INFLATION'S LONG SHADOW

INFLATION SPIKE SPURS INTEREST IN, CONCERNS ABOUT, RETIREMENT INCOME

BY JUDY WARD

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"FOR PRE-RETIREES, INFLATION HAS PUT A QUESTION MARK AROUND, 'WHAT DOES MY RETIREMENT LOOK LIKE?'" SAYS JEFF CIMINI, SENIOR VICE PRESIDENT, RETIREMENT PRODUCT MANAGEMENT AT NEW YORK-BASED VOYA FINANCIAL. "WE'RE HEARING FROM BOTH PLAN SPONSORS AND PARTICIPANTS HOW IMPORTANT IT IS TO HAVE A PLAN AS A PARTICIPANT APPROACHES RETIREMENT, AND THAT PARTICIPANTS ARE ASKING FOR ASSISTANCE FROM THEIR EMPLOYER."

Two additional factors make now an even more complicated time to think about retirement-income planning, Cimini believes. The pandemic and health concerns have led some Americans to think about retiring earlier than they planned, and market volatility has heightened many pre-retirees' nervousness about a potential shortfall in their retirement income. "Pre-pandemic, these things were muted: We had reasonably steady capital markets, and low inflation," he adds.

Wylie Tollette, San Mateo, California-based executive vice president, client investment solutions at Franklin Templeton, understands why people near retirement are concerned. "Honestly, there's good reason to be worried, as inflation stays higher for longer than virtually anyone anticipated," he says. "Now, folks are worried that it will 'settle down' at a level higher than they anticipated. Even if long-term inflation runs 1% higher than someone planned for, that extra 1% can really make a difference for a retiree."

PRIORITIZING RISKS AMID LIMITED CHOICES

Overall, 73% of Baby Boomers say they're worried that they might not be able to afford the lifestyle they want in retirement because of the increased cost of living, according to the "2022 2Q Quarterly Market Perceptions Study" from Allianz Life Insurance Company of North America. And 60% of respondents from all generations say they think it's important to have some retirement savings protected from loss.

No matter the timing, those nearing or entering retirement have limited choices if they're worried that they don't have enough to fund their retirement. They can try to save more, work longer, or hope to boost their investment returns by taking more market risk—or they can cut their spending in retirement. However, the current economic and market dynamics make all four of these options especially complicated decisions now.

"The people approaching retirement are the ones who have the least amount of time to adjust for these spikes in inflation and dips in the market," says Kelly LaVigne, vice president of advanced markets and solutions at Minneapolis-based Allianz Life. "And the first years of your retirement are supposed to be the fun years: They call it the 'go-go' years. This is when you start checking off all the items on your bucket list, and spending in retirement is at its highest. That's why it's so difficult to have the decline in market returns, in addition to the inflation."

LaVigne calls the 10-year period running from five years before someone retires to five years after someone retires "the fragile decade," from a planning perspective. So for people in this timing range, the addition of surging inflation as a factor is a big concern. "Inflation risk is really top of mind, because let's face it: We haven't seen numbers like this in 40 years," he says. "Even if inflation runs at a 3% average, your cost of living would double in 24 years."

And often, few of the levers to boost retirement income are actually available to pull once someone gets to the point of retirement, Cimini says. "As long as you're not near retirement, all the levers—working longer, being different with your investment approach, saving more—are levers you can pull to help yourself. But generally speaking, once you enter retirement, all those things are really a challenge (which may leave only budget-cutting). So I think that folks are becoming more aware of the risks they can encounter once they enter retirement."

Christopher Nikolich, head of glide path strategies (U.S.) for multi-asset solutions at Nashville, Tennessee-based AllianceBernstein, agrees that people have limited options for dealing with inflation and economic uncertainty as they near retirement. "Of the levers, there are only two that people can pull as they approach retirement: They can work longer, or they can spend less in retirement," he says. "There's the notion of saving more for retirement, but by the time you are getting ready to retire, it's too late. And you can't suddenly, immediately preceding your retirement, use a more aggressive asset allocation to get you to a better place. You've waited too long to do that, and you'd create a downside risk that isn't managed."

A lot of people probably are going to try to work a few more years, which is a good choice for those who have the option, Tollette says. "Even a couple of years can make a real difference," he says, "because that increases the retirement 'pot' people will have once they do retire, and it shrinks the number of years that they need to use that pot of money."

People nearing or entering retirement face multiple risks, including not just inflation risk but others such as market risk and longevity risk. They need to decide how to balance the different risks, based on that individual's situation, risk tolerance, and goals.

"Inflation is at the forefront of everyone's mind now, particularly those people who are near retirement," says Jeremy Stempien, principal, portfolio manager, and strategist at Newark, New Jersey-based PGIM DC Solutions. "Inflation can force people to withdraw more of their savings than they expected, to pay for their expenses in retirement. Withdrawing more than they planned early in retirement can really impact the growth potential for someone's portfolio, and the ability to provide income later in life for that person."

But people shouldn't lose sight of other risks such as market risk, Stempien continues. "When we think about risks

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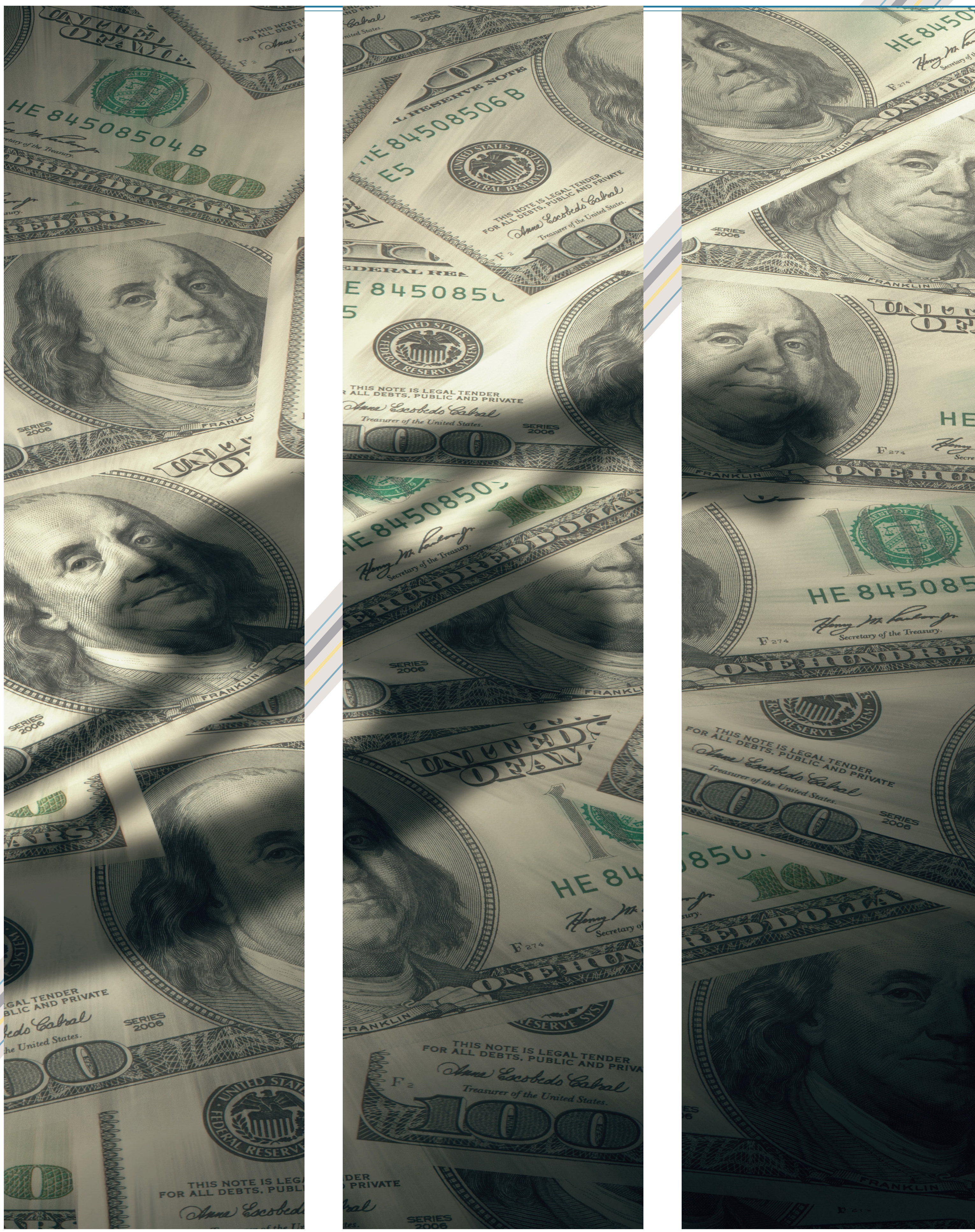

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for all individuals, how you should prioritize those risks changes over time," he says. "For somebody who is 60 years old, they may have 30 years of retirement ahead of them, so inflation risk is important. Somebody who is 70 or 75 years old probably has 20 years or less when he or she will need sustainable income." So inflation risk may be less of a factor for that person than longevity risk and market risk.

While market risk also is a significant factor now, Nikolich says that people should think of it as a two-sided factor. "You want to alleviate the impact of a downturn in equity markets as best you can. But if all you focus on is minimizing the short-term market risk (by investing very conservatively), that leaves you with a substantial long-term risk of your account value not growing enough by the time you retire. You're trading one risk for another, because there is a long-term opportunity cost to investing overly conservatively. You have to think about both sides."

Many pre-retirees worried about market risk may not understand that equities generally have been the best hedge against inflation over time, says Rob Stevens, a financial planning strategist at New York-based TIAA. Asked how he'd talk to a nervous pre-retiree about maintaining a significant exposure to market risk, he says, "It's about having a balanced approach and saying to a pre-retiree, 'You're facing a number of risks, and some of them are on the opposite ends of the barbell. If someone puts too much of their account into cash and fixed income, it will help with market risk, but hurt with inflation risk.'"

A RETIREMENT INCOME PLAN

Once pre-retirees understand their big-picture options for dealing with a projected retirement income shortfall and their preferences for balancing inflation risk and other risks, they need a written retirement income plan. "Not enough individuals have an actual written plan for their retirement. Some surveys have found that only about 10% of current retirees have a written plan," LaVigne says. "If someone is 50 years old or older, that's the time to start putting this plan in place. Many people have just created a plan in their head, or they went online and used a calculator tool, and they say, 'It says I'm going to be okay,' because they fudged some of the inputs."

Especially in a time of high inflation, people approaching retirement need to think about their budget in terms of what expenses they will *need* to pay—such as their mortgage and utility bills—versus what they *want* to spend money on in retirement, Stempien suggests. "There's a myriad of decisions that people need to think about," he says. "How often do they plan to go on vacation? How often do they want to go out to dinner? How nice of a car do they want to drive?"

It's become more important to not just set a retirement budget, but also to identify the steady or guaranteed income sources someone will use to pay living expenses in retirement. Pinpointing sources of guaranteed or steady income versus variable income in retirement "is really the key" to a sustainable plan, LaVigne says. "Having a plan where you've tracked all your expenses and matched them to your income sources is better than just saying, 'I need 75% of my pre-retirement income,'" he says.

Most participants who only have a defined contribution plan just know what their balance is, Cimini thinks. "They don't know how to convert that into a monthly income stream in retirement," he says. "The next step after setting a budget is to help a participant look at their sources of income. One perspective is that you need to cover all your fixed expenses with guaranteed income, such as Social Security and a defined benefit plan, and you buy a guaranteed income product to cover the 'gap,' if there is one." With that approach, a retiree would use withdrawals from their retirement savings accounts to cover discretionary expenses.

Many pre-retirees may have heard about "the 4% rule" for retirement withdrawals, and believe they're safe to take at least that much out of their account annually. "The 4% rule is not a bad starting point, but that's what it is—a starting point," Stempien says. "Some people took it too far in recent years, and made it a 'rule of thumb.' The more customization that goes into deciding on someone's withdrawal rate, the better,

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and the customization that's needed is really based on someone's expenses."

With inflation causing many everyday costs like groceries and gas to rise, pre-retirees need to evaluate whether it's worth keeping up their current discretionary spending, such as a gym membership, multiple streaming services, and getting a cell phone provider's highest-cost plan, Stevens says. "There's a conversion of mindset that needs to happen, to look more at income choices in retirement," he says. TIAA suggests that pre-retirees think of a diversified lifetime-income plan that identifies "buckets" to pull from for income in retirement. Essentially, TIAA suggests that a retiree use the steady income from Social Security and annuities to cover living expenses, creating a guaranteed income floor that's protected from market volatility. Withdrawals from a participant's retirement account would cover additional, discretionary expenses.

MAKING INVESTMENT AND LIFETIME INCOME CHOICES

Tollette has a background in defined benefit plan management, including serving as chief operating investment officer at the California Public Employees' Retirement System (CalPERS). Pension plan managers have learned lessons about hedging against inflation risk that can apply to defined contribution plan participants seeking to protect their portfolio and retirement-spending ability, he thinks. "The best time to prepare your portfolio for inflation is before it arrives: to buy the fire insurance before the fire arrives," he says. "But it's not too late to do anything."

One lesson to learn: Defined benefit plan investment managers utilizing a liability-driven investing (LDI) strategy typically maintain a significant exposure to equities. "Stocks are a very poor short-term hedge against inflation, but a pretty good medium-term and longer-term hedge against inflation," Tollette says. "So potentially, retirees with a defined contribution plan account will need to get more comfortable with having a little more equity in their portfolio." Participants nearing retirement also may want to learn from the pension world by increasing their allocation to inflation-protected bonds such as TIPS (Treasury Inflation Protected Securities) and reducing their allocation to conventional bonds.

"Lastly, people near retirement may want to add some real-asset exposure," Tollette says. "Well-selected real assets, such as private real estate, provide income that's indirectly indexed to inflation." When inflation runs higher, owners of apartment buildings and commercial spaces tend to raise rents, increasing their revenues. "At CalPERS, we had extensive direct holdings in real estate," he says. "And increasingly, vehicles are coming to market that allow (average) investors to invest in direct holdings."

Pre-retirees planning for their retirement income also may be helped by utilizing a lifetime income product, although they remain a relative rarity among defined contribution plans. AllianceBernstein's Nikolich thinks that outcomes-focused sponsors will need to reevaluate their decision. "If you're a plan sponsor and your goal is to have a large majority of your participants have sustainable income for life, you have to embed it into the default investment," he says. "If you don't, typically the participant take-up rate on a lifetime income solution will be in the low single digits. And the people who need the help the most, who are not confident about making investment decisions themselves, tend to keep their assets in the default investment."

Utilizing a default investment that has a lifetime income solution embedded would, of course, require a plan sponsor to feel comfortable with the higher QDIA fee that it inherently brings, and to consider the additional benefits. "The notion of what sponsors should be looking at has to go beyond only looking at fees," Nikolich responds. "I feel like the pendulum has started to swing back from where it has been for much of the past decade. The simplest option—just offering cheap passive funds—is not always the best one. The good news about making a lifetime income solution part of the default is that it puts participants back to where they were a couple of generations ago, when people had a pension plan. As an industry, we've used the default strategy to fix everything else. Now,

ROB STEVENS
TIAA

ROBERT CAPONE
LGIM AMERICA

MICHAEL BARRY
O3 PLAN ADVISORY SERVICES LLC

by incorporating a well-thought-out retirement income solution, that means that participants will have income for life, and they don't have to make decisions that they are ill-equipped to make."

Defined contribution plans need to evolve to include a sustainable and steady income in retirement, believes Robert Capone, Boston-based head of defined contribution at LGIM America. But one solution doesn't fit every participant, he says, so he believes that investment managers need to personalize some aspects of these products to incorporate an individual's preferences. "We think there are four key risks when someone is taking out retirement income, and any viable solution has to address those as best it can," he says. They include:

- investment risk and the need to be well-diversified;
- longevity risk;
- liquidity risk ("We believe strongly that participants want control and access to their wealth in retirement, with no restrictions," he says); and
- utilization risk ("The solution needs to be easy to understand and easy to use—otherwise, it becomes a lost cause," he says).

Retirement income solutions need to have a balance between the stability of income and the simplicity of the income solution, Capone says, "and participants have to understand that tradeoff between stability and simplicity." If a retiring participant wants to maximize simplicity, that could mean taking a set amount annually out of his or her target date fund—a simple solution, but one that leaves that person's assets highly vulnerable to market volatility. On the other end of the spectrum, a participant who wants to maximize stability can purchase an annuity that provides guaranteed monthly income. "But the tradeoff is that annuities are typically complex for participants to understand, and to administer with recordkeepers," he says. "They're also generally expensive and illiquid."

Michael Barry, a Chicago-based senior consultant at October Three and president of O3 Plan Advisory Services LLC, thinks that more work needs to be done on developing lifetime-income products that address the "point in time" risk for people buying one. By "point in time" risk, he means the risk of unexpected future inflation.

Someone can factor expected future inflation into the purchase of an annuity, but not unexpected inflation. "Unexpected inflation, like we're going through now, creates a very specific problem for the person who is annuitizing," Barry says. "An annuity solution, while it can get rid of interest rate risk, longevity risk, and asset-performance risk, uniquely creates an inflation risk for the annuity buyer. Annuities are a 'point in time' purchase, and the risk is that an investor has to make a one-time bet about whether there is going to be unexpected inflation in the future. If there is, the annuity holder will find his or her spending power unexpectedly diminished, with no real way to make up for that discrepancy."

The way to deal with that is to allow people to "average in" their purchase of a lifetime income product over multiple years, as they often do with equities, says Barry. "Nobody has thought much about, how do we manage that 'point in time' risk for the person who is annuitizing?" he says. "Inflation comes right out of the hide of the person annuitizing. We need to think more about this risk and the people dealing with it." NNTM

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