

A three-bucket blueprint for de-accumulation, from the U.K.

By Kerry Pechter Thu, Jul 2, 2015

Britain's public-option defined contribution plan, NEST, thinks that a decumulation strategy that used tax-deferred savings to fund a small cash bucket, a big income-generating bucket and a longevity annuity might work best for the most people.

NEST, the UKs' state-backed, auto-enrolled defined contribution plan for workers without a employer-sponsored plan, has created a "[blueprint](#)" for a default income distribution strategy from their "pension pots"—aka tax-deferred savings—in retirement.

The strategy resembles the kind of three-bucket approach (involving a cash bucket, an income-producing bucket, and a longevity insurance bucket that produces a flat income starting at age 85) that various decumulation experts in the U.S. have proposed over the past decade.

Now that Britain has dropped its policy of incentivizing DC plan participants to buy life annuities at retirement (or, at the least, to annuitize any unspent tax-deferred assets at age 75), the directors of NEST (National Employment Savings Trust) felt that it should fill the policy vacuum by designing a suitable default decumulation strategy.

Launched in 2012 after the UK government committed itself to universal auto-enrollment of UK workers in a retirement savings plan, NEST has grown to about 2.2 million members with about £475m (\$738m, €660m) invested. That's less than £250 per member, on average, so the de-accumulation strategy might not be implemented for a while. That doesn't stop the model from serving as an informal guide for individual retirees right away.

"I wish we had a similar default decumulation strategy that average retirees could follow in the United States," said Michael Finke, who teaches financial planning at Texas Tech University, in an interview with *RIJ*. "When asked whether there was an ideal decumulation product at the Morningstar conference last week, my response was a combination of a managed payout fund, a QLAC, or a participating variable annuity. The only question is, how will a retiree manage a decumulation strategy between 65 and 85."

"Without commenting on the specifics, I think this represents a much better 'core' approach than what we see in the US 401(k)/DC space," said David Blanchett, Morningstar's chief retirement researcher. "This type of strategy is clearly designed to be attractive both from an outcomes perspective and from a behavioral perspective (i.e., is something that will both help retirees and something they would potentially be interested in doing. I often worry

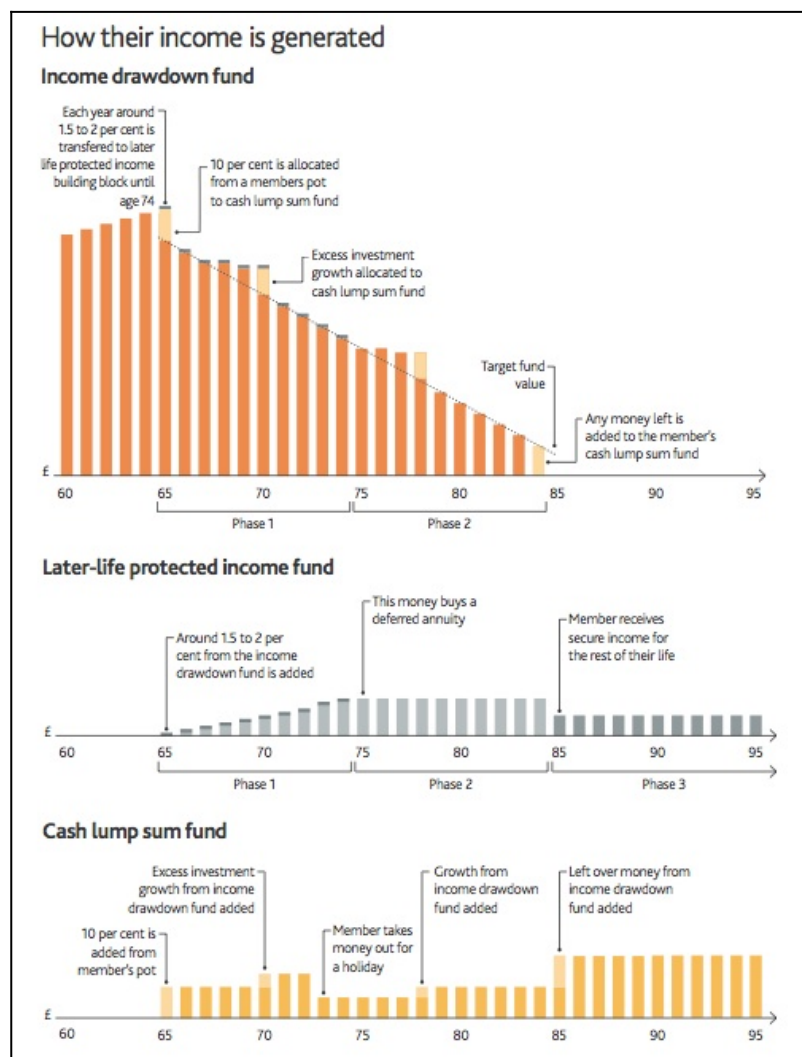
retirement research often focuses too much on the former, not the later). I think this is definitely a step in the right direction for defaults in decumulation.”

The three-part strategy (click on chart below right) was developed with input from British groups as well as U.S. firms like AllianceBernstein, BlackRock, JP Morgan, Milliman, and State Street Global Advisors. So far it’s just a blueprint; NEST participants have just started saving. NEST said that it is hoping that the financial services industry will create new products that can help bring it to life.

The strategy, which is intended to function without input from the retiree, is structured as follows (assuming a NEST participant who retires at age 65 and doesn’t opt for another distribution method):

On retirement, 10% of the participant’s target-date fund savings would enter a cash account, available for emergencies and short-term expenses. The other 90% would be

invested that changed the management technique TBD—that would generate a level (in real terms) monthly income from age 65 to age 85. Any excess earnings generated by the retiree's investments between the ages of 65 and 85 would spill over into the cash account. The income objective would be met by distributions of principal, with an eye toward spending down the fund by age 85.



“Drawing the money down over a set number of years until phase three, when the later-life protected income kicks in, would be easier to manage than attempting, through pure investment in capital markets, to make the pot last indefinitely,” according to the blueprint.

Retirees tend to avoid annuities that involve a sudden, irrevocable transfer of assets. NEST deals with that reality by having retirees contribute to an annuity purchase fund gradually. Starting at about age 65, 1.5% to 2% of the income fund would enter a side fund each year; at about age 75, the side fund would be locked into the purchase of a deferred income annuity. It would start making payments at age 85.

Two retirement experts who reviewed the NEST proposal, Wade Pfau of The American College and advisor Harold Evensky, commented that it wouldn't be easy for NEST to manage a fund to meet all the desired objectives. For instance, the NEST blueprint says that the income from the DIA at age 85 should equal the SWP income at age 84. But it didn't

show exactly how a 1.5% to 2% transfer (from a presumably shrinking account value) for 10 years would pay for a DIA that fulfilled that projection in all markets for all participants.

“It’s an interesting proposal,” said Wade Pfau in an email. “I’m in an ongoing research project with Steve Vernon and Joe Tomlinson, and one of the issues we are looking at is how it is actually quite difficult to calibrate the income flows in the transition from systematic withdrawals to when a deferred income annuity kicks in.

“Especially, at least in the U/S., DIAs do not provide an option to inflation-protect the initial spending amount. In practice, there will have to be a lot of effort put into the thought process about how much to put into the DIA each year. [Contributions of] 1.5% to 2% may or may not be appropriate.”

Referring to the section of the blueprint that says the DIA fund would remain liquid, Evensky, wrote, “I’m not sure how any product can meet this criteria.” But “I was impressed with its acknowledgement that ‘a one-size-fits all approach may result in some people being on paths that are less than perfect,’” he added.

“Although there are certainly issues and suggestions raised that require further thought, all in all I believe (a few examples below) it is exceptionally thoughtful (particularly the guiding principals) and well done,” Evensky wrote in an email to *RIJ*.

The NEST blueprint appears to reflect a belief that it makes little sense to try to manage a portfolio so that it lasts for an indeterminate period—a lifespan—and that annuities offer the most value as insurance against extreme old age. Once you accept the philosophy behind this strategy, it just becomes a matter of execution.

“We believe this is possible but it requires innovation,” said Mark Fawcett, chief investment officer at NEST, in a news release. “We’ve developed an evidence-based blueprint for how to meet members’ needs. We hope this will stimulate the innovation necessary for us and others to deliver what members will need and want.”