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IMPROVING RETIREMENT OUTCOMES WITH MORE EFFICIENT PORTFOLIOS AND PERSONALIZATION

Plan sponsors can meaningfully improve retirement outcomes for DC participants and should focus on expanding the number of asset class offerings in DC plans and offering personalized guidance tools today.

Many DC plans (still) focus on accumulation rather than retirement. Improving DC plans has the potential to generate better retirement outcomes for participants.

First, more extensive asset classes can improve many core menus and portfolios. Our research suggests doing so potentially improves expected risk-adjusted returns by more than 100 bps, which could generate five or more years of additional income for retirees. This also suggests that plan sponsors should proactively reevaluate their investment offerings to ensure they include the essential building blocks for more efficient portfolios.

Second, we demonstrate how optimal portfolio risk levels and initial withdrawal rates can vary notably across participants, especially retirees. This implies DC plan sponsors should consider making a suite of options available so that each participant can personalize their retirement journey based on their unique situation and preferences, to the extent they wish to engage.

In summary, many DC plans are not “retirement ready” today. It’s up to each plan sponsor to ensure it’s doing what it can to help its employees and participants retire successfully, given the significant potential impact doing so can have on the outcome.

EXTENDING ASSET CLASS COVERAGE TO BUILD MORE EFFICIENT PORTFOLIOS

To help deliver better outcomes for retirees, we believe the toolset of asset classes should be expanded within DC plans.

When focusing on the core menu, it’s important to note how it’s evolved considerably over time. As DC plans increasingly rely on features like automatic enrollment and default investments, particularly target-date funds, fewer participants are building portfolios using the core menu funds.

Considering the overall plan sponsor interest and general availability of asset classes, we can place them into three broad groups, which are included in the exhibit below.

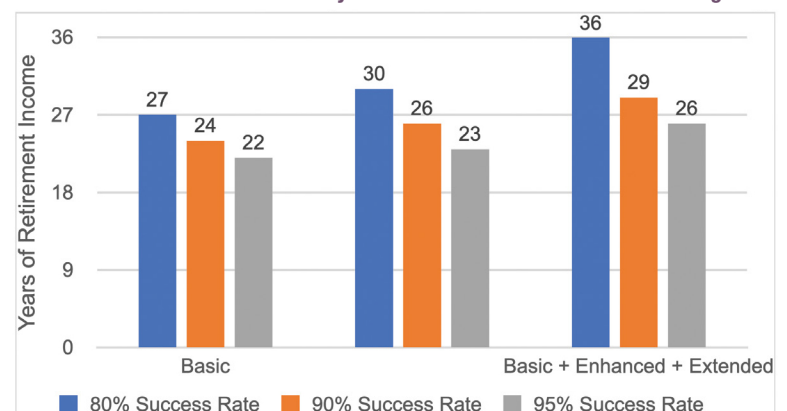
Asset Classes by Coverage Level

Basic	Enhanced	Extended
US Large Cap	Emerging Markets Equity	Private Real Estate Equity
US Small Cap	REITs	Private Real Estate Debt
Non-US Equity	Commodities	Long Duration Bonds
Core Fixed Income	High Yield Bond	Infrastructure Equity
Cash	TIPS	Defensive Equity

We find that increasing the investment opportunity set beyond just the Basic asset classes can notably improve portfolio efficiency, especially for retirees, given the unique benefits of including inflation-sensitive assets in a retirement portfolio. For example, our research suggests that including the Enhanced opportunity set (in addition to Basic) and then the Enhanced plus Extended has the potential to increase returns by 0.54% and 1.28%, respectively.

Improving portfolio returns can result in more income in retirement. To demonstrate this, we ran a series of Monte Carlo projections. The following exhibit summarizes the results and includes the number of years of income that could be generated from the various sets of efficient portfolios building the respective opportunity sets targeting different success rates while targeting a 5% initial withdrawal rate, where the initial amount is subsequently increased by inflation.

Years of Retirement Income by Success Rate and Asset Class Coverage



For illustrative purposes only. Past performance is not a guarantee or reliable indicator of future results.

Building the more complex portfolios has the potential to generate five or more years of additional retirement income compared to the more Basic portfolios.

USING PERSONALIZATION TO ADDRESS THE DC RETIREMENT INCOME CHALLENGE

While multi-asset strategies such as managed payout funds may provide retirees with a generally efficient portfolio and withdrawal rate, it’s important to note that every employee and participant is different and that these differences could result in notably different advice or guidance



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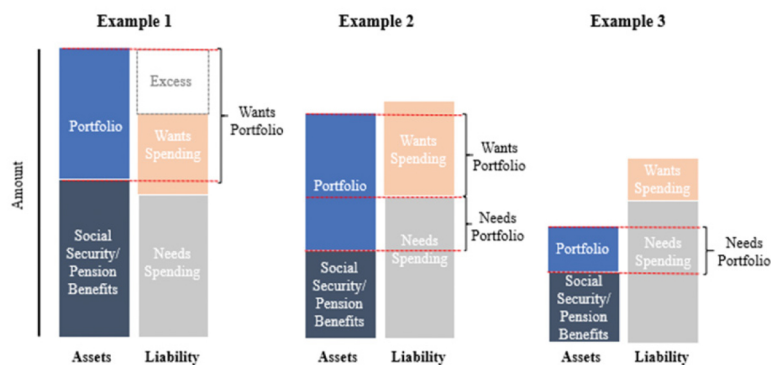
should the participant wish to engage. We explore this for two general decisions: optimal portfolio risk levels and spending rates.

First, when it comes to the optimal portfolio, we think it is essential that the portfolio's risk consider the entire structure of the participant's assets and liabilities. We define assets not only as savings amounts (e.g., the 401(k) balance) but other sources that can be used to fund the retirement income goal, such as Social Security retirement benefits and/or a defined benefit (DB) plan (i.e., pension benefits).

Regarding liability, breaking out the retirement goal based on spending flexibility is important since the disutility of not achieving the overall goal will vary depending on the shortfall. For example, if we generalize the retirement income goal into two components: "needs" spending and "wants" spending, a shortfall in the "needs" category is going to be significantly more painful than a shortfall in the "wants" spending.

Once we have a better idea of the participant's respective assets and liabilities, it is possible to determine better what the optimal portfolio should be, a concept we explored in previous research by Blanchett and Stempien (2022), titled "Spending Elasticity and Optimal Portfolio Risk Levels."¹ We illustrate this point in the exhibit below for three hypothetical participants.

Creating Portfolios to Target Specific Spending Goals



Source: Blanchett (2023). For illustrative purposes only.

The efficient retirement portfolios for the hypothetical participants varies significantly based on the structure of their respective assets and liabilities. Some participants will likely need most or all of their DC balance allocated to fund more essential spending, while others can focus on funding more discretionary spending.

In addition to differences in optimal portfolio levels, we've also looked at differences in optimal initial withdrawal rates at retirement. We find that while 5% may be a generally appropriate initial withdrawal rate for participants at retirement, in reality, withdrawal rates will easily vary between at least 4% and 7%, based on each participant's situation and preferences.

While 7% may seem like an unusually high initial withdrawal rate, our approach to determining optimal retirement strategies focuses on more holistic outcomes that are more robust than other standard metrics like the probability of success.

Our approach captures not only the magnitude of failure if there is a shortfall but also the dissatisfaction based on the type of shortfall (i.e. if it occurs for essential or more flexible spending). This perspective can lead to notably higher initial withdrawal rates, especially for retirees with a higher portion of their retirement assets in guaranteed income and more flexibility around their retirement goal.

CONCLUSION

DC plans were historically designed for wealth accumulation, not wealth decumulation. As DC plans have emerged as the preeminent way Americans save for retirement, with roughly \$10 trillion in assets,² many plan sponsors are asking what role they can potentially play in helping participants use savings to fund consumption in retirement.

Plan sponsors can meaningfully improve retirement outcomes for DC participants and should focus on expanding the number of asset class offerings in DC plans and offering personalized guidance tools today.

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FOOTNOTES

¹ Blanchett, David and Jeremy Stempien. 2022. "Spending Elasticity and Optimal Portfolio Risk Levels." Available on SSRN: https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4175484

² ICI Quarterly Retirement Market Data posted June 14, 2023. https://www.ici.org/statistical-report/ret_23_q2

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