AllianceBernstein

Lessons from United Technologies Corporation

United Technologies Corporation (UTC) recently became the first company to partner with AllianceBernstein on a secure lifetime income default option within their defined contribution (DC) plan. Lifetime Income Strategy (LIS) combines the simplicity of a target-date fund with the security of lifetime income, guaranteed by multiple insurance companies.[1]

LIS preserves the key DC features of flexibility and control while providing what most employees want from their plans: secure retirement income. It's also an individualized, next-generation target-date portfolio, because each participant's portfolio is based on his or her birth date. LIS is designed to protect participants from the risk of outliving their money and the impact of market volatility on retirement income while providing the opportunity for growth.

Kevin Hanney, Director of Portfolio Investments for UTC's DC plan, talks with AllianceBernstein.

AllianceBernstein: Kevin, let's start with probably the single most important question—why did UTC decide to go where no other large DC plan had gone before?

Kevin Hanney: This is our company's retirement plan for the 21st century and beyond. Since we've closed our defined benefit (DB) plan, we wanted our DC plan to function like a pension plan. And in order to do that, we had to redesign it so that income was a fundamental part of that design.

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AllianceBernstein: I hear so many sponsors say that they've had a DC plan for years but never really thought about its goals or objectives. That seemed to be a critical aspect of what you were doing.

Hanney: Many plan sponsors put a lot of work into developing an investment policy statement, and then it goes into a drawer and stays there—people don't continually refer to it. We did something a bit broader and, ironically, the first step was to establish what our plan's objectives were.

We had to get back to basic principles and determine why we were offering this. The benefits group, treasury, investments and legal sat down over a series of meetings and came up with three simple principles that informed the entire design process: Keep it simple. Make it even lower-cost than before. And keep it flexible. Not only do we want people to have the opportunity to save and invest for retirement; we want them to be confident that they'll have adequate income in retirement.

That was a very meaningful shift in framing from the savings-and-investments framework, which is very inefficient. Most people in plans don't want to be investors—they'd rather just be wives and husbands and mothers and fathers, work their job and go home and do what they love to do in their off time. So, turning this into a retirement plan with income as an explicit objective was very important to us.

AllianceBernstein: So why does UTC offer a DC plan?

Hanney: It's simple: it makes our business better. There really is an interest for the plan sponsor and shareholder to make sure the retirement benefit offering from UTC is as strong as it can be for our employees, because ultimately we not only want to retain our existing talent; we also want to make it possible to attract and retain new talent. That requires a very smooth and measured transition from employment to retirement to open up that chair for the next person in line.

AllianceBernstein: It sounds like income was always critical. How would you describe the role of income, specifically inside your DC plan?

Hanney: It's about security and certainty. DC plans, as we know them, are designed around choice, and choice can be a really good thing. However, choice without any certainty or security leaves participants wanting. So we wanted to design an option that was going to preserve freedom and flexibility while offering security and certainty.

[1]Guarantees are based on the financial strength and claims-paying ability of each insurance company.

AllianceBernstein: Can you briefly describe UTC's Lifetime Income Strategy (LIS)?

Hanney: In order for LIS to work for employees, they simply have to do two things: First, get hired by UTC—be an employee. Second, retire. That's all they have to do. LIS is the plan default: they'll get that unless they opt out. As employees go through their careers, if they determine that the level of income guaranteed through this program is not sufficient to meet their needs in retirement, they have the freedom and flexibility to front- load it, increasing contributions. And that's one of the beautiful things about this: it gives freedom to people who want to change where they are today in order to improve where they'll be in the future.

AllianceBernstein: I've heard you describe LIS as a personalized investment and savings strategy. Why?

Hanney: Essentially, it's a target-date portfolio—I choose the word "portfolio" very specifically. It's not a fund. It's not a series of funds. It could work as simply as a DB plan. I'd say we've really cracked the nut, and in many ways created something that can take the place of DB, and be even better in the long run.

AllianceBernstein: When UTC was thinking about the different ways to secure income, how did you decide on a guaranteed lifetime withdrawal benefit, or GLWB?

Hanney: When we started looking at this several years ago, we looked at everything out there on the market—from annuities to systematic withdrawal plans. Each product had trade-offs that represented a different aspect of retirement our employees might face. Clearly, the level of income is one of them, but the need for liquidity is, too.

So, when we evaluated the range of alternatives available to us, we tried to compare them on the basis of those trade-offs. Ultimately, we decided that while we would probably get the highest income out of an immediate fixed annuity and the greatest flexibility from systematic withdrawal plans, it was the GLWB that really hit on all cylinders. It addressed each aspect and option we felt was critical to our ultimate solution.

AllianceBernstein: How did you think about those trade-offs, as they relate not only to the goals of the plan but to the needs of participants in retirement?

Hanney: We felt it was critical to balance the level of income with other options we thought were necessary. Think about a participant or employee who locks into an immediate annuity one day, goes to a doctor the next day and gets bad news. That employee just lost the mortality lottery. We didn't want our solution to be so limited that it could have that potential, so we included liquidity.

AllianceBernstein: Once you decided specifically on the withdrawal benefit, what were some of the design decisions the investment committee needed to make?

Hanney: There were about 54 different decisions on that list! Some were as mundane as "Do you want to use a unisex longevity table or make it gender-based?" But the most important decision we made, which impacted virtually everything else after it, was to have a fixed price up front on the benefits we purchased. To get this, we needed to include additional flexibility. Ultimately, the value of the benefits can change in the future, but anything that's already been purchased is fixed at that time.

AllianceBernstein: How did UTC evaluate the additional cost of adding lifetime income? Equally important, how did it evaluate the additional value?

Hanney: The fees are not necessarily the cost. There are various other costs, including opportunity cost. Just as the cost can be intangible, so is the value built into it—not just a withdrawal rate or an expected return. There's confidence, too. In terms of fees, we looked at what people were paying for very similar benefits in the retail market. We looked at what alternatives cost in the institutional market. In terms of our three basic principles, we've addressed simplicity and flexibility, while keeping cost dramatically lower than what's available in virtually any other form.

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We wanted to make sure people understood the explicit fee, so we spent a lot of time developing charts and tables for brochures and fact sheets. We created little vignettes, "People like Me," scenarios that show UTC employees and participants in different life situations and how the value of the Lifetime Income Strategy works for them—or not. It's a very balanced presentation: some people don't select LIS because it's not the right choice for them.

AllianceBernstein: Can you describe the mechanics of the multi-insurer structure?

Hanney: We felt that it was attractive from at least two different perspectives: one was competition and pricing power, and the other was sustainability and capacity. One of the very appealing initial characteristics was not being beholden to one particular insurance company.

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We've actually implemented a structure where, on a regular basis—daily, monthly, quarterly—our insurance companies are competing for capacity within the program, and we're buying from them based on competitive bids. Now, this all happens under the hood to keep things simple for participants. What's very important to us, from a plan sponsor's perspective, is getting the best price and value the market is willing to offer with this particular design.

There's a standard of care that requires plan sponsors to get optimal pricing for the benefits their plans receive. That doesn't always mean the lowest price; it doesn't always mean the highest withdrawal rate. We want the price that's in the best interest of our participants, but it also needs to be in the interest of the insurance company, or it won't be in the interest of our participants.

AllianceBernstein: Why did you choose to make LIS your default?

Hanney: Even if you make annuities available to people through a DC plan, they don't just go out and buy them. That doesn't mean they don't value the certainty and security of an annuity—it means most of them simply don't have the time, the motivation or the skill to understand whether or not it's right for them.

By making lifetime income the default, we're communicating to the employees that we spend a lot of time working on this and come up with what we think is the best solution. And we do think this is going to be right for the vast majority of our employees and participants. However, we've also included the freedom and control that people need so they can opt out if they decide it isn't for them.

AllianceBernstein: What key behavioral issues were you looking to solve by making LIS your default?

Hanney: Many people buy insurance to guard against bad things: fire insurance for your house, collision for your car. How many people buy insurance for living too long? By building it into the design, we think we've addressed the systematic bias of people to underestimate how long they're going to live. On the other side of the coin, by adding optionality—including liquidity and death benefits—we've also addressed what we see as the main behavioral obstacles to people using a design like this and reaping the benefits.

AllianceBernstein: How do you see LIS helping participants get to retirement? In other words, how does it help them plan and save?

Hanney: The immediate impact is that people now have a number—a minimum level of income they're guaranteed to get in retirement. People can determine whether it's too high or too low.

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Usually, they look at the accrued number and find that it's too low. They say, "I don't think this level will satisfy the standard of living I want in retirement." So they save more.

AllianceBernstein: Regulation and adoption have unfortunately created almost a stalemate for some sponsors. How did you get comfortable with adopting this solution?

Hanney: From a regulatory standpoint, I think everything is in place for us to adopt this and get the key fiduciary protections we wanted. We actually satisfied the QDIA rules from two different angles. This is a target-date portfolio, and I think of it in many ways as a managed account. It's based on the birth date of the individual, and that's all you need to get managed-account coverage for safe harbor.

AllianceBernstein: How would you characterize Washington's view on what you did?

Hanney: We've talked with Washington a lot, and we think what we've shown the people there is very attractive. The bottom line is that they understand we're trying to do the best we can to address something that's very important to them, and high on their list of priorities. So, we really think Washington is supportive, but we're also expecting more guidance that reflects how the agencies view what we're doing compared with more traditional products.

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AllianceBernstein: Let's turn to perhaps the most critical aspect of the implementation: communications. How did you communicate the complex simply?

Hanney: From the beginning, we knew our communications had to be age-based and personalized. We've developed a whole series of communications, starting with a brochure that tells the story soup to nuts, and we have age-based fact sheets.

Communications are triggered as participants reach certain milestones in their lifecycle. So, at the age of 48 they get a letter that says "Hey, you're enrolled in LIS. At the beginning of this year you're going to start securing guaranteed income. The fees will go up in return for these guarantees, but so will the value of the benefits." If somebody isn't in LIS, there's a communication that says, "Hey, we noticed you're not in it, and you're now at the point where you would start to secure guaranteed income. You might want to see if this makes sense for you."

AllianceBernstein: Let's move to some of the challenges in launching Lifetime Income Strategy. How did you overcome them?

Hanney: Probably the single most important challenge we needed to overcome was making sure that all our partners were working together to achieve the best outcome for our participants. It was very important for us to set the stage with each key service provider—to make sure they understood what was in it for them. We believe that in the next couple of years, you'll see many very large plan sponsors pick something similar to this design.

AllianceBernstein: Since you've gone live, any surprises—good or bad?

Hanney: We honestly haven't had any bad surprises. One extraordinary result is that we've had hundreds of phone calls asking questions about LIS, and almost every call leads to an income-benefit estimate, using an estimator tool we developed working closely with AllianceBernstein. It's a powerful piece of information for people—now they have a number, something they can work with. And we believe it will lead to more efficient savings behavior. It will address people who undersave and even those who oversave. And in the end, it will make employees more productive and more valuable to UTC.

AllianceBernstein: When you implemented LIS, did you do a reenrollment?

Hanney: We didn't do a broad plan reenrollment, because we'd actually gone through various evolutionary phases in the plan. At each step, we asked people what they wanted, and many of them had actually given us direction—we weren't going to change that.

But there were still about 5,000 participants with no investment elections on file. We moved them into our new custom target dates, the default, at the beginning of 2011. We went through the same process in April and May. We informed people who hadn't given us direction that we were upgrading our default to LIS and, in the absence of any direction, we were going to move their assets in x number of days after the option became live. So we actually mapped in about 5,000 people.

AllianceBernstein: What's the adoption rate so far?

Hanney: It's been live for about a month and a half. Within the first two weeks, we saw three million dollars move in—several hundred participants. Of the participants who moved money in, the average age was somewhere in the late fifties. Many of these participants were actually retirees seeking more certainty. ■

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Guaranteed Lifetime Withdrawal Benefit (GLWB) is a type of annuity that sets a withdrawal amount that will last throughout a participant's retirement, even if the market falls or the account's assets run out. The insurers will continue the withdrawal payments, if needed. Guarantees are based on the financial strength and claims-paying ability of each insurance company.

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