Target Dates and Annuities … It's Complicated

Can a new wave of target-date strategies be the easy button for retirement income?

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Key Takeaways

- The number of Americans turning 65 will accelerate over the next several years. As they near or enter retirement, they face several challenges when shifting from accumulating savings to living off them, particularly regarding longevity risk and stable income.
- Retirement-income products continue to be a quandary for investors; however, target-date providers are looking to succeed where others have fallen short by including insurance against running out of money in retirement in the form of annuities.
- At least 10 target-date series incorporating some form of annuity have launched since 2020.
- Investor demand for these strategies has been muted. In April, BlackRock planned to launch a new series with an annuity to which more than a dozen defined-contribution retirement plans have committed about $25 billion, but even then, total assets in such vehicles will still be less than $50 billion, under 2% of target-date assets.
- Target-date funds with annuities offer investors target dates' familiarity with the longevity hedge of annuities. For investors who plan to annuitize some or all their retirement savings, they may be a good option, but they shouldn't take the decision lightly.
- Annuities can help with many retirement spending decisions, but they still may not be the right choice for everyone. We list some behavioral and financial factors to consider before purchasing an annuity.
- Education remains these products' biggest hurdle to success. One target-date manager already has dropped annuities because of suboptimal investor behavior.

Introduction

Retirement is supposed to be about spending time with grandchildren, traveling, and winning the local pickleball league, not worrying about running out of money. But one of the most challenging parts of retiring is the transition from living off paychecks to paying yourself. That seismic shift presents the average retiree with a complex problem with numerous unknowns, a slew of psychological obstacles to maneuver, and, on top of all that, math. And, as current savings and spending patterns show, retirees need help making these monumental decisions.

The number of retirees who need help is also set to skyrocket over the next several years. One estimate from the Alliance for Lifetime Income, a nonprofit educational organization, suggests that more than 4 million people in the US will hit the retirement age of 65 every year through 2027.

In this research, we will take a deep dive into a new wave of target-date strategies that try to make that transition easier by including annuities as part of their glide path. Target dates are one of the most popular ways investors save for retirement today, and they have proven to be a great tool for saving. In retirement, however, their benefits diminish. These new strategies want to change that by giving investors the option to insure some, or all, of their nest egg. Products are only one component of the retirement-income dilemma, though. Another component—people—may be harder to solve for en masse.

The Psychology of Retirement Spending

Any discussion of retirement income would be incomplete without acknowledging the individual investor psychology. Besides deciding how much to set aside for bequests (if any), retirees must then set a withdrawal rate while juggling two extremes: running out of money and enjoying the assets they've painstakingly saved over the years. Although they can turn to software and online guidance to arrive at an adequate withdrawal rate, many still struggle to manage their income in retirement. Here's where the psychology of decumulation decisions begins to play a role.

Retirees tend to fall into two camps: Those who spend too little of their retirement savings and never enjoy the fruits of their labor, and those who spend too much too quickly and risk running out of money. Some investors struggle with self-control due to temporal discounting and availability bias; they allow immediate wants to win over long-term needs and overspend in retirement. Other retirees fall on the opposite side of the spectrum and hoard their savings. These investors may be victims of their own fear and be caught in a never-ending loop of "what if?" What if they outlive their assets? What if the markets go haywire and they lose money? What if they are confronted with a big expense somewhere down the line? These worries are related to longevity risk: The odds of outliving your savings. Although these questions have merit, many investors let their biases—such as risk aversion, loss aversion, and the endowment effect—cloud their judgment. Research suggests guaranteed income sources can help retirees manage these and other psychological obstacles.

How Guaranteed Income Can Help

Annuities are designed to combat longevity and market risk. They also can tackle many of the psychological and behavioral obstacles in retirement-spending decisions, by:

- making withdrawal payments automatically;
- putting the annuity portion of savings off limits for discretionary spending, helping to curb spending;
- setting aside some savings for the annuity up front, easing the psychological shift from saving to spending; and
- providing a steady paycheck for those who prefer a smooth income.

Despite annuities' benefits, not many retirees purchase them. Past research has pointed to the complexity of annuities, their marketplace, and behavioral barriers to annuities, such as our tendency to loss aversion, regret aversion, and temporal discounting, as reasons for the takeup rate. Some retirees, for example, may see annuities as a gamble, since they can't know for certain they will live long enough to spend all the money they put in an annuity. Others might be uncomfortable with some annuities' lack of flexibility.

Even given their complexity, annuities can still help retirees with their retirement spending. New advancements in the form of target-date funds with annuity components may make them more accessible than ever.

Building off the Success of Target Dates

Target dates are one of the greatest retirement savings innovations. They offer professionally managed portfolios of stocks, bonds, and other investments that start off emphasizing growth and then gradually become more conservative as their target retirement dates approach. They're easy buttons for investors who don’t want to manage their own money.

Target dates' simplicity has helped make them the most popular investment option in defined-contribution plans. At the end of 2022, 98% of defined-contribution plans used target dates as their qualified default investment option, according to Vanguard’s How America Saves 2024 report, with 83% of participants using a target date when offered. At the end of 2023, target dates had a record $3.5 trillion in assets, according to Morningstar's 2024 Target-Date Strategy Landscape.

Target dates' extensive use makes them a natural starting point for tackling retirement challenges. In retirement, target dates morph into traditional conservative portfolios that own more bonds than stocks. From there, target-date investors are on their own when it comes to spending their savings.

The Secure Act of 2020 gave managers more flexibility to manage retirement income. The law grants plan sponsors a fiduciary safe harbor when selecting insurance providers, lowering the legal risks of offering guaranteed income and opening a door that firms are walking through.

The Expanding Lineup of Target Dates With Guaranteed Income

Since 2020, around a dozen new target-date series including a form of guaranteed income have launched or have planned to launch.

There are advantages to bundling target dates and annuities. For investors who plan to annuitize some of their assets, this package deal eliminates having to sort through myriad complicated options. Target-date providers choose the type of annuity, which varies by series, and then performs the due diligence on insurance companies.

AB Lifetime Income is the largest series with approximately $10 billion in assets as of the end of 2023. Its assets more than doubled to $5 billion in 2021 after the passage of the Secure Act, and it has continued to grow. BlackRock's LifePath Paycheck series likely will surpass it after its April 2024 launch, because more than a dozen plan sponsors have committed about $25 billion to it. Most of those sponsors are converting from BlackRock's LifePath Index series, which is identical to LifePath Paycheck, until the latter starts building up a guaranteed income allocation around 10 years before retirement. After LifePath Paycheck launches, target-date series with guaranteed income will claim between $40 to $50 billion, although that is still a drop in the ocean of target-date assets.

The table below shows a sample of those series, including BlackRock LifePath Paycheck. It shows whether the target date’s guaranteed income is an income or savings annuity and if there is one or more insurers. Series with multiple insurers could make better payments as they jockey against each other, but it’s too soon to say if that has been the case.

Exhibit 1 Target Dates With Guaranteed Income Options

Target-Date Series	Annuity	Subtype	Insurers
BlackRock LifePath Paycheck	Income	Fixed	Multiple
Nuveen Lifecycle Income*	Income**	Fixed	Single
SSgA IncomeWise	Income^	Fixed	Multiple
NCIT American Funds Lifetime Income Builder	Savings	Fixed	Single
SSgA GTC Retirement Income Builder	Savings	Fixed	Multiple
AB Lifetime Income	Savings	Variable	Multiple
Lincoln PathBuilder Income	Savings	Variable	Single
Income America 5forLife	Savings	Variable	Multiple

* There are three versions of the Nuveen series: an all-active, all-passive, and blend version.
**Technically a savings annuity that converts to an income annuity.
^A Qualified Longevity Annuity Contract; payments start at age 78.

Annuities come in so many different forms that the word needs further definition. To simplify things, we’ll separate target dates into two groups based on what they offer: income annuities and savings annuities. For more detail on both, check out Morningstar’s Guide to Annuities.

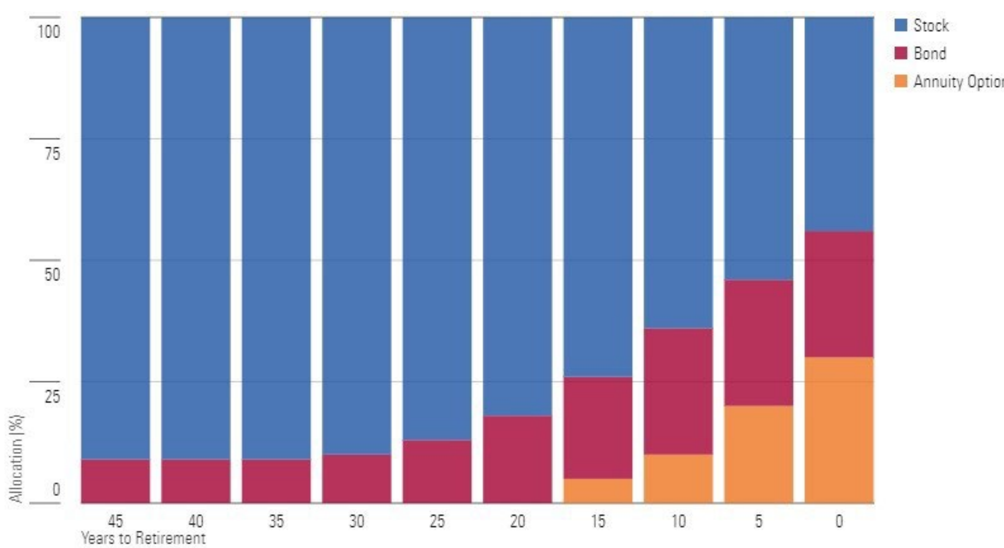
Income Annuities

Income annuities are the more straightforward of the two. They provide a guaranteed stream of cash in exchange for a lump-sum payment. For example, in February 2024, a $200,000 investment in an immediate income annuity might net you $1,200 a month for the rest of your life (or until the insurance company ceases to exist).[1]

The downsides of income annuities include locking up $200,000 you could have invested in something that might have yielded the same amount or more. Inflation also can erode the purchasing power of the fixed payments over time. Morningstar research, however, has found that using an income annuity as a part of your bond portfolio can help improve outcomes, since it allows you to take more risk in other parts of your portfolio to offset inflation. Also, the guaranteed payments provided priceless peace of mind for some.

Income annuities are incorporated into target dates in two ways. Under the first approach, investors have the option to buy an income annuity with a portion of their balance at the retirement target date. With the second approach, the target date buys units of guaranteed income before the target retirement date. In other words, the target date buys a series of deferred-income annuities. In either case, investors can access their funds until they choose to annuitize or turn on the income stream. The exhibit below shows a hypothetical example of how a target date could allocate to deferred-income annuities as it approaches the retirement date.

Exhibit 2 A Hypothetical Glide Path With an Allocation to an Annuity



Source: Author's Interpretation.

1 There are some state guarantees in place in case an insurance company does go bankrupt that will allow investors to recoup at least a portion of the net present value of their annuity up to a certain limit, which varies by state.

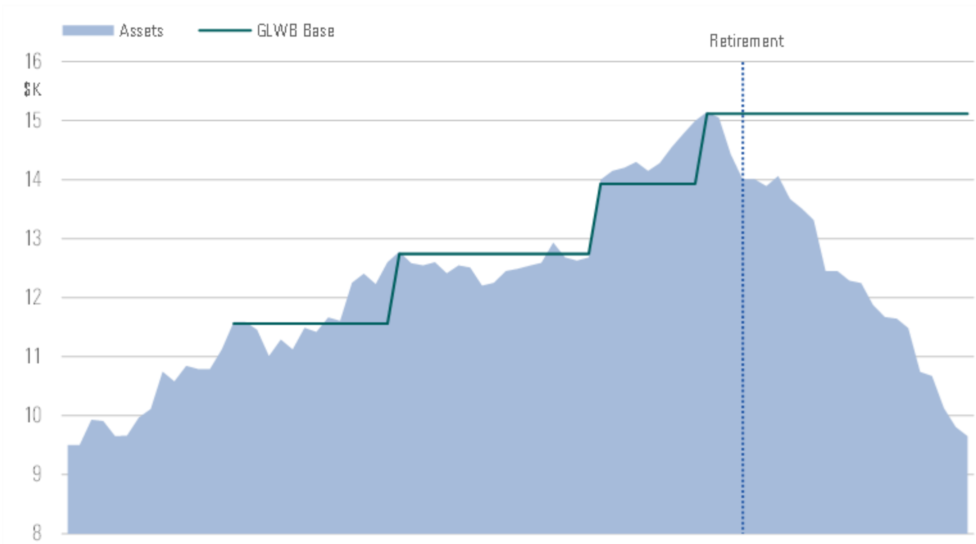
Spreading out the purchases over a decade or longer may help lower the risk of locking in an annuity in unfortunate market conditions, like when interest rates are very low. The drawn-out approach has risks, too, though. For example, accumulating the deferred income over the last decade of low rates would probably have led to lower payouts than buying a lump-sum annuity in early 2024, when interest rates were higher. Trying to predict future interest rates is nearly impossible, though, so diversifying the timing of the purchases could be beneficial.

Savings Annuities With a Guaranteed Lifetime Withdrawal Benefit

Savings annuities with a guaranteed lifetime withdrawal benefit, or GLWB, don't require investors to surrender control of their investments, and they potentially have more upside than income annuities.

GLWBs allow investors to withdraw a certain percentage of assets each year. Target dates incorporate GLWBs in two ways. When the underlying contract is a variable annuity,* the GLWB is wrapped around the funds' total investment. Alternatively, the GLWB can be wrapped around a fixed index annuity sleeve within the target date. The guaranteed income from the fixed index annuity supports the targeted income rate and any fund-level promises. The GLWB is typically based on the account balance or the account balance's high-water mark before withdrawals begin, though there are other ways to calculate the GLWB's income base. The exhibit below shows a hypothetical example of how a GLWB base could be set for a growing target-date balance.

Exhibit 3 A Hypothetical GLWB Base Scenario



Source: Author's Interpretation.

The payments will vary based on what age the owner starts taking out money. Like with Social Security, the longer you can delay withdrawals, the bigger the payment, but the payments are typically not as generous as those of income annuities because they offer more flexibility in retirement. For example, investors can withdraw more than the GLWB, which can lead to the GLWB resetting to a lower benefit amount. In any case, if the account balance reaches zero, the insurance company will continue to make payments based on the GLWB.

The Costs Aren't Always Transparent

Defined-contribution plans have been lightning rods for excessive-fee lawsuits over the past several years. There were 48 such cases in 2023, according to Encore Fiduciary, a fiduciary liability insurance underwriting company. While that's fewer than the 88 filed in 2022, the more than 300 suits filed since 2019 have kept plan sponsors vigilant.

Fees are a big obstacle for target dates with annuities. Income annuities, for example, don't have an explicit fee attached to them. Instead, the fee is baked into the guaranteed payment. That makes comparing the fees of target dates with income annuities with traditional target dates difficult.

Savings annuities, on the other hand, may have both explicit and implicit fees. The former can range from 50 to 100 basis points on top of the underlying funds' fees and any management fee on top of those. It's easier to compare these costs with traditional target dates, but they look more expensive in almost all cases.

Hard Lessons Learned

One target-date series has already pivoted away from guaranteed income because of participants' poor adoption rates. After 2024's first quarter, the Empower IncomeFlex Target series will no longer include annuities.[2] Empower found that 401(k) investors were not allocating enough to the target-date fund to generate enough guaranteed income to make the option worth opting into. This highlights that the biggest hurdle of these strategies is the lack of education.

There's Still no Retirement-Income 'Easy' Button

Target dates with annuities show that the industry is seriously considering how to help investors make retirement spending decisions, which is a step in the right direction. The marriage of target dates and annuities may help many investors. A lot of retirees who have used target dates to accumulate assets are familiar with the format and adding annuities to the vehicles can help users tackle the knotty problem of how to spend their nest eggs in retirement. Combining target dates with annuities also can make annuities less intimidating by simplifying the annuity buying process, giving them flexibility, and allowing access to most of their assets in the target date.

Regardless of annuities' benefits, investors need to consider their unique situations before buying one, even via a target date. Target dates with annuities are still not a one-size-fits-all solution. Some retirees may not benefit from annuitizing a portion of their assets or may wish to have more control over their

2 Investors in vintages 10 years or less from retirement, where there is an allocation to guaranteed income, will be transitioned over to standalone portfolio that does still include guaranteed income and has the same 60% allocation to equities as those vintages; for those investors, the impact should be minimal. But in the future, investors in the target date series won't have a guaranteed income option.

asset allocation. Also, these products do not offer retirees personalized advice. In other words, they may not be the right solution for some retirees because retirement income decisions are very personal.

To help retirees grapple with the decision to annuitize a portion of their savings, we created the following list of questions. The list considers both the financial and psychological benefits[3] of annuities.

Exhibit 4 Checklist: Is an Annuity Right for You? Factors to Consider When Deciding to Annuitize

Existing guaranteed income replacement:	How much of your annual income need is already covered by any existing pension, defined-benefit plan, annuity, and Social Security? The portion of your annual income need that isn't covered by existing guaranteed income is the amount you must make up for with your savings. We like to call this portion your revised annual income need (revised annual income need = total annual income need - existing guaranteed income).
Wealth level:	Considering the amount you have saved, how many times your revised annual income need do you have? There is a "sweet spot" when it comes to annuity decisions, where those who have saved a lot or too little may not benefit economically from an annuity.
Spending guardrails:	Do you currently live paycheck to paycheck for reasons related to overspending versus lack of income? Or have you had trouble justifying spending in the past? If you can relate to either of these questions, then considering an annuity may be a good choice.
Investment decision comfort level:	How comfortable are you making decisions regarding your asset allocation or product allocation? A target date with annuity can help on both fronts.
Anticipated life expectancy:	Considering your existing health, family history, and statistical numbers, gauge your expected life expectancy. A long life span may favor an annuity.
Income risk comfort:	Does running out of money keep you up at night? Sometimes an annuity is worth it, if only for peace of mind.
Flexibility need/preference:	If you anticipate needing your funds on an ad hoc basis, it may be imprudent to lock it away in an annuity.
Retirement wealth goal:	Is your goal to spend down your assets or leave a sizable bequest? Annuities can help make sure you spend your hard-earned money but requires trade-offs between spending and bequest motives.

Source: Author's Interpretation.

Conclusion

It's clear that retirement income is a problem that will only continue to grow. For retirees with savings outside of defined-benefit plans and pensions, consistently spending down savings is difficult from a mathematical and psychological perspective. Our research shows that the industry is stumbling to catch up to this problem; though, its most recent efforts—target dates with annuities—show promise. They automate investors' asset allocations and payments in retirement. They also simplify the annuity buying process by providing only vetted annuity products to investors as well as avoiding advisor commission fees.

3 More in-depth assessments of a person's retirement income preferences are available; for example, the RISA profile assessment: https://risaprofile.com/.

Target dates with annuities, while a retirement income advancement, are not the set-it-and-forget-it solutions that target dates have become. They remain complex and can be confusing. Also, retirement income decisions may be too unique and personal for generalized solutions. Investors still need to pay close attention to their retirement-spending decisions and may still benefit from expert advice and technological solutions.

Appendix

A Brief History of Retirement-Income Solutions

(Time Immemorial[4]) **Do-It-Yourself**: No rule says you have to get help when developing a retirement-income strategy. But just like no rule says you can't have ice cream for every meal, there may be some discomfort associated with going solo.

(1700s BCE) **Annuities**: In exchange for a lump sum of money, an annuity contract guarantees you regular income until you die (provided the other side of the contract doesn't go bankrupt first). These types of contracts have been around since ancient Egypt, but they didn't become popular in the US until the 1930s when the Great Depression drove people to look for some insurance against running out of money. Since then, the types of annuities have multiplied and so has the complexity.

(1870s CE) **Pensions**: Pensions, or defined-benefit plans, gave workers the peace of mind that they would have a regular income stream in retirement provided by their employers. It's a great deal for workers, but for companies, it's much easier to transfer that responsibility to the individual. Pensions have been gradually disappearing and being replaced by defined-contribution plans, where the amount to save and where to invest are left to the individual.

(1930s) **Social Security**: Social Security remains a valuable source of retirement income, especially if you have the wherewithal to delay your benefits until age 70. But for most people, Social Security will only replace a percentage of their salary in retirement, so they still need some supplemental savings to cover the rest, plus other goals like leaving money behind for heirs.

(1980s) **Defined-Contribution Plans**: DC plans were born out of corporations' desire to no longer provide pension benefits. Although they don't offer the same security as a pension plan, DC plan features, like auto-enrollment and auto-escalation, help investors along the way to retirement. For many, their investments in DC plans are their entire retirement savings.

(2000s) **Target-Date Strategies**: Target-date strategies aren't specifically designed to deliver income in retirement, but they are the most popular default investment option in DC plans. These strategies offer a hands-off solution for investors that automatically allocates contributions to a diversified portfolio of

4 Astute readers will note most people didn't live long enough to worry about retirement income until recently.

stocks and bonds. The allocation is aggressive but gradually becomes more conservative as it nears the retirement date, and some continue to lower the percentage of equities for longer.

(2020s) **Target Dates With Annuities?** The passage of the Secure Act in 2019 reduced the fiduciary liabilities for a DC plan sponsor that offers annuities for its participants. This opened the door to the dozen or so target-date series with an annuity component that have launched since. It’s too early to tell if these strategies truly offer an evolution for retirement income or are as fleeting as the benefits of eating ice cream for every meal.

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