T. Rowe Price

# Drawdown with annuities can balance retirement income and liquidity

**In the Spotlight**
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## Key Insights

- There is renewed interest in annuities as a potential retirement income solution by plan sponsors focused on recreating a paycheck-like experience for retirees.
- A drawdown strategy paired with a deferred annuity may be a better match for retirees who need to maximize income and maintain adequate liquidity.
- Due diligence is key during insurer selection and when evaluating the product to ensure that it is a good fit for the plan.

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Many Americans approaching retirement have most of their retirement savings in defined contribution (DC) plans. While conversations about retirement have mostly been dominated by the saving or accumulation phase, the emphasis for DC plans is shifting to the spending or decumulation phase of the retirement journey. The next big problem for the retirement industry to solve is retirement income, and data show that most retirees manage their money to preserve or increase their assets.[1] Retirement income solutions should balance adequate income generation while addressing longevity risk (the likelihood of running out of money) and liquidity needs.

[1] Sudipto Banerjee, "Asset Decumulation or Asset Preservation? What Guides Retirement Spending?" EBRI Issue Brief, no. 447 (Employee Benefit Research Institute, April 3, 2018).

While the adoption of retirement income solutions in the past has been nominal, things are changing. Our 2024 Defined Contribution Consultant Study revealed that, when it comes to in-plan retirement income solutions, plan sponsors are evolving from an exploratory mindset to a more decision-oriented posture. In particular, there was a dramatic decrease in the percent of plan sponsors described by consultants as "having no stated opinion" on in-plan retirement income solutions from 59% in 2021 to only 19% in 2024. Meanwhile, the percentage of plan sponsors that consultants categorized as currently offering or planning to add a retirement income solution more than doubled from 8% in 2021 to 18% in 2024.

## Why this shift?

With a growing number of retirees keeping their assets in plan after retirement, the Setting Every Community Up for Retirement Enhancement (SECURE) Act of 2019 sought to clarify a plan fiduciary's responsibility regarding the selection of an annuity provider. This law spurred product creation and encouraged the launch of innovative in-plan retirement income solutions. The passage of SECURE 2.0 at the end of 2022, which included additional provisions to further support lifetime income, also provided a legislative boost.

In addition, data suggest that plan sponsors are currently focused on recreating a paycheck-like experience for retirees. Results from the T. Rowe Price 2024 DC Plan Sponsor Considerations and Actions on Retirement Income Study—as well as our 2024 DC consultant study—show that plan sponsors, consultants, and advisors identified solutions with a simple systematic withdrawal capability as the most appealing. Plan sponsors also rated potential investments that incorporate a partial guarantee and target date investments with an embedded annuity feature among the top three appealing ways of delivering retirement income.

The retirement income conversation has, for the most part, centered around annuities because:

1. Life expectancy has been steadily climbing over the past century for all developed economies. According to the CDC/National Center for Health Statistics, life expectancy at age 65 for the total U.S. population was 18.9 years in 2022, an increase of 2.5 years from 16.4 years in 1980. For men aged 65, life expectancy increased during the period by 3.5 years from 14.1 years in 1980 to 17.5 years in 2022. For females, life expectancy at 65 increased by 1.9 years from 18.3 years in 1980 to 20.2 years in 2022.

   People are therefore increasingly concerned about longevity risk. In fact, when we asked participants to prioritize various aspects of preparing for and living in retirement, "not running out of money before I die" and "maintaining my quality of life" were both top-rated statements.[2]

2. Defined benefit (DB) retirement plans, which offered workers a fixed pre-established benefit at retirement, have significantly declined. In 1975, DB plans covered roughly three times the employees covered by DC plans. However, by 2023, 67% of private industry workers had access to DC plans compared with 15% of private workers who had access to DB plans.[3]

## Yet retirees typically don't choose annuities

The factors outlined in the prior section highlight what makes annuities more attractive. However, although academic studies show that annuitized income increases lifetime utility—a measure of a consumer's satisfaction as a function of

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[2] T. Rowe Price 2024 Exploring Individuals' Retirement Income Needs and Preferences Study. See Sources.
[3] United States Department of Labor, 2024. bls.gov/opub/ted/2024/15-percent-of-private-industry-workers-had-access-to-a-defined-benefit-retirement-plan.htm

the consumption of preferred goods and services over a lifetime—participants often don't choose annuities. Banerjee (2013) has shown that when DB plans offered participants a choice between a lump sum and an annuity, only a small share of participants (27.3%) chose to annuitize.[4] Mottola and Utkus (2007) also reported similar annuitization rates in DB plans.[5] The current evidence from DC plans also points toward this trend. Brown, Poterba, and Richardson (2022) analyzed retirement income choices made by participants in a large DC plan with multiple withdrawal options between 2000 and 2018. They found that the share of life annuitants fell from 52% in 2008 to 31% in 2018.[6]

So, if annuities can provide guaranteed income[7] and hedge against longevity risk, why aren't they more popular? Annuities can be expensive, and a narrow focus on specific attributes, such as the guaranteed income benefit, could limit a retiree's ability to assess their value appropriately. For example, monthly annuity payments might seem too small for individuals with limited savings, while the lack of liquidity in certain types of annuities is a key downside for individuals planning to bequeath assets or who may have emergency funding needs. There may also be a common misunderstanding that annuities are an all-or-nothing decision for retirees. We believe that pairing annuities with liquid investments could create a more balanced retirement experience that better matches a retiree's needs for both income and liquidity.

## By the numbers: How to combine an annuity and a liquid investment strategy

The retirement industry generally offers two types of withdrawal strategies to produce retirement income from liquid investments:

- An endowment strategy—where income/withdrawals are sourced from portfolio returns and the principal is mostly preserved.
- A drawdown strategy—where income/withdrawals are sourced from both principal and portfolio returns, which gradually depletes the principal.

Providers have been known to pair endowment strategies with annuities to generate retirement income and hedge longevity risk. However, we argue that annuities are a better match with drawdown strategies for two key reasons. First, a key benefit of an endowment strategy is that it sources income from returns as opposed to principal. This product design allows for a relatively consistent account balance that mitigates longevity risk. However, this hedge becomes less meaningful if longevity risk is also hedged through annuities. Second, pairing annuities with a drawdown strategy can deliver a high level of income without significant loss of liquidity.

In the following discussion, we provide hypothetical illustrations of different types of fixed annuities—immediate annuities that start making payments immediately after annuitization and deferred annuities where payments start at a later date—paired with a liquid investment strategy to show how income levels and liquidity varies with each combination. It is important to note that there is no clear or "best" solution when pairing annuities with liquid investment strategies as there are always trade-offs including a number of considerations such as applicable fees, taxes, and product features. The benefit and risks of each approach will therefore vary based on individual preferences.

We outline comparisons based on a hypothetical individual who retires at age 65 with an account balance of $500,000 over a 30-year retirement horizon. In each example, we use a different allocation between hypothetical annuities and liquid investments to illustrate how each combination can generate different levels of steady income with varying liquidity. **These examples are intended for illustrative purposes only, and this is not a recommendation to take any specific investment action.**

### Assumptions:

- **30% annual payout rate for 15-year fixed deferred annuity**
- **7.5% annual payout rate for fixed immediate annuity**
- **5% annual rate of return for the investment**

1. **Endowment strategies with immediate annuities**

   Let's assume a retiree purchases an immediate annuity for $200,000 (40% of their portfolio) and invests the remaining $300,000 (60%) into an endowment strategy. Given our assumptions, the allocation could generate a total of $30,000 in income for life (assumed to be 30 years)—$15,000 from the annuity and $15,000 from the investment (Figure 1A).

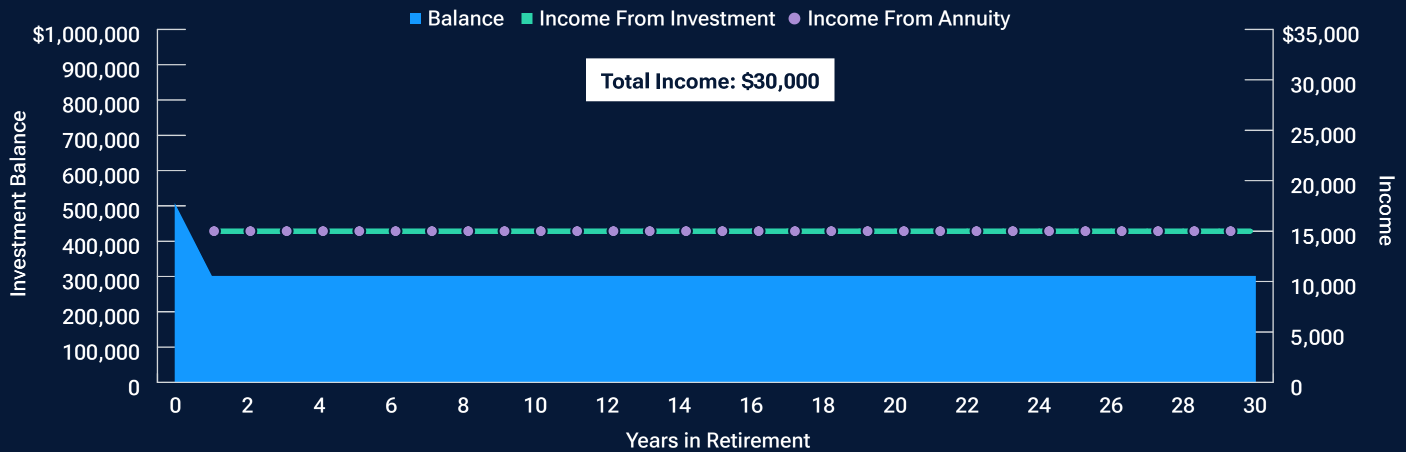
   The key benefit in this instance is the potential high and steady income throughout retirement. However, the main drawback is the loss of liquidity in the beginning of retirement when 40% of the account balance is used to purchase the immediate annuity.

[4] Sudipto Banerjee, "Annuity and Lump-Sum Decisions in Defined Benefit Plans: The Role of Plan Rules," EBRI Issue Brief, no. 381 (January 2013).
[5] Gary R. Mottola, and Stephen P. Utkus, 2007, "Lump Sum or Annuity? An Analysis of Choice in DB Pension Payouts," Vanguard Center for Retirement Research, Vol. 30.
[6] J.R. Brown, J.M. Poterba, and D.P. Richardson, "Trends in retirement and retirement income choices by TIAA participants: 2000–2018," *Journal of Pension Economics and Finance.* Published online 2023:1-22. doi:10.1017/S1474747223000070.
[7] **Income guarantees are based on the claims-paying ability of such annuity provider.**

**The charts shown below (ranging from Figure 1A through Figure 3) are for illustrative purposes only, do not represent actual investments, and do not predict or project returns or represent actual results. Actual results may differ materially. There is no assurance that any objective will be met. Changing the assumptions may result in different outcomes that could lead to different conclusions than those outlined in this material. All investments are subject to risk, including the possible loss of principal. See the Appendix in this material for additional information on the exhibits and assumptions used as well as risks.**

## Higher income generated, but loss of liquidity may be meaningful

(Fig. 1A) Pairing an endowment strategy (60%) with an immediate annuity (40%)




Source: T. Rowe Price analysis. For illustrative purposes only.

## Less income generated, but retiree maintains higher liquid account balance

(Fig. 1B) Pairing an endowment strategy (80%) with an immediate annuity (20%)

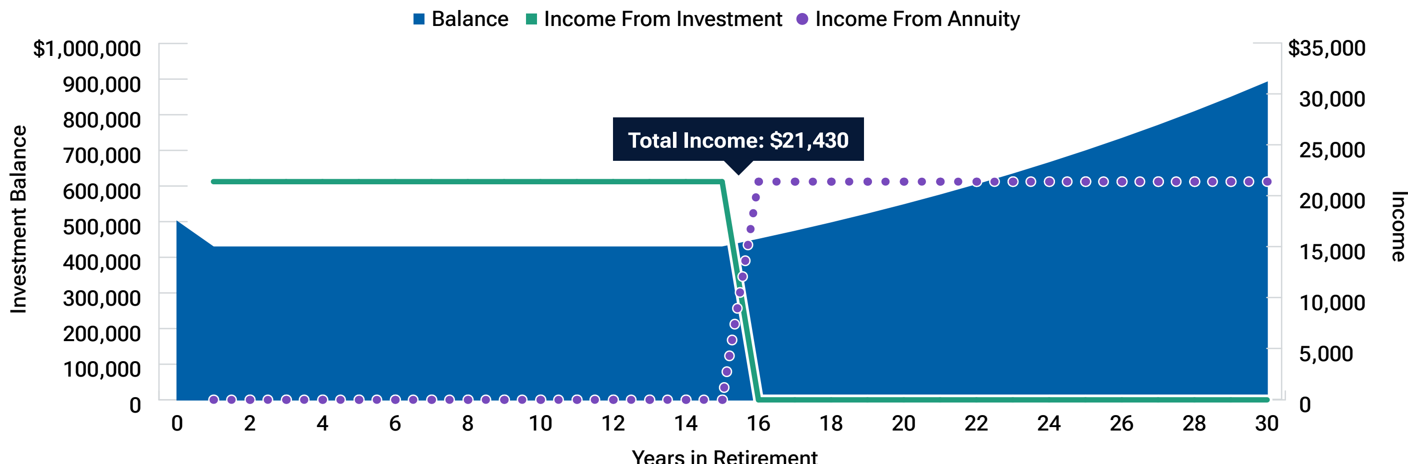
Source: T. Rowe Price analysis. For illustrative purposes only.

To address the liquidity challenge, the provider could tweak the allocation of the portfolio by investing more, e.g., $400,000 (80% of the portfolio), in the endowment strategy and purchasing an annuity for the remaining $100,000 (Figure 1B). With this allocation, the retiree would receive $20,000 in income from the endowment strategy and $7,500 from the annuity for a total of $27,500 annually for life. This second allocation may be preferred by a retiree seeking additional liquidity, but it comes at the cost of lower income.

Both of these examples pair an immediate annuity with an endowment strategy. For the retiree, the difference in the two approaches is income and the available liquid balance, trade-offs that should be considered when evaluating a retiree's preference.

## Limited loss of liquidity, but the income generated is low

(Fig. 2) Pairing an endowment strategy (85.71%) with a deferred annuity (14.29%)




Source: T. Rowe Price analysis. For illustrative purposes only. See Appendix for additional information regarding allocations.

### 2. Endowment strategies with deferred annuities

In this example, the endowment strategy is paired with a deferred annuity, where payments begin at a later age (Figure 2). The retiree would initially receive income payments from only the endowment strategy for a period of 15 years. At that point, the payments from the endowment strategy stop and the deferred annuity payments begin and continue until the end of retirement.

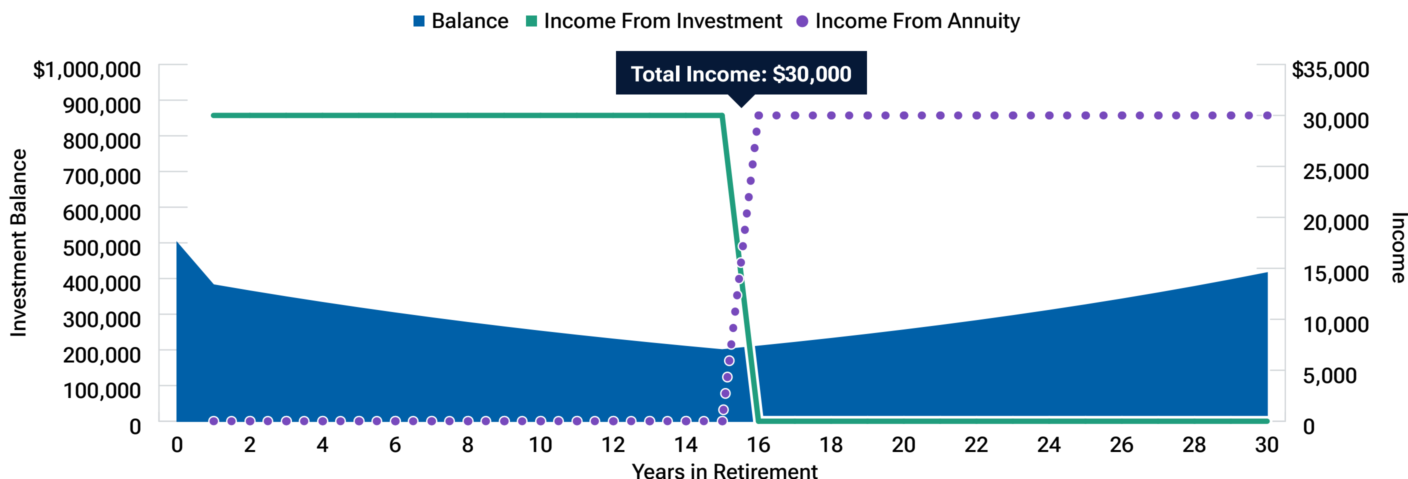
With this option, not only does the retiree experience a lower loss of liquidity at the start of his/her retirement, but the account balance in the endowment portfolio grows again once the deferred annuity payments start. On the flip side, the retiree's overall income is the lowest compared to the other options and the high residual balance toward the end of retirement signifies underspending. This drawback brings us to our next option.

### 3. Drawdown strategy with deferred annuities

As outlined in Figure 3, a drawdown strategy—where income is derived from principal and portfolio returns—paired with a deferred annuity can produce a favorable outcome. In this example, with a relatively small (20%) allocation to the annuity, the retiree can maintain a higher level of income. There is some loss of liquidity at the beginning of retirement due to the annuity purchase,

## Higher income generated and initial loss of liquid account balance later reverses

(Fig. 3) Pairing drawdown strategy (80%) with a deferred annuity (20%)




Source: T. Rowe Price analysis. For illustrative purposes only.

and the liquid balance declines as the retiree takes withdrawals from the liquid account balance. But this trend starts to reverse once the deferred annuity payments begin after 15 years. At that point, the liquid investment should start to grow again.

## What's the verdict

In our view, the income and balance allocation profile outlined by the drawdown and deferred annuity illustration can better meet the needs of retirees in the real world (not considering specific preferences), especially given the well-documented challenges with undersaving during the accumulation phase of the retirement journey.

An endowment strategy typically hedges longevity risk but provides lower income levels. However, a drawdown strategy can provide higher income, but usually at the cost of longevity risk. This is the trade-off between the two strategies. The presence of an annuity—which also provides a longevity hedge—changes this picture by offsetting the benefit from the endowment strategy and dispelling the drawback of the drawdown strategy. Our numerical example (beside "3." in the previous section) shows that the combination of drawdown strategy with a deferred annuity provides a better income/balance allocation combination profile, with high overall income and without significant loss of liquidity.

Notably, all the strategies could hedge longevity risk; the illustrations show low risk of balance depletion at any time in retirement and can generate similar income stability throughout retirement, but the main difference across the strategies was the level of payments and the available liquid account balance. For retirees who need to maximize their steady income, while maintaining a reasonable level of liquid account balance, the drawdown strategy with a deferred annuity could be the most preferred.

## Things to consider for plan sponsors

- **Income and liquid balance trade-off considerations:** There is no free lunch. Hence, the choice between expected income and liquid account balance should meet the unique preferences and needs of retirement investors. As illustrated in Figure 3, the initial depletion in account balance is likely temporary and is expected to reverse when deferred annuity payments begin.

- **Messaging/education:** To drive engagement and adoption, the participant experience is key and is just as important as the product itself. As part of overall participant education, communication strategies that leverage digital and/or in-person services can help educate and inform employees about their options and empower them with tools to make better-informed decisions about their retirement savings.

- **Annuity riders are key:** Optional features that provide additional benefits and flexibility will be crucial for most participants, especially the inclusion of a death benefit. The idea of purchasing a deferred annuity and not benefiting (personally or via beneficiaries) due to a premature death can be a significant deterrent to adoption. Riders can have additional costs that need to be considered.

- **Fiduciary responsibility:** Due diligence is key when evaluating the product to determine whether it is a good fit for the plan and when assessing insurance providers to ensure that quotes are competitive. Additionally, investments that are appropriate to use with a particular withdrawal strategy should also be considered. Consultants and advisors can help plan sponsors choose the right mix of capabilities that work for their participant demographic and provide ongoing support as needed.

- **Portability of income benefits:** Plan sponsors should understand the portability of these benefits and confirm that they can be transferred to a new recordkeeper, without loss to the participant, if needed.

- **Plan document amendments:** An extensive review of plan documents and amendments may be required to make sure that these types of distributions are permissible in the plan. When it comes to retirement income solutions, 32% of plan sponsors in our recent plan sponsor study indicated that they had updated the plan's distribution provisions to allow retired participants more flexible access to their savings.[8]

## Conclusion

A retirement income strategy that pairs a deferred annuity with a drawdown strategy can offer retirees a balanced retirement experience. This solution provides a hedge against longevity risk, can help deliver adequate income over the long term, and also, with appropriate allocations, maintains a reasonable level of liquidity should retirees wish to access their retirement savings.

[8] T. Rowe Price, 2024 DC Plan Sponsor Considerations and Actions on Retirement Income. See Sources.

# Appendix

**Illustrations:**

- The investment is assumed to have an annual rate of return of 5%. This is not an actual return on an investment and is not meant to represent the performance of any specific investment option. The assumptions used may not reflect actual market conditions. Investments that are appropriate for the drawdown and/or endowment withdrawal strategies should be discussed with a plan consultant or advisor.
- The illustrations are based on nominal numbers, no inflation or tax is assumed.
- Retirement age is 65.
- The payout rate for the annuities is what we view as a reasonable net-of-fees rate based on industry data. It does not reflect all fees that can apply for an actual annuity purchase.
- No fee is assumed for the investments.
- To determine the investment and annuity allocations for Option 2, we matched the income level from the investment for the first 15 years with the income level from the annuity after 15 years. Assuming the allocation to the endowment strategy is x%, then the income level from the investment is 5 * x%; the income level from the deferred annuity is 30 * (1-x%). Equate both and solve, x% = 30/35 = 85.714% (investment allocation = 85.71% * $500,000 = $428,550). 1-x% = 1 - 85.714% = 14.286% (annuity allocation = 14.29% * $500,000 = $71,450)

The illustrations do not show volatility associated with investments which could impact the results and the conclusions made. Taxes, inflation and other costs are not considered in this analysis, and if considered, might change the results or lead to different conclusions.

**Investment Risks:** Investments are subject to risk including possible loss of principal. Those at or near retirement are subject to sequence of returns risk, where potential losses at this time could have a more significant impact on income for retirement from investments.

Where the term "liquid investment strategy" is used throughout the content, we mean investments where investors could access sales proceeds typically within a few days of sales. Investments are subject to market risk, and certain traditionally liquid investments can be subject to higher liquidity risk in stressed markets.

Examples of liquid investments include stocks, mutual funds and U.S. Treasuries.

**Annuities information and risks:** Guarantees are subject to the claims paying ability of the insurer.

Annuities may be subject to higher fees, including commissions upon purchase, surrender charges, administrative fees and other costs.

Riders may be available to help customers customize their policy and provide additional benefits. Riders are optional and available at an additional cost. There is no guarantee that the benefits received under the terms of a rider may not exceed the cost to include the rider on a policy. All withdrawals or partial surrenders will reduce the death benefit and may be subject to surrender charges. Some annuities with income for life may not allow access to the principal value. Additionally, once in the income phase, excess withdrawals will reduce subsequent future payments.

An annuity is a contract between a customer and an insurance company. Contracts and other offering documents should be read carefully as they describe risk factors, terms of the contract, and fees and charges that may apply.

An annuity is a long-term vehicles designed for retirement. An annuity isn't intended to replace emergency funds or to fund short-term savings goals. There may be a 10% federal tax penalty on withdrawals before age 59½.

The illustrations do not take into account individual investor circumstances including total assets, that should be taken into account when determining the appropriateness and allocation percentages of certain investments and insurance, including annuities which involve illiquidity.

T. Rowe Price does not issue any annuity products.

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**Sources**

**2024 Defined Contribution Consultant Study:** This study included 48 questions and was conducted from January 12, 2024, through March 4, 2024. Responses are from 35 consulting and advisor firms with over 134,000 plan sponsor clients and more than $7.5 trillion assets under administration.

**2024 Defined Contribution Plan Sponsor Considerations and Actions on Retirement Income Study:** The survey was fielded from November 14, 2023, through December 22, 2023. Data reflect responses from 119 plan sponsors that have a role in overseeing and/or selecting their organization's DC plan investment offerings and indicated a combined approximate DC plan asset size of $100 million or greater.

**2024 Exploring Individuals' Retirement Income Needs and Preferences Study:** Data reflect responses from 2,582 individual investors age 40 to 85 who were currently enrolled in a DC plan and had at least $100,000 saved in their plan accounts. The survey was fielded from December 2023 through February 2024.

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**Past performance is not a reliable indicator of future performance.** All investments are subject to market risk, including the possible loss of principal. All charts and tables are shown for illustrative purposes only.

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