A Closer Look at "Income+"

By Editor Test *Thu, Feb 3, 2011*

Financial Engines CIO Chris Jones answers questions about his firm's new in-plan income program.

As Baby Boomers retire, they threaten to roll their money out of 401(k) and 403(b) plans, thereby endangering the livelihood of all those who manage plan assets or advise participants. How, then, to keep managing those billions even after the employees vacate their cubicles?

Financial Engines, the big third-party provider of unbiased advice to participants in hundreds of large plans, thinks that its Income+ program, announced on January 31, will help solve that problem, at least for participants who use its managed account program. This week, FE's chief investment officer, Chris Jones, answered a few questions about Income+.

RIJ: Chris, FE has said that Income+ can succeed where other in-plan concepts have failed. Please elaborate.

Jones: Retirement income products have been pitched to plan sponsors for about five years. None of these products have received any traction in the large employer space. Large employers aren't adopting them. Most of the programs involve putting some form of insurance into the plan. But that produces a 'fiduciary lock-in.' A fiduciary has to be able to hire and fire providers. Those programs are easy to hire, but hard to fire. It's messy. That's one of the big constraints on sponsor behavior. With Income+, the idea is to take away the big objection, the fear of fiduciary lock-in.

RIJ: But Income+ seems to go to the other extreme. It's voluntary, liquid and has no costs beyond the basic managed account fees. Is it 'sticky' enough to be effective? How do you make sure the money stays in the plan?

Jones: We see this as a way to extend our relationship with the near-retiree participant beyond the accumulation years. Our expectation is that once people get into the strategy and we start managing their portfolio, these relationships will be sticky. Who 'owns' the client? It depends on who the fiduciary advisor is. Sometimes we have a direct relationship with the participant. In some cases we're a subadvisor and maybe JP Morgan, for example, owns the client. Participants with large balances will be targeted by outside advisors, as they have always been. But our objective is to reach people of relatively modest means, people who need income for groceries.

RIJ: Are the managed account holders defaulted into Income+ when they're five years away from retirement?

Jones: Income+ will be a mix of opt-in or opt-out. It depends on the provider. One advantage of default into the plan is that it lowers the fees. So some sponsors are likely to choose that. We'll have to see how it plays out.

RIJ: What exactly happens when the program starts?

Jones: We’ve built in a transition period. As most people approach their retirement horizon, they worry more. Beginning five years before retirement, we’ll move about 20% of their assets each year from an accumulation focus to an income focus, so that they have a ‘payout-ready’ portfolio at retirement. If you’re three years from retirement, for example, 40% of your portfolio is retirement ready. This reduces the risk of the portfolio from going down. We call it a ‘glide path,’ but we’re generally not using target date funds. Usually we’re using the core options that are in that particular plan.

RIJ: As I understand it, Income+ allocates 65% of a client’s assets to a bond fund composed of short, intermediate and, if available in the plan, long-term maturities. A floor income is drawn from that. Twenty percent of the assets goes into equities for upside potential. And the last 15% goes into a reserve of fixed income investments. This sounds like an institutionalized bucket strategy, where the bonds offer ready money and protect against market risk, where equities offer inflation protection, and where a ‘granny fund’ protects against longevity risk.

Jones: There’s some analogy there, between Income+ and buckets. But financial advisors usually structure their buckets by saying, ‘We’ll invest in ladder of certificates of deposit for five years of income, then well invest in stocks for the later years. It’s a bonds-early-stocks-late approach. But the problem with that approach is that it’s reliant on stocks achieving their historical returns so that the money will be there. We’re doing something quite different. We use the fixed income investments to lock in a floor income for life, not just for the early years. We use the equities as your upside. If the equities do well, you spend more. If not, still have your income from the bond portion. We want to take equity risk out of the equation. We don’t ever want to rely on that to meet the needs of the floor.

RIJ: You also promise that income can grow but not shrink.

Jones: We’re managing the assets in such a way that there’s a high probability that the payouts won’t go down. We’ve done historical backtesting, and we’ve never seen a historical situation where we couldn’t maintain the ratchet.

RIJ: In the past, Jason Scott and other FE researchers have published academic papers espousing the benefits of a retirement strategy that involves buying an advanced life deferred annuity at age 65, managing assets from age 65 to 85, and the relying on income from the ALDA, if necessary, from age 85 onward. But there’s no mention of ALDAs in Income+.

Jones: In the first generation of the product, we’re not having people buy longevity insurance—the deferred income annuity—for tax reasons. Right now you can’t buy a longevity contract with qualified dollars because the contract wouldn’t allow you to take required minimum distributions at age 70½. You’d have to take a taxable distribution from the plan and use that money to pay for the contract. With Income+, to deal with the RMD rules, we’ll invest about 15% of your assets to help you buy a fixed immediate income annuity at some point in the future that will lock in whatever annual payments you’re receiving at the time. If you wait until age 85 to buy the annuity, that 15% will probably have become, because of growth and the pay-down of the rest of the portfolio, about 80% to 90% of your portfolio. In short, we’re managing the portfolio in such a way that you can maintain a steady income for life.

RIJ: Who will provide the income annuities? Will you be using the Hueler Companies’ Income Solutions platform, where plan participants can choose among competing bids from a variety of annuity providers?

Jones: We will make use of the Hueler platform if it’s available to the 401(k) plan in question. We think the concept is a good one. If Hueler isn’t available, we’ll provide annuity options another way. Our objective is to provide a multitude of annuity vendors. We’ll facilitate the process but the participant has to make the decision. No commissions are involved, and they’re purchasing the annuity outside of the plan. We have no affiliation with Hueler. We’ve talked to Cannex and explored the idea of getting information about annuities from them, but we have no relationship with them right now. The question of when to buy an annuity is mostly driven by issues in the individual household. Most people are not interested in annuitizing early. At about age 73, they become more aware of the need for a lifetime annuity.

RIJ: But FE’s 20 to 60 basis point managed account fee is asset-based. Won’t you lose revenue if people buy life annuities?

Jones: Ultimately, that’s a challenge. Our business model is asset-based. On the other hand, we have no interest in any particular [investment products]. We think that annuities will be the right choice for a substantial number of participants. With Income+, at least we’ll be extending the relationship longer. And by time most people buy the annuity, we’ll have sold down most of the assets for income annuity. But we can’t completely eliminate that issue. We just want to be objective about the pros and cons of annuitization. In many cases, we think it’s the right thing to do. A big part of our value proposition is trust. None of our advisor reps work on commission. We have embraced that business model.

RIJ: This is either the best of times or the worst of times to start your new income program, given the interest rate environment. Are you prepared for whatever the future might bring?

Jones: The idea is to pursue liability driven investing. Historically, pension funds have invested in an allocation of stocks and bonds, and when the market goes up or down, they’re affected. But if you match up assets and liabilities, you immunize against changes in interest rates and market movements. We’re doing that at the individual account level. We’re exposed if long-term rates go down a lot, so we have to be conservative early in the period. We aren’t buying hedges, but we’re hedging in the sense that we use a dynamic [bond] portfolio strategy. If you’re of the mind that interest rates are going to rise, then that’s a good thing for this concept. Your liabilities get cheaper faster than your assets decline in value. So if that’s your belief, then this is a decent time to engage in a strategy like this. On the other hand, interest rates can stay low for a long time.

RIJ: Thank you, Chris.