Financial Engines’ Secret Income Plan

By Kerry Pechter *Tue, Aug 24, 2010*

Financial Engines CEO Jeff Maggioncalda expects his firm to roll out an in-plan income option to DC participants in late 2010 or early 2011. He won't reveal details, but there are clues to his intentions. Photo by Robyn Basso.

Financial Engines, Inc., the provider of investment advice and managed account services to defined contribution plan participants, intends to begin offering an in-plan retirement income option to its clients starting in late 2010 or early 2011 and to offer it to as many as 4.2 million participants within three years.

Jeff Maggioncalda, CEO of the Palo Alto, Calif.-based firm, said in a recent conference call with security analysts that the “solution will be different from what’s offered today, and will address concerns that have caused employers to avoid embracing” in-plan income options so far, such as high costs and fiduciary issues.

While offering no details, Maggioncalda said the program would be an extension of the company’s Professional Management managed account services and would allow users of those services to draw a monthly income in retirement. He did not say whether a rollover IRA would be involved.

The program would not require plan sponsors “to add an annuity or change their investment lineups to offer our solution” and would “eliminate the counterparty risk associated with adding an annuity to their plan,” he said, noting that the program would work “with any open architecture combination of investment products.”

Despite that disclaimer, there’s reason to believe an annuity or annuity-like feature could be involved. Financial Engines offered a description of what it considered a viable in-plan income option in an eight-page written response last May 3 to the Department of Labor’s request for information regarding such plans, and a type of annuity was integral to it.

That hypothetical plan involved the purchase of longevity insurance—life-contingent deferred income annuities that can be purchased at a steep discount because they don’t pay out unless and until the contract owner reaches an advanced age, such as 80 or 85.

Longevity insurance has drawn serious attention from academics in recent years, but not from investors. PIMCO has recommended that investors combine its inflation-protected payout fund with a longevity insurance contract as a retirement income strategy. Annuity expert Moshe Milevsky of York University has written about the advantages of longevity insurance. MetLife, Hartford and Symetra offer quotes on longevity insurance, but the product is rarely purchased.

Currently, the most prominent in-plan income solution might be Prudential Retirement’s IncomeFlex program, which allows participants to add a guaranteed lifetime income benefit, like the ones offered on variable annuities, to target-date funds in a 401(k) account. Great-West also offers such an option. MetLife offers SponsorMatch, a program that allows participants to buy chunks of income far in advance of retirement with their employer match.

Financial Engines, which was co-founded in 1996 by Nobel Prize winner William Sharpe, started as a respected but fairly modest provider of online investment advice to 401(k) plan participants. Among other things, it gave participants access to a colorful Internet-based widget that enabled them to conduct their own Monte Carlo projections of hypothetical portfolio returns.

Over time, the company has come to offer Internet-mediated managed accounts to participants within 401(k) plans, and was recently identified as the largest Registered Investment Advisor in the U.S. The company reported $29.4 billion in 401(k) managed accounts as of June 30, 2010, and $300 billion in "assets under contract." That number refers to the total assets in the 385 retirement plans whose 4.2 million participants can purchase Financial Engines' managed account services.

In the DoL comments, Jason Scott, Ph.D., the managing director of the Retiree Research Center at Financial Engines, urged the Department of Labor to amend the tax laws to exempt assets in longevity insurance contracts from the calculation of required minimum distributions.

Though not specific, Scott's comments describe a managed "hybrid solution" in which participants would draw monthly income from a managed account early in retirement "while always maintaining sufficient assets to give participants the option of increasing the income payout through an annuity purchase."

In addition, "The advantage of the hybrid approach is that as the insurance becomes compelling, the hybrid solution facilitates a shift from a highly liquid and flexible solution to one more focused on guaranteed lifetime income," the comments said. Such a program sounds similar to the Retirement Management Account that MassMutual briefly marketed until the financial crisis.

Scott has written about longevity insurance for some time. In a 2009 research paper called, "What Makes a Better Annuity?" he and others suggested that the introduction of longevity insurance, because it protects the owner against longevity risk much more cheaply than immediate annuities, could greatly expand the annuity market.

In the DoL comments, Scott noted that an "allocation of 10 to 15% of wealth to a longevity annuity creates spending benefits comparable to an immediate annuity allocation of 60% or more." The comments also recommend that any future DoL-approved qualified default income solution contain the following elements:

• **Fee reversibility** – In the accumulation phase, qualified default arrangements must be fully reversible at no cost for 90 days. A similar guideline should apply to retirement defaults.

• **Liquidity** – Some insurance products, such as an immediate annuity, exchange liquidity for additional retirement income. However, a default that involves the loss of liquidity could be a significant shock to unaware participants. To manage this concern, we recommend either an extended period where liquidity is retained or a requirement that loss of liquidity requires a proactive participant decision.

• **Death benefit** – Insurance that maximizes income will not pay a death benefit. However, in a default context, the lack of a death benefit could also be surprising to the heirs of DC plan participants. Similar to liquidity provisions, we recommend either an extended period where a death benefit is retained or a requirement that loss of a death benefit requires a proactive participant decision.

• **Conflicts** – If the retirement default is an advisory relationship that helps participants with drawdown decisions, existing rules governing prohibited transactions should extend to lifetime income services. Participants should be protected from advice that could be influenced by conflicts of interest associated with the compensation of the advisor.

• **Role of Fiduciary in Selecting Default**– If a retirement income solution is made a plan default, we recommend that the plan sponsor still play a fiduciary role in the selection and monitoring of any such default.