Do Annuities And 401(k) Plans Mix?

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Once upon a time, retirees received pensions through defined benefit plans. Nowadays, instead, most employees have defined contribution plans—largely in the form of 401(k)s.

Lately, a growing number of 401(k) plans are offering annuities as an investment choice. Congress has even made overtures toward helping this trend along. Nevertheless, despite compelling arguments in favor of including annuities in these plans, some industry veterans are sounding the alarm. Wrapping an annuity inside a 401(k) could actually prove harmful, they warn.
Are they overreacting?

Income Insurance

In simple terms, annuities offer security. While some peg account values to rises and falls in the investment markets, all annuities are basically contracts with a guaranteed payout. They are more insurance products than investment vehicles.

“Annuities are technically insurance to protect against longevity risk, or the risk of running out of money,” explains Michael Guillemette, a CFP Board ambassador and assistant professor of personal financial planning at Texas Tech University in Lubbock, Texas.

For the risk-averse, Guillemette says, annuities are a great replacement for the bond portion of a portfolio. But he adds that it doesn’t work the other way around. “Bonds are not a substitute for annuities, since the former don’t mitigate longevity risk,” he says.

Taxes And Other Considerations

One key objection to placing annuities inside 401(k)s is that both are tax-advantaged instruments. Combining them is sort of redundant—that is, it provides no additional tax benefit.

Yet that argument only goes so far. “Tax deferral is not the main reason people purchase an annuity,” says Jack Dolan, a spokesperson for the American Council of Life Insurers (ACLI), a Washington, D.C.-based industry group. “They buy it for the unique insurance features.”

Those features can come in a variety of forms. “Immediate annuity options in a 401(k) plan can offer certainty of lifetime spendable income comparable to pensions previously offered by employers,” notes H. Adam Holt, a certified financial planner, chartered financial consultant and CEO of Asset-Map, a Philadelphia-based financial technology provider. “In other cases, some fixed deferred annuities can provide bond-like returns without the typical bond mutual fund principal volatility in rising rate environments.”

Too Complex For Plan Sponsors?

Given all these and other intricacies, annuities can be difficult for clients to grasp. But difficult doesn’t always mean bad.

“There is nothing wrong with including annuities as an option in a 401(k) plan,” says Scott Matheson, a managing director and defined-contribution practice leader at CAPTRUST, a fee-based advisory headquartered in Raleigh, N.C. However, he says, “plan sponsors should monitor that annuity with the same prudence and rigor that they would any plan-designated investment option—and, of course, only add it if it’s in the best interest of the participants and their beneficiaries.”

The plan sponsor would not only have to select the types of annuities to make available but also “decide if additional features or riders are needed,” says Matheson, citing the need for cost-of-living adjustments, death benefits and “joint and survivor” options that would ensure a surviving spouse receives income after the first annuitant dies.

The plan sponsor should also weigh costs. “Are you able to achieve institutional pricing?” Matheson asks. If not, annuities can be relatively expensive.

Other Disadvantages

Perhaps a greater problem is that annuities in 401(k)s are “typically not portable from one plan to another,” says Toni Brown, a San Francisco-based senior vice president of retirement strategy at the Capital Group. “This is problematic when you consider that the average wage and salary workers will have had upwards of 10 different jobs—and therefore, 10 different 401(k) plans—over their working lifetime. As a result, participants who purchase an in-plan guarantee may become tied to that specific plan for life, or may be forced to surrender and leave the guarantee behind when they move their assets outside of the plan.”

Brown says that retirees may be better served by annuities purchased outside the 401(k). “In-plan annuity offerings often provide guarantees that are less robust than those available to individual investors in the open marketplace,” she says.

Another disconnect between annuities and 401(k)s is how they’re funded. The 401(k) retirement plan is designed as an ongoing savings vehicle, whereas annuities are designed more for onetime purchases, says Spencer Betts, chief compliance officer at Bickling Financial Services in Lexington, Mass. “It is difficult,” Betts says, “for annuity companies to design a product that can handle ongoing contributions that may or may not continue long term.”

Fiduciary Responsibility

Nonetheless, if plan sponsors decide to include annuities, they should be prepared for certain challenges. “Since annuities must pay out over the lifetime of those purchasing them, it becomes a responsibility of the plan fiduciary to evaluate the financial viability of the company insuring the annuity,” says Amber Kendrick, vice president and retirement plan consultant at Procyon Partners in Shelton, Conn. “Retirement plan sponsors may be uncomfortable with assuming that kind of risk.”

Indeed, some say it’s not so much a matter of deciding whether to include annuities as picking the right ones. “Rather than asking what’s wrong with including annuities as an option within a 401(k), the question should be what kind of annuity is the right fit within a 401(k),” says Louisville, Ky.-based Craig Hawley, head of Nationwide Advisory Solutions. “There are many types of annuities that can serve different purposes during the three different stages of an investor’s financial life cycle—accumulating wealth, generating retirement income and legacy planning.”

To be sure, the current array of annuities includes countless variations. “Many of today’s annuities can be customized to your exact needs, so you pay only for features and add-on benefits that you need or are important to you,” says Cyrus Bamji, head of communications at the Alliance for Lifetime Income, a Washington, D.C.-based nonprofit dedicated to educating Americans about protecting retirement income. “This is one reason why we always recommend discussing annuities and the various add-on options with a financial advisor, and always in the context of a comprehensive retirement plan.”

Defining Goals

Dr. Steven Podnos, a certified financial planner at Wealth Care in Merritt Island, Fla. (he’s also a physician) says that using a 401(k) distribution to purchase an immediate annuity is “a fine option” for someone who is “worried about longevity risk and doesn’t need to provide for heirs.” But, he adds, “delayed annuities are generally a terrible choice due to high costs.”

That speaks to the importance of defining each client’s goals. “The individual objective is not always the most efficient use of capital,” says Philip Chao, principal and founder of Chao & Co., a wealth advisor in Vienna, Va.

For instance, clients who are primarily worried about maintaining retirement income will find annuities bring them peace of mind. For them, it scarcely matters if it’s inside or outside a retirement plan. But for those who don’t want to lock up their savings—who want “optionality,” as Chao puts it—annuities may not belong anywhere in their plan.

Deb Dupont, an associate managing director at the LIMRA Secure Retirement Institute in Windsor, Conn., takes the long view. “We can’t say there’s anything ‘wrong’ with including an option to annuitize, especially if the sponsor has done so responsibly and having exercised due diligence in the choice and it’s part of a menu of choices for the retiring participant,” she says.

To ease some of the confusion, the federal government has floated proposals to standardize reporting procedures and help employees compare annuity options, among other provisions. "Smoothing the way for annuities to be considered as distribution options from defined contribution plans—not necessarily recommendations—could be seen as leveling the playing field a bit, giving some retirees a needed safety net," says Dupont.

Dolan at the ACLI says his organization supports a measure called the Retirement Enhancement and Savings Act (RESA). "RESA will mitigate current employer regulatory roadblocks," Dolan explains. "[It] will help participants better understand their retirement savings by providing an illustration of how their savings account balance translates into monthly lifetime income in retirement."

Concern about fiduciary liability is at the center of much of the legislative debate. Future legislation, it's hoped, will define a "safe harbor" for plan sponsors—that is, it should provide detailed standards for how they should assess different annuity providers to meet their fiduciary obligations.

Some hope legislation will go even further. "It is imperative that legislative and regulatory initiatives ensure that any evaluation of a saver's preparedness for retirement includes an assessment of their guaranteed income needs," says Jamie Ohl, an executive vice president and president of retirement plan services at the Radnor, Pa.-based Lincoln Financial Group. Such consideration, Ohl points out, is in keeping with clients' best interests.

It's crucial, though, not to overreach. Doug McIntosh, vice president of investments at Prudential Retirement in Hartford, Conn., stresses that annuities already undergo a rigorous approval process by state regulators. Federal regulators shouldn't be "second-guessing state insurance departments regarding the viability or suitability of insurers or particular annuity products," he says.

Not For Everyone

Make no mistake: Annuities aren't universally popular.

Tony D'Amico, CEO and senior wealth advisor at Fidato Wealth in Middleburg Heights, Ohio, contends that annuities are "oversold completely. The biggest drawback with annuities as part of a 401(k) is that there are participants of many different ages—from just entering into the workforce to those nearing retirement."

For a 401(k) to fairly represent the interests of everyone involved, he says, there would have to be a range of annuities "designed for different ages and different time horizons."