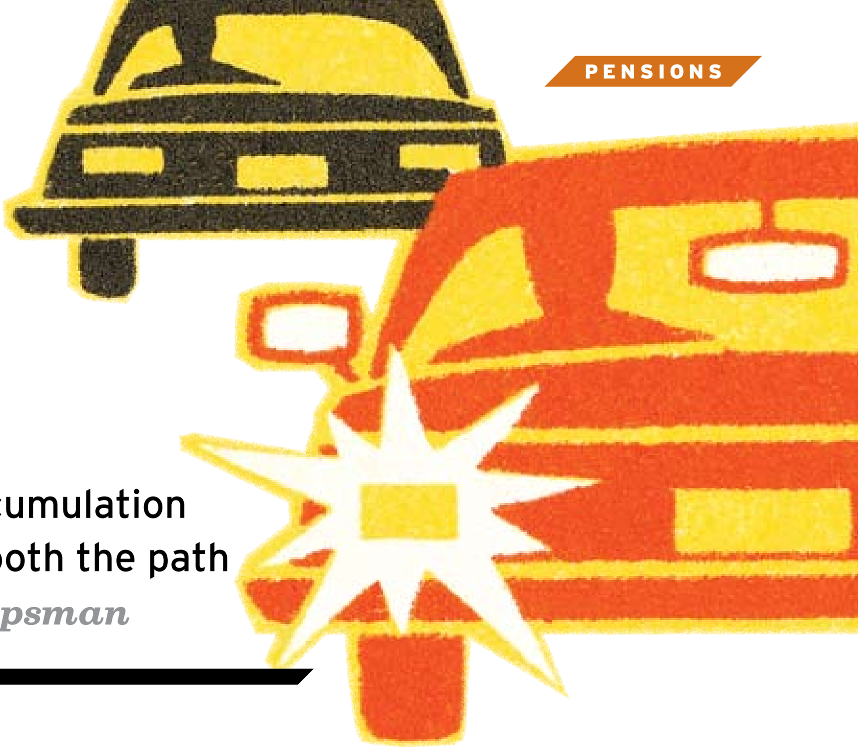

Target date funds that link accumulation and de-accumulation help smooth the path for plan members *By Colin Ripsman*

A well-structured DC plan helps members to build savings during their working (accumulation) years and generate sufficient income for their retirement (de-accumulation) years. For plan sponsors, the challenge lies in structuring investment offerings that support members well through both the accumulation and de-accumulation phases. In practice, most DC plans focus more on the accumulation phase and largely ignore the retirement income needs of the member.

DC investment lineups generally suffer from the same deficiency, but well-designed target date funds (TDFs) can help address this issue. TDFs consist of a series of balanced funds that use a dynamic asset mix path (a glide path) designed to provide members with an optimal asset mix at each stage of their career. The proportion of each fund that is invested in equities reduces as the target retirement date approaches.

TDFs represent a huge advancement for the accumulation phase of DC plans: they make it simple for DC members—many of whom are not comfortable making investment decisions—to implement and maintain a prudent asset mix over the course of their working career. However, many TDFs largely ignore the income needs of members in retirement.

As TDFs continue to gain popularity in DC plans, these funds will evolve to better meet the lifetime needs of DC investors in two primary ways: improved glide paths and greater focus on income.

Improved Glide Paths

Extended glide paths TDFs that focus primarily on maximizing accumulations over the employment years use an asset mix glide path that ends at the fund's targeted retirement date or soon thereafter. These types of glide paths are known as *to retirement* glide paths.

In reality, many investors will live well beyond their retirement date and will continue to invest their DC assets and draw income after that date. The truncated time horizon of these TDFs leaves DC investors with an asset mix strategy that is considerably more conservative than what might be optimal, given that their actual investment time horizon could extend more than 30 years beyond the retirement date.

More sophisticated target date products now recognize the importance of a glide path that optimizes the asset mix over the course of the investor's expected lifetime. These TDFs are referred to as *through retirement* funds.

This lifetime focus does not lock the DC member into the TDF investment options. As with other funds offered by DC plans, investors may withdraw their plan assets upon retirement or termination and invest them in a similar strategy outside of the program. However, the objectives and time horizon of the investor should remain consistent both within and outside of the plan.

More effective de-risking Similarly, the approach that many TDFs take to de-risking incorporates a clear accumulation bias. As the investor ages, a TDF glide path will reallocate assets *away from* equities—which have historically been more volatile—*into* fixed income assets that have historically been more conservative (e.g., shorter-duration nominal bonds and cash).

As the member approaches retirement, this type of strategy will reduce the volatility of the lump sum accumulated in the fund. This would be appropriate if the member were looking to withdraw the lump sum at retirement and use it to fund a lump sum purchase, such as buying a cottage. In practice, however, most members will remain invested into retirement, either in the plan or on their own, and will look to draw regular income from their DC savings over time.

A de-risking approach that accommodates both the accumulation and de-accumulation periods involves shifting assets into a portfolio that moves in lockstep with the cost of the future income that the member will need. The goal should be to move the assets into a fixed income portfolio that matches the duration and term structure of the income stream required by the investor into retirement. Even near retirement, the duration of this liability will result in a longer-duration bond portfolio. If long-term interest rates decrease significantly, the cost of funding the regular income will increase significantly, even though the lump sum remains stable.

This is the same liability driven investing (LDI) approach taken by many DB plans to match the duration of the assets and liabilities to reduce the fluctuation in the cost of the necessary income stream. Cash represents a significant duration

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THIS WAY TO RETIREMENT

Urban Systems' holistic retirement planning workshops put employees in the driver's seat

By Jill Hilderman

Until April 2011, Chris Town, 56, didn't think a lot about retirement. He and his wife, Susan, 61, felt they had their financial house in order, including a professionally developed financial plan. But they hadn't consciously discussed their visions of what their lives would look like.

Fast-forward to June, and Chris and Susan now have a far more comprehensive view of the transition from primary work life to what comes next. The catalyst was their participation in a two-and-a-half-day retirement planning workshop in May sponsored by Chris's employer, Urban Systems, where he works as a senior environmental engineer and partner.

The workshop was offered through the company's University of Urban Systems (U of U), an in-house initiative started in 2004 to provide employees with coaching and learning opportunities to foster career development and help people to understand and implement the company's core strategies. Urban recognizes that its commitment to career transitions extends to ensuring that employees are well prepared for the transition to retirement.

"We want to be sure our older employees have the opportunity to look at the broader picture for their life after full-time work and put together a solid plan for that transition," says Joel Short, senior planner and U of U leader at Urban. "So, for the last three years, we have offered the Charting Your Path to Retirement workshop to employees age 50-plus, together with their life partner."

The workshop features seven distinct presenters during 18 hours of interactive

mismatch—which, in an LDI framework, makes it quite risky. However, most TDFs make the same mistake that DB plans have made in the past: holding fixed income assets with a shorter duration than the duration of the stream of payments.

If the investor's objective is to generate a nominal income stream, long nominal bonds are an option. If the objective is to support a standard of living in retirement that keeps up with inflation, an allocation to long real return bonds can be used in the de-risking process.

Focus on Income

The next stage in the evolution of TDFs is to combine them with optional payout vehicles that enable DC plan members to customize an income stream in retirement to meet their own specific requirements. TDFs should also allow some degree of flexibility during the accumulation stage so that investors may modify their future income stream if circumstances change.

Currently, DC members are forced to manage their withdrawals on an ad hoc basis to support their retirement income needs. If they are too aggressive with their withdrawals, they may run out of money. But if they are too cautious, their standard of living may suffer unnecessarily.

The following income features could be offered in conjunction with a TDF to accommodate cash flows in the accumulation period. These could be embedded as options within the TDF or offered outside as a complement to the TDF by the recordkeeper.

SWPs A systematic withdrawal plan (SWP) will allow the TDF glide path to continue to manage the asset mix while enabling the DC member to elect to withdraw income on a regular monthly basis. The SWP can be structured as a fixed-dollar withdrawal from the TDF or as a fixed percentage of the member's invested assets.

The SWP structure will continue to expose the investor to some level of investment risk. In the case of a fixed-dollar withdrawal, the payments will continue until the assets are fully depleted, the timing of which will vary depending on investment performance. In the case of a fixed-percentage withdrawal, the amount of the withdrawal will vary based

sessions, in which the couples receive practical information and insight to help them plan for the next stage of life. Part of the learning is informing participants how they can maximize employee benefits, including pension plans, healthcare and supplemental offerings.

"This can be an eye-opener for employees and particularly their partners," says Sally Hass, past benefits education manager for Weyerhaeuser Company and workshop developer and co-facilitator. "Some benefits either are not known about or are not being maximized, and there's an opportunity to discuss all that the company provides—including the up to 4% matching of RRSP contributions. Plus, we explore the Canada Pension Plan and Old Age Security, all in relationship to what is available now and what can be accessed later as part of a full financial picture."

In addition to considering financial plans, estate plans and personal directives, the workshop identifies three stages of retirement and how to transition from one to the next:

1. **active stage** - when you may be travelling or starting a new business, for example;
2. **middle stage** - when you are doing less physically and mentally but have different needs from retirement, including income, caregiving or support services; and
3. **later stage** - when you may be in residential care.

"The life-planning sessions encourage participants to explore their unique talents and strengths and align these with their values. It's a time to explore their purpose—where they want to be and what they want to be doing [in] post-work life," says Nigel Brown, life coach and transitions facilitator and co-facilitator of the workshop.

Understanding essential physical and mental well-being in retirement is also part of the package. Expert presenters address aging issues and the new science in brain and body health and nutrition for optimal aging.

Chris says that by the end of the sessions, he had the tools to create a multi-faceted plan for retirement that meets his and Susan's goals.

"I have started to think about phasing out of work. I expect that change to occur on investment performance. However, the TDF's glide path will help to control the investment risk.

Immediate annuities An annuity purchase allows a plan member to take a portion of the balance accumulated in the TDF and convert it to a guaranteed regular lifetime income, ensuring income certainty.

Annuity pricing is tied to long bond yields. Accordingly, in low interest rate environments such as the current one, annuities can be quite expensive. However, the ability to use a portion of the TDF balance at retirement to provide an income floor could be quite attractive to risk-averse DC members.

Annuities would be particularly appealing in conjunction with a TDF in a DC plan if they could leverage preferred group annuity pricing. Additionally, where the TDF is structured with a de-accumulation focus, the fixed income strategies used by the investment manager to de-risk during the accumulation stage will reduce the volatility of the cost of purchasing that annuity at retirement.

GMWBs A guaranteed minimum withdrawal benefit (GMWB), also

for me within four years; now I'm training a younger engineer to take my place," he says. "The biggest learning for me through the workshop was realizing that you need a purpose and meaning in your retirement…I need to have some activities in my retirement that are going to contribute to society. My field is water and waste water management, and there's a demand for that in the Third World."

Susan began to reduce her workload and has now transitioned her role as a medical office assistant to two days a week. "Now we're really looking at what's important to each of us," she says. "I used to approach thoughts of retirement with fear and trembling. As a result of the weekend, I know I can look forward to it; it's now a positive, cup half-full picture."

For Urban Systems, the program offers numerous benefits. Employees are more aware of the diverse considerations of planning for retirement. They have tangible tools and information that increase their ability, confidence and motivation to take charge and plan for the future, and they gain enhanced clarity around the duration of their careers and Urban's commitment to them. The social opportunities stimulate conversations around future planning, including thoughts about how to leave a workplace legacy of expertise.

And the learning doesn't end with the workshop: employees are offered follow-up coaching from the program facilitators and can join an informal network of program alumni who get together to discuss how their retirement planning is progressing.

Urban is also exploring the possibility of extending some company benefits to retired employees.

"This type of education and discovery reduces pre-retirement anxiety in our employees and gives them more certainty in their current work and for their future," says Short. "It's also a tangible demonstration to our younger employees of Urban's commitment to long-term employees and our hope for everyone to have successful transitions throughout work and life."

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Many TDFs largely ignore the income needs of members in retirement

referred to as a variable annuity, is an insurance contract that provides a guaranteed minimum income stream from an underlying investment fund. The income stream is a percentage of the underlying investment balance (the "benefit base") at the time of retirement. The benefit base at the retirement date will grow with strong investment experience in the underlying investments. At the same time, the GMWB wrapper ensures that the benefit base will not fall, regardless of poor market performance.

The issuer of the GMWB will charge a fee for this guarantee on top of the investment management fee on the underlying asset portfolio, calculated as a percentage of the underlying asset portfolio. The GMWB may incorporate other guarantee options or features, such as a principal guarantee or minimum death benefits.

The extreme equity market volatility over the last several years has created more interest in GMWBs. At the same time, it has caused issuing companies to adjust pricing and limit equity exposure. Given the lower equity weightings in a typical TDF in the de-accumulation phase, GMWBs would be an ideal structure to offer as an optional complement to a TDF, allowing risk-averse members to maintain a degree of equity market exposure into retirement.

Deferred annuities Deferred annuities are lifetime annuities purchased prior to their commencement (or during the accumulation phase of a TDF). Instead of shifting assets from equities into a portfolio designed to mirror the duration and term structure of the income that the member is hoping to purchase in retirement, the TDF can actually pre-purchase this income using deferred annuities.

The purchase of deferred annuities by a TDF will limit potential mismatch risk between the bond portfolio and the liabilities. At the same time, by purchasing deferred annuities over time, the TDF would greatly reduce the timing risk associated with the purchase of an immediate annuity at retirement.

While this structure has been successfully incorporated in the U.S., there are challenges to implementing this strategy in Canada, including a limited market for deferred annuities; the need to group annuitants in age groupings around the target date (since investors of various ages will invest in any given TDF); the ability to cash the deferred annuities (to provide investors with liquidity and avoid restricting withdrawals prior to retirement); and the potentially high pricing structure for a flexible deferred annuity product of this nature, which could offset much of the benefit to DC investors.

For DC plan members, the transition to retirement is a tumultuous process, requiring a move from a plan and investment structure built with an accumulation focus to one focused on the need for retirement income. By designing smarter TDFs, focused on providing lifetime solutions through enhanced glide paths and flexible income options, managers and sponsors could better maximize the benefits these plans offer. BC

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