

ANOTHER **BRIGHT PAPER™**
BROUGHT TO YOU
BY **SUN LIFE FINANCIAL**



RE-THINK YOUR CAPITAL ACCUMULATION PLAN

WHY INCOME SHOULD BE THE OUTCOME

It's inevitable that things change – even for long-term arrangements like retirement plans – and it's time that the way we think about these plans changes too.

Capital accumulations plans (CAPs) are a perfect example. When CAPs were first introduced in the 1980s, they were designed and positioned as “additional” savings vehicles – often to encourage employees to supplement the guaranteed income they could expect from government income programs and defined benefit (DB) pension plans, or as a way

for companies to encourage employees to invest in company stock. They were typically small to mid-sized, optional plans.

Fast forward to today and the role of CAPs is far more critical. As DB plans have declined in the private sector, more and more Canadians will be relying on DC pension plans and other CAPs as their number one source of retirement income, supplementing the money they receive from the Canada/Quebec Pension Plan and Old Age Security, and any other personal savings.

Life's brighter under the sun

Sun 
Life Financial

THE ISSUE? Our CAP “thinking” and resulting plan designs are based on what CAPs were decades ago, not what they are today.

Changing the focus – from account balances to retirement income

As an increasing number of Canadians rely on CAPs as a major source of retirement income, we need to change the conversation about these plans to be less about account balances and more about income replacement. There are several reasons for this:

- **People understand income:** If you're a 50-year-old plan member and you have an account balance of \$400,000, is that enough to live on during retirement starting at age 65, assuming you continue saving? It's hard to say. But if you're told that your savings and current contributions have you on track to generate between \$1,000 to \$1,400 per month of retirement income, that's useful and much easier to understand.
- **People can take action:** The beauty of DB plans is the simplicity in calculating a retirement income from the plan, typically based on earnings and years of service. A member in a plan with a 2% benefit formula knows they need to work 30 years to have a pension that replaces 60% of their working income. It provides an action strategy based on a desired target income for the plan members. Likewise, providing income projections or personalized messaging that shows a plan member how an increase in contributions translates into higher retirement income provides the plan member with a clear action plan to reach their targeted income goal.
- **Consistency:** Shifting the focus of CAPs to income puts these programs on a similar footing as all other income focused retirement programs – whether the Canada/Quebec Pension Plan, Old Age Security and DB plans. This enables plan members to see a more holistic picture, understand whether they are on track and what actions they may need to take that are within their control.

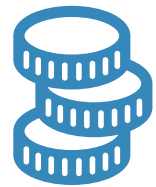


- **Simplicity leads to better outcomes:** An account balance approach is about the investing process – stocks, bonds, benchmarks, and investing for growth. It can be complicated and hard to understand for many members. And there's plenty of evidence to show that complexity leads to member inertia, rather than increased engagement. On the other hand, an auto-investment solution, combined with clear, guided messages that focus on a member's targeted income goal and action steps to help achieve it, may ultimately result in more saving in the workplace and higher income replacement rates for employees.

Rethinking plan outcomes – the focus on income

If a DC pension plan (or other CAP) is expected to play the same role in retirement that DB plans played for former generations of workers, we need to broaden and realign the traditional plan measurement metrics to include income-oriented measures.

In a series of plan sponsor focus groups conducted by Sun Life Financial in 2016, nearly all acknowledged that retirement savings (and aligning to a set financial budget), rather than retirement income (and aligning to a targeted income goal), is still the primary focus of their CAP. However, the same plan sponsors acknowledged that retirement income should really be the focus.



For retirement income to become the main goal for CAP members, plan sponsors need to create a culture that focuses on this key outcome. Here are a few strategies that can help:


- **Educate about income:** Introducing an educational program that puts a member's retirement income goal front and centre – and extends beyond investment-focused topics – can be an important step in highlighting the need for employees to think about their plan assets and what they expect them to generate as monthly income during retirement.
- **Convert balances to income:** Communicating CAP balances as estimated retirement income can be an effective method to begin to change plan members' mindsets about the main purpose of their retirement plan.
- **Explain the risks:** A retirement income education program should also include information about retirement income-related issues (such as longevity risk – see below), how to create retirement income, the pros and cons of annuities vs systematic withdrawal solutions, and the pros and cons around when to begin government retirement or age-related income benefits.

Retirement income risks: avoiding the triple play

Reframing your CAP as a retirement income plan is the first step to helping plan members understand the actions they need to take to improve their retirement readiness.

It's important to keep in mind that at retirement, as plan members put a retirement income plan in place, they need to be aware of the “triple play” of retirement income risks that could partially derail their retirement income security. Any one, two or three of these risks could negatively impact a plan member:

Market risk, Inflation risk or Longevity risk.



HERE'S A CLOSER LOOK AT EACH

MARKET RISK

For plan members with sizable equity and bond market investments, a market downturn just prior to or in the early years of retirement, can be devastating to their portfolios and their potential income.

In the table below, each scenario has average annual returns of 7% over three years. But poor returns at the beginning of retirement can have a significant impact on the rate at which savings are depleted.

FIG. 1 PORTFOLIO INVESTMENT SCENARIOS

RATE OF RETURN			Age when money is depleted	# of months money lasts from baseline
Year 1	Year 2	Year 3		
+7%	+7%	+7%	86.5	Baseline (0)
+7%	-13%	+27%	83.3	38 months less
-13%	+7%	+27%	81.1	65 months less
+27%	+7%	-13%	94.9	101 months more

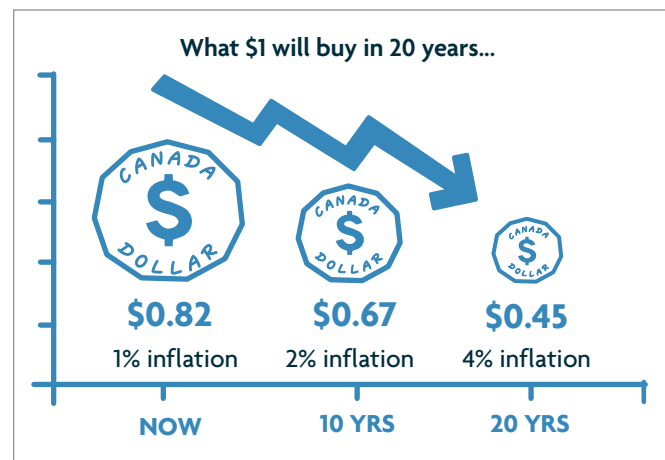
Note: Assumes \$100,000 portfolio with monthly withdrawals of \$750 beginning at age 65. Source: Milevsky & Salisbury, September 2006.

INFLATION RISK

Inflation rates are currently low at about 2%, but even these low rates can have a devastating effect on retirement assets. At 2% inflation, the purchasing power of a dollar is reduced by over 30% after 20 years. At 4% inflation (which is the average inflation rate over the past 50 years) a plan member's buying power is reduced by almost 55% after 20 years.

With so many Canadians living 20 to 30 years or more in retirement, **inflation will have a dramatic impact** on their spending power during this time period.

FIG. 2 EROSION OF PURCHASING POWER



LONGEVITY RISK

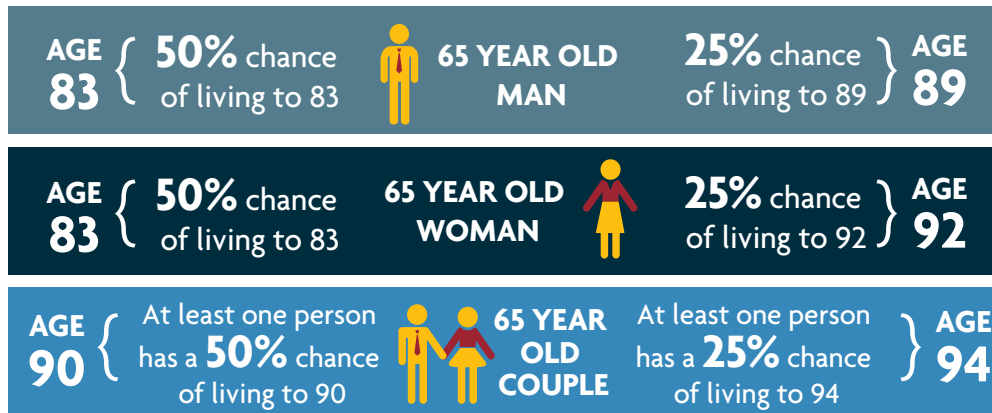
Here's the issue with longevity: individuals who spend their retirement assets based on their life expectancy could run out of savings if they live longer than expected. And by the law of mathematics, half of the population will live longer than average.

To put it in perspective, let's say you're one of 10 high school friends who all just turned 65. If this is an average group, the first of the 10 friends could live for five years to age 70, and the last for 35 years to age 100. One person needs to save for five years of retirement spending, the other for 35 years. The problem is you don't know who is who. And that's what the risk of outliving your assets is all about.¹

If you “guess” that you'll be the one to die at age 70, the risk of getting this wrong is significant. So, plan members need to build a buffer (such as a guaranteed income product) against a longer than expected lifespan. The graphic below (Fig. 3) illustrates why this buffer is so important.

¹ Thanks to Allianz U.S. for this approach to describe life expectancy

FIG. 3 PROJECTION ON LIFE EXPECTANCY



Source: Canadian Institute of Actuaries, UP-94 projected to 2015 (based on Canadian population assumes age 65 reached)

Plan sponsors have many obligations vis-à-vis plan members, including communicating (as retirement approaches) about the risks plan members may face after they leave the plan, and the types of strategies that can help manage these risks, such as guaranteed income products to offset longevity risk, diversification to guard against market risk, and growth investments to hedge inflation.

Expecting plan members to understand these risks may be a monumental task. Greater success may be achieved by addressing these risks within packaged or “do it for me” type of solutions.

There are new choices available

If the role of your DC pension plan or other CAP extends beyond supplemental savings – and is a key part of your workforce management program to help employees retire on time – it’s time to provide your plan members with the income-focused support they need.



Now is the time to work with your provider to explore the different ways you can “make income the outcome.” There are smart defaults that can nudge plan members to higher savings rates and ensure they’re taking full advantage of your workplace plan. Targeted education can increase employee understanding of their needs for income – and the new risks they will face as they approach retirement.

There are also innovative new approaches to plan design that personalize income targets and asset allocation to the plan member’s situation, factoring in elements such as retirement date, current contribution rate, and other sources of retirement income.

INTEREST RATE RISK

For plan members looking for sustainable income in retirement, there’s another risk that can negatively impact income levels – *interest rate risk*.

Here’s an example.

Let’s say a plan member decides to retire, and they want to allocate a portion of their retirement plan assets

(\$200,000) to secure guaranteed investments that pay a 3% return. This will provide a guaranteed annual income stream of \$6,000.

However, the plan member is persuaded by management to delay retirement and work for one more year. During the year, the plan member continues to save, and increases the amount they can allocate to guaranteed investments to \$210,000. The bad news is that interest rates have declined during the year, and guaranteed investments now pay only 2%. Even though the plan member has \$10,000 more in capital to invest, their guaranteed annual income stream has been reduced to \$4,200.

The movement in interest rates can also impact other income producing assets that plan members might own. For example, bond values decline as interest rates rise, and the cost of an annuity rises as interest rates decline. These are all risks that plan members face in building a sustainable income stream for retirement.

Income should be the outcome for any CAP-based retirement program and the possibilities are there to make it happen for your plan.

