum Distribution (RMD) calculation for eligible assets. Longevity annuities usually provide lifetime income starting when investors are in their 70s or 80s.

- **Fiduciary Rule:** Beginning in 2017, the DoL has broadened the definition of "fiduciary" under the Employee Retirement Income Security Act of 1974 (ERISA) in a manner that extends ERISA fiduciary status – and hence fiduciary responsibilities – to advisors and firms for a broader range of services relating to retirement assets, including IRAs.[17] Many plan sponsors recognize that these guidelines may reduce the level of assets leaving DC plans, heightening the demand for in-plan retirement income solutions.[18]

What should the solution look like?

These changes in the demographic, regulatory, and investment landscapes indicate the growing potential of DC plans to serve as platforms for retirement distributions. Allowing investors to continue using their employer plan in retirement could both capitalize on shifting regulatory rulings and help retirees to better navigate the new retirement reality.

Solutions for retirees, as reflected in the ongoing legislative and regulatory agenda, include TDFs and insurance products as logical stand-alone or integrated components. Insurance guarantees, especially when embedded within a TDF structure, can assist in reducing cashflow volatility and longevity risk. Academic research indicates the important role partial-annuitization can play towards optimizing savings assets in retirement.[19] We also know that, historically, insurance products in any form have had limited take-up by investors in these types of situations.

16 "Treasury Issues Final Rules Regarding Longevity Annuities," U.S. Department of the Treasury, July 1, 2014, https://www.treasury.gov/press-center/press-releases/Pages/jl2448.aspx

17 "Your fiduciary practice: life after the DOL rule," BlackRock, 2017, https://www.blackrock.com/investing/financial-professionals/dol-fiduciary-rule

18 https://www.cerulli.com/publications/us-retirement-markets-2016-preparing-for-a-new-world-post-conflict-of-interest-rule-P0003F1

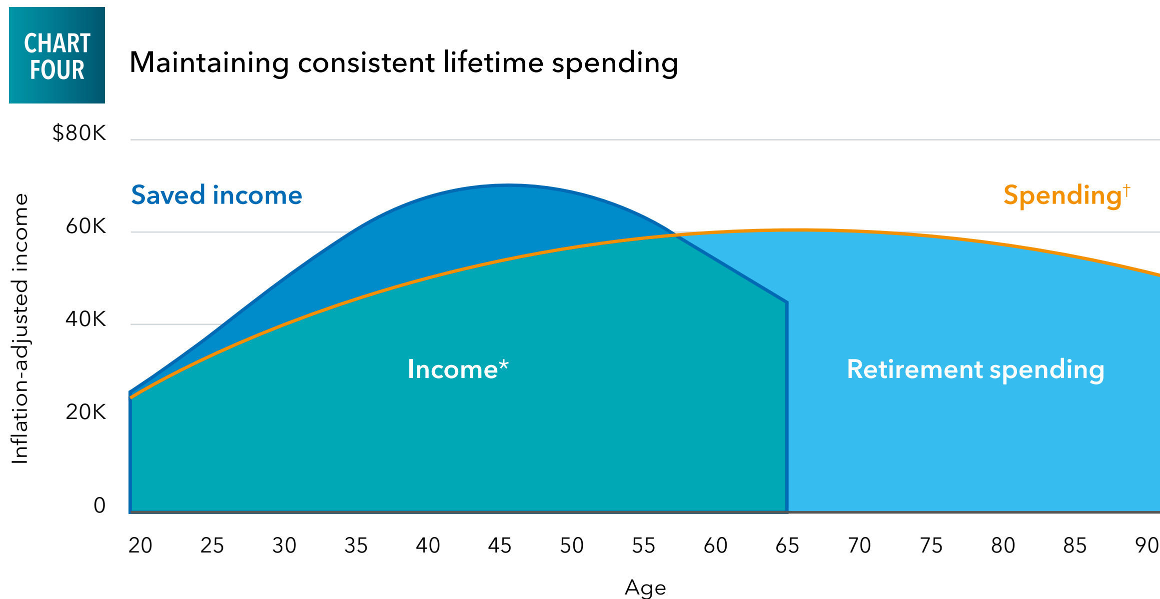
19 http://162.144.124.243/~longevl0/wp-content/uploads/2016/07/VleYvm-Optimizing_SCL_for_web_final.pdf

However, even without an insurance guarantee, TDFs – when appropriately designed – can serve as effective vehicles for distributing retirement income. TDFs have become one of the most common approaches to investing for retirement and carry many benefits with them, from automatically and dynamically managing age-appropriate asset allocations to addressing market and inflation risks, to name a few. While the traditional focus of TDFs has been the savings phase, these products can be designed to draw down assets into and throughout retirement.

However, in our view, this application is currently underserved and overlooked. Despite the ubiquity of the 401(k) and TDFs, participants have traditionally left TDFs for other options upon retirement. This trend continues today, as a majority of participants roll over assets from their employer plan at retirement.[20]

Ideally, TDFs used as a retirement income solution would optimize pre-retirement savings with retirement distributions to create a seamless, smooth lifetime spending profile (Chart Four).[21] This would require accounting for growth in income and spending early in an investor's career, income and savings tapering off as they approach retirement, and retirement itself, when income ends and savings fund spending. And throughout, the TDF would need to balance longevity risk and savings utility for the investor, while providing practical guidance about optimal distribution amounts to maintain a consistent standard of living.

CHART FOUR Maintaining consistent lifetime spending



20 "Consumer Attitudes to Rollovers and Retirement Planning," The American College of Financial Services, 2017, http://retirement.theamericancollege.edu/sites/retirement/files/Rollover_Report.pdf

21 "BBVA Compass: LifePath Target Date Funds. With you and your participants all the way," BlackRock, 2017, Slide 6.

* University of Michigan Panel Study of Income Dynamics (PSID) dataset from 1968–2011.

† Please refer to BlackRock's glidepath whitepaper titled Reexamining "To vs. Through" (May 2014) for additional details on the model.

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Though plan sponsors may have a range of objectives for their plans – such as encouraging plan participation and contributions, providing an attractive investment menu and an overall competitive plan. Conversely, approximately 73% of participants agree that "maintaining a consistent standard of living as I did when I was working" is extremely or very important.[22] A TDF product design could match this top reason that DC investors save for retirement.

A TDF structured for both accumulation and decumulation can help investors to do just that.

Roadmap to implement TDFs as a decumulation solution

At a basic level, how do plan sponsors, recordkeepers and asset managers execute a retirement distribution capability?

The necessary changes may be simpler to develop and implement than envisioned. Yet, they will require plan sponsors, recordkeepers and asset managers to work together on several key topics, including plan design, governance, distribution functionality, and participant communications.

Plan sponsors and recordkeepers have a variety of motivations to undertake this process. By doing so, plan sponsors are not only responding to plan participants' top priority for why they save, but also helping them to establish good asset withdrawal behaviors. This will raise the probability that their retirees make the most of their savings. From the recordkeeper's perspective, providing a number of mechanisms to deliver income in retirement is critical if they want to continue to grow.

- **Governance:** Plan documents need to reflect this new provision, including:
  - Plan sponsors updating their plan documents to include partial distributions post separation from service, if they are not already available. Currently, many plans only offer a lump sum distribution without additional forms of payment.
  - Participants should also have the ability to aggregate other qualified retirement assets from outside the plan, be they DC assets or IRA rollovers.

22 "Inside the minds of 401(k) plans and participants: 2017 BlackRock DC Pulse Survey," BlackRock, 2017, Pg. 34

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- **Partial Distributions:** Recordkeepers should develop the functionality to support participant-elected partial distributions for a specified dollar or percentage amount. The drawdown for the partial distribution should be flexible enough to allocate from single or multiple investments, and these withdrawals should be matched off against Required Minimum Distributions to ensure no violations of the rule.

- **Account Aggregation:** Plan sponsors should offer services that include spousal retirement accounts to further help retirees manage their finances throughout retirement. This will enable households to aggregate qualified assets from accounts outside the plan in order to have a more integrated approach to accessing retirement savings.

- **Income Projections:** Plan sponsors and recordkeepers should develop or direct investors to tools that translate assets into future, life-contingent income, such as BlackRock's CoRI Retirement Calculator.[23] Giving participants the ability to understand how their assets convert into income at retirement would greatly complement and inform the investor's eventual distribution process.

- **Education:** Plan sponsors should create an effective retirement income communication and education program. Communication content, design and delivery would be most effective if segmented based on life stages. BlackRock's approach pairs target date product information with financial wellness content and evolves both over time based on how far a participant is from retirement. For those nearing and in retirement, for example, content shifts from a focus on driving savings toward planning for retirement and strategies for converting savings to income.

- **Balance Sheet Management:** Plan sponsors and recordkeepers should develop tools that help retirees manage both income and spending obligations.

Plan sponsors and recordkeepers may find that supporting TDFs as in-plan decumulation platforms is relatively simple. With some minor adjustments and repurposing, e.g., reversing the systematic reinvestment process to a distribution one, they can deliver a sound solution to participants starting today.

23 "Meet CoRI® - BlackRock's Retirement Calculator," BlackRock, 2017, https://www.blackrock.com/cori-retirement-income-planning

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LifePath: the solution hiding in plain sight

We believe BlackRock's leading target date fund – LifePath – already features many of the product design elements that would allow a TDF to serve as an effective retirement income distributions platform. In fact, our LifePath framework is based on a comprehensive assessment of savings, investing, assets, and spending at every point in an investor's life – both the accumulation and decumulation phases.

Unlike many TDFs, LifePath is already structured to help investors maintain smooth spending in order to sustain a consistent standard of living over the course of their entire lifetime, including retirement.

To meet this goal, LifePath harnesses a unique lifecycle utility framework based on actual savings and spending behaviors and actuarial data. This framework enables LifePath to find the optimal pre-retirement spending rates, necessary savings rates, and sustainable withdrawal rates to maximize the lifetime utility of an individual's spending. This means that using LifePath throughout retirement is already an integral element of the product's objectives and structure. The result is a solution that can enable participants to maximize their retirement savings while minimizing the level of savings required – all through an employer plan they are familiar and comfortable with.

As plan sponsors, regulators, and participants begin to consider TDFs for retirement savings distributions, LifePath is a ready vehicle created for exactly this purpose. It can help investors to meet their top goals for retirement assets, align with evolving regulations, and provide an effective tool for the changing market environment.

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CONCLUSION

As tens of millions of new retirees shift from saving to spending, TDFs are poised to help investors navigate the next phase of their financial journey and effectively draw down retirement assets. Indeed, plan participants may be able to use a TDF as a comprehensive retirement solution, from their first paycheck, during their working and saving years, and through retirement and decumulation. Plan sponsors can take the following three steps today so that participants can receive the full value of their retirement assets through such a vehicle:

1. **Plan flexibility** – Begin the process to update plan documents to allow for partial distributions post separation from service and the ability to aggregate other qualified assets outside the plan, including spousal assets.

2. **Investment tools** – Integrate a robust set of income projection and balance sheet management tools that provide participants greater clarity around income and managing expenses upon entering and over the course of retirement.

3. **Participant education** – Offer materials around retirement income and decumulation for participants approaching or in retirement that speak to both the investment and behavioral challenges they may be experiencing.

The next generation of retirement distribution platforms could well be the DC plans that already serve as savings and investing vehicles for many investors today. We believe that these plans, if designed for smooth lifetime spending, can be repurposed for retirement income with relative ease. BlackRock is committed to helping plans in these efforts and offers tools and educational resources plan sponsors can use to improve retirement outcomes.

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ABOUT

BlackRock Retirement Institute

The BlackRock Retirement Institute (BRI) is BlackRock's global thought leadership platform on retirement and longevity established to enable our clients and broader community to make better decisions toward a financially secure and dignified retirement.

Lifespans have shot up over the last several decades but the way the world thinks and acts to address this new reality has yet to catch up. We at BlackRock recognize this emerging revolution – its challenges, its opportunities – and through BRI we join our voice with the voices of other experts to create and amplify some of the best thinking on retirement and longevity.

As the world's largest asset manager[24] – with two-thirds of the funds we manage related to retirement – BlackRock understands that our firm has a special responsibility to assist people all over the globe to live out their later years with dignity and security. An essential component of that is helping governments, institutions and individuals understand and take action in response to this new phase in mankind's history – that's what BRI is here to do.

The BlackRock Retirement Institute helps to enable our clients and broader communities to make better decisions towards a financially secure and dignified retirement.

24 Based on $5.69 trillion assets under management as of 6/30/17.

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- Global market and investment insights
- Sophisticated risk and portfolio analytics

We work only for our clients, who have entrusted us with managing $5.69 trillion*, earning BlackRock the distinction of being trusted to manage more money than any other investment firm in the world.

* AUM as of 6/30/17.

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Investing in target date funds involves risk, including possible loss of principal. Asset allocation models and diversification do not promise any level of performance or guarantee against loss of principal.

LifePath target date funds are invested mainly in U.S. and global stocks early on, shifting to more conservative investments, such as bonds, as investors get closer to retirement. The target date is the approximate date when investors plan to start withdrawing their money. The blend of investments in each portfolio are determined by an asset allocation process that seeks to maximize assets based on an investor's investment time horizon and tolerance for risk. Typically, the strategic asset mix in each portfolio systematically rebalances at varying intervals and becomes more conservative (less equity exposure) over time as investors move closer to the target date. The principal value of a fund is not guaranteed at any time, including at and after the target date.

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