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Trigger Age in Hybrid Retirement Solutions

When Does Financial Life Get *(More)* Complicated?

nextcapital™

Executive Summary

Hybrid qualified default investment alternative ("HQDIA") plans have been growing in popularity in the retirement industry. A HQDIA plan is a personalized, holistic retirement plan used in conjunction with a low-cost target date fund option for participants who have not reached a specified milestone, or *"trigger."*

The following research gives an overview of HQDIA plans and examines different triggers used in the industry, such as level of funding, accumulated wealth, propensity to engage, and participant age.

The research argues that age (or a closely related trigger, such as years to retirement) is the most appropriate criteria for most fiduciaries, and gathers evidence in support of that conclusion. The evidence examined includes:

- **Broad demographic financial and life milestone data,** such as age at first marriage, age at first home purchase, peak financial earning years, etc. This data shows that, **on average, people tend to reach their peak earning years in their 40s to early 50s,** and that **financial complexity peaks around the same time.**
- **Internal NextCapital personalization factor data by age.** This data shows that **salary risk decreases dramatically around age 50,** and that accumulated wealth dispersion continues to grow from a low level at age 20 before reaching its widest level at age 50.
- **Personalization recommendation dispersion data by age.** In the NextCapital solution, **the dispersion of equity levels (95th percentile relative to the mean) begins to widen around age 40-45.**
- **Target date fund dispersion and complexity by cohort age.** Industry target date fund equity level dispersion begins to increase around age 40. **Complexity of target date fund sub-allocations (as measured by increasing exposure to inflation linked bonds, commodities, etc.) begins to increase around age 50.**

After examining the evidence, the research concludes that the age of 45 is an appropriate trigger age for the majority of participants.

BACKGROUND

HQDIA is intended to provide the benefits of personalization while minimizing total lifetime costs through use of a familiar TDF option for a subset of participants, generally younger ones. Participants who do not meet the trigger **criteria** may receive some level of plan, and may choose to opt-in to the managed advice solution.

But HQDIA spurs the question: what should be the trigger? This research will argue that age (or years until retirement) is the most appropriate trigger. And while specifics can be customized for individual retirement plans--fiduciaries should give consideration when appropriate to their plan's demographics and other considerations--a trigger age of 45 is well-supported by the evidence.

What kind of trigger should be used?

The basic concept of HQDIA is that participants can be divided into two groups: those for whom a more customized implemented asset allocation solution (managed advice) is needed, and those who are well-served by a standardized investment solution. The goal of that division is to minimize overall solution cost and complexity, and to maximize familiarity and comfort. Generally the trigger is based on age, based on the observation that people's financial lives tend to get more complex as they get older.

There are other trigger options to consider besides age. One potential option is level of funding: participants might want to grow their balance, then use personalization to protect their accumulated savings.[1] However, we see greater variation in participant circumstances as they age (and have higher balances).

Another potential trigger could be the level of retirement savings (assets). We might indeed expect participants with higher balances to have more complex financial lives and greater need for personalization. However, many elements of financial complexity are independent of level of wealth, and wealth as a trigger risks introducing a bias against lower-wealth participants.

Lastly, some participants have historically more readily engaged with the personalized retirement solution and provided data. However, propensity to engage is not fully known until the participant is in the solution, so it is not well-suited as a trigger. Also, managed advice solutions are designed to add incremental value over purely age-based solutions even without full engagement and data. Lastly, participant outreach efforts can significantly increase engagement. Some participant groups, such as unionized workers, may have retirement ages earlier than 65. For those plans, using a customized, earlier trigger age, or years to retirement instead of age as the trigger, may make sense.

[1] See for example Willis Towers Watson [2019]

Factors leading to definition of trigger age

Assuming that an age-based trigger is used for transition to hybrid QDIA, what should that age be? We will approach this question from several perspectives.

Typical life events

Younger participants may have less complex financial lives and retirement plans, suggesting an age-based trigger. Is there an inflection point of age at which financial lives begin to transform? Exhibit 1 illustrates demographic data on typical (average or median) ages at which, in the U.S. population, significant life events that affect finances happen.

As shown, in the 40-50 age range, the typical investor is reaching or approaching their peak earning year. Notably, there are significant differences between typical peak earning age for men and women, driven by a number of factors including typical job category by gender, and gender pay gap. Participants in this age range are also, on average, coping with college costs for their children, and (at the top of the range) typically receiving any inheritance. Collectively, these factors point to the 40-50 age range as a transition point.

It's important to note that this demographic data represents averages or medians, and not only is it the case that individuals can and will deviate significantly from the norm, but there are also differences among demographic subgroups, for example when considering level of education. Decisionmakers setting a trigger age for their plan should remain mindful of their plan demographics and how that might differ from national averages.

Exhibit 1: Average/median age for major financial life events (U.S. data)

	AVERAGE/MEDIAN AGE FOR BROAD DEMOGRAPHIC
Begin paying off student loans	26
(First) marriage	28 (women) - 30 (men)
First home purchase	34
First child	26 (women) - 31 (men)
Second marriage (if any)	33 (women) - 35 (men)
Peak earning year (women)	**41**
First child in college	**44 - 49**
Finish paying student loans	**45**
Receive any inheritance	**51**
Peak earning year (men)	53
First child married	54 - 61
Retirement	**63 (women) - 65 (men)**

Participant characteristics

Consider the participant factors that may influence portfolio personalization. If there is an inflection point for any of these characteristics--an age at which dispersion among participants typically occurs, suggesting a greater need for a personalized solution that does not treat all participants the same--then that might have influence on optimal trigger age.

We analyzed profile, questionnaire response and account data across approximately 50,000 participants in managed advice solutions and summarized the results in Exhibit 2. We grouped the participants by age cohorts in five-year intervals, restricting the studies to users who provided validated data.

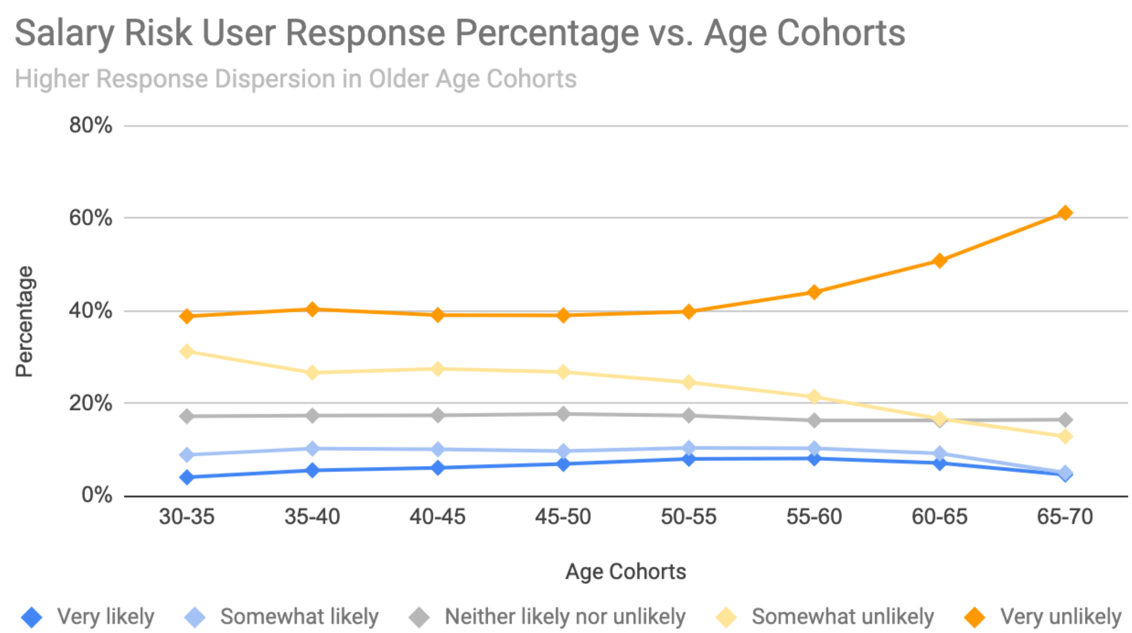
Exhibit 2: Participant Data

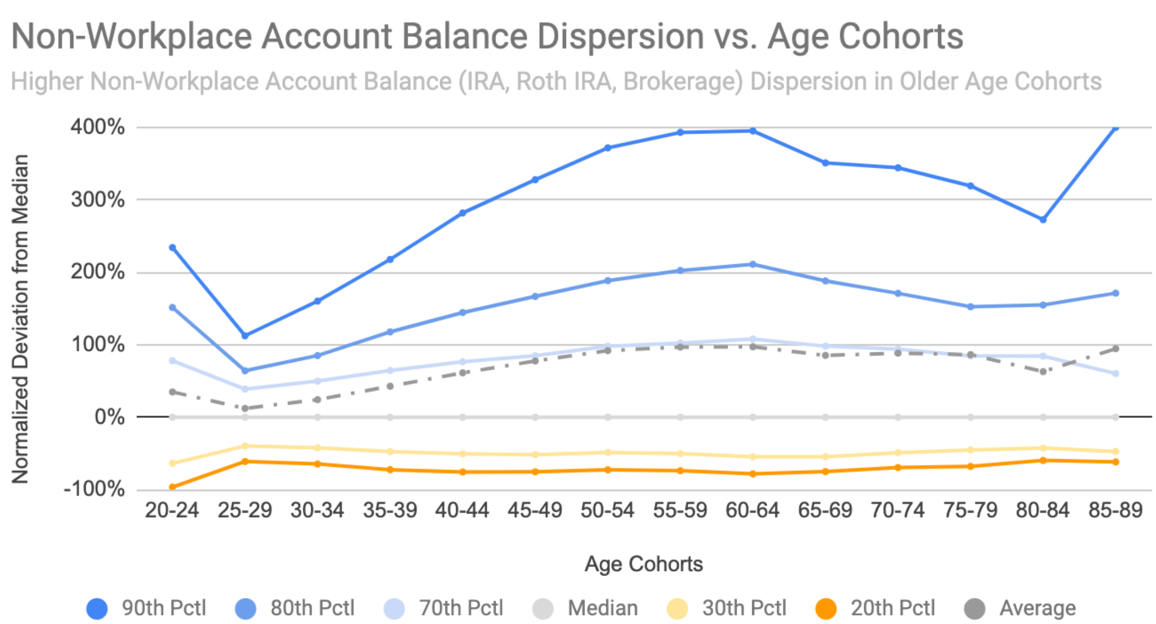
FACTOR	PERSONALIZATION IMPACT	RESULT
Salary risk	High salary risk comes with large variations in annual income and results in lower equity level	Salary risk shows an inflection point, beginning to decrease at age 45-50 as income tends to become more certain / possibly more diversified
Funding gap	Lower relative funding status results in higher equity level to boost the funded status	Dispersion in outside assets shows an inflection point, where gap between mean and median peaks by age 50
Gender and marital status	Married (vs. unmarried) and female (vs. male) comes with longer life expectancy and results in higher equity level	NextCapital data on marital status is in line with U.S. averages. Age at first marriage is likely correlated with age at first child in college, which are ages 44-49.
Health risk	Lower health risk comes with longer life expectancy and results in higher equity level	Data suggests a steady increase in health risk with age without a clear inflection point. Therefore there are no clear implications for determining a trigger age for personalization.
Retirement age	Early retirement comes with higher sequence risk and results in lower equity around retirement	There is no data on when users start to customize or determine their target retirement age. Such data would likely be noisy even if available, as users can experiment with their target age. Therefore this factor does not lend itself well to determining a trigger age for personalization.
Guaranteed income	Higher relative guaranteed income comes with lower sequence risk and results in higher equity level	Most guaranteed income comes at or near retirement i.e. social security or later in life such as rental or annuity. There's not enough information in the study to show an inflection point.

More detail on the factors with the clearest inflection points, salary risk and outside assets is shown in Exhibit 3. In the salary risk analysis, we see that concern about compensation uncertainty begins to fall away at age 50 in a clear inflection point (the share of investors who rate salary concerns as "very unlikely" rises from about 40% to 60%.)

The non-workplace account balance analysis shows a different measure: the dispersion from median assets, by age and percentile of dispersion. We see that the participants with the greatest outside assets relative to typical (the 70th, 80th and 90th percentiles) continue to pull away from the median until leveling off beginning in the age 50-54 cohort.

Exhibit 3: Dispersion of Salary Risk and Outside Assets in Participant Data



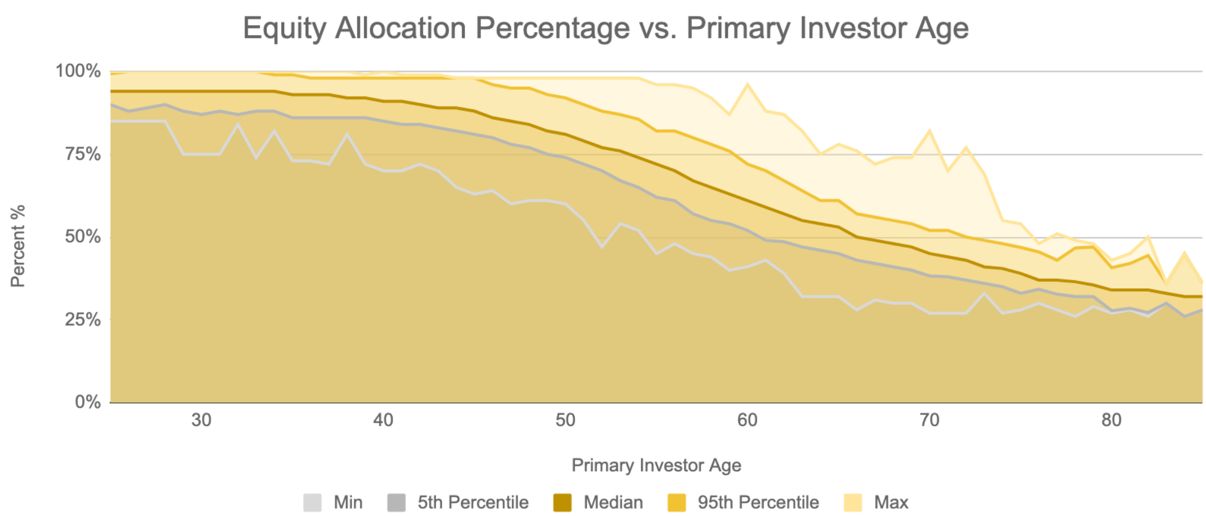


Personalized portfolio results

Bringing together the previous considerations, a managed advice solution will recommend a personalized portfolio for each participant who meets the trigger definition. An inflection point in the variation of a recommended solution across participants would be the most direct support for a particular trigger age.

Managed advice solutions will differ by provider, so the conclusions about trigger age may also differ. We present aggregate results from the NextCapital solution below. In our solution, dispersion of equity allocation, notably 95th percentile relative to median, begins to grow around ages 40-45.

Exhibit 4: Dispersion of Recommended Equity Allocation in a Managed Advice Solution

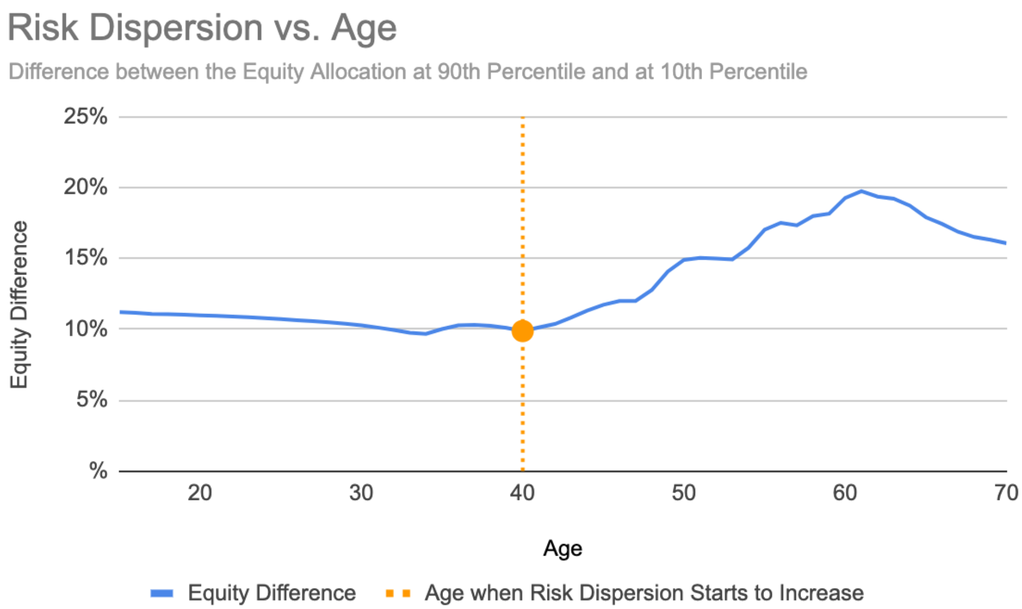


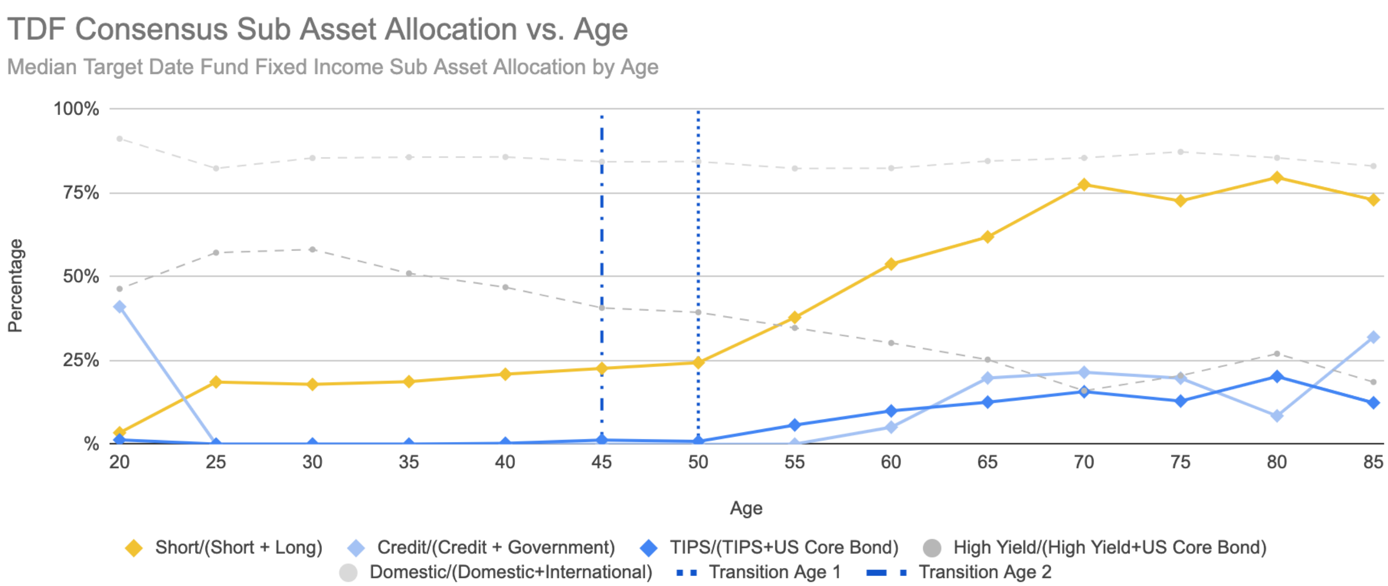
Investment management industry practice

Hybrid QDIA solutions use a target date fund as the solution for participants who do not yet meet the trigger requirements. The evolution of TDF investment strategies with age may provide insight into trigger age, since there will need to be a transition from TDF age-based strategy to managed advice personalized strategy at some point, and also the asset allocation views of the $2.5 trillion TDF industry are informative to the participant asset allocation question in general. What does the data tell us?

- Differences among TDF managers' equity allocations start growing considerably at age 40. Before that, TDFs are more similar in terms of overall risk level, the most important determinant of investment outcomes.
- TDF portfolio structure (credit/government and inflation-linked vs. nominal bonds, etc.) also tends to become more complex around age 50.

Exhibit 5: Dispersion of TDF Equity Level and Portfolio Composition





Also, minimum eligibility of some leading retirement income products is age 50, suggesting that the trigger age for solutions with a retirement income component might ideally be no later than that.

Plan sponsor practice

There is a limited amount of survey data available on trigger age; our suggestion to organizations running regular plan sponsor surveys is to add this question to their data collection.

However, a recent Defined Contribution Institutional Investment Association (DCIIA) survey suggests that the most common trigger age is currently 50, to allow participants sufficient time to benefit from a managed advice solution and act upon recommendations as part of a holistic financial plan before retirement. Notably, trigger age was dependent on **typical** retirement age (e.g., lower for some union plans).

CONCLUSION

A personalized investment implementation can provide a net benefit at all ages, but is especially pronounced for older participants. Given that the goal of a hybrid retirement solution is to provide optimal retirement and investment planning support with a familiar approach at an attractive cost to participants at all ages, the goal of a trigger should be to maximize the utility/cost tradeoff, and therefore should focus personalized investment services on those who benefit most from them.

Age, as a trigger, appears to offer benefits in terms of effectively defining participants who may benefit the most, without the drawbacks of other alternatives such as level of funding, savings or engagement. Based on the evidence summarized in the preceding exhibits, we identified that age 45 (twenty years prior to a standard retirement age of 65) is an appropriate trigger age, for the reasons summarized below:

- Broad demographic financial and life milestone data suggest that adults in the 40-50 year old range have increasingly complex financial situations which would benefit from personalization.
- Internal NextCapital personalization factor data shows that participant salary risk and wealth dispersion increases meaningfully around age 50, suggesting gains from personalization.
- Personalization recommendation dispersion in the NextCapital solution widens around age 40, which illustrates participants have an increasing range of outcomes around this age.
- Target date fund dispersion and complexity points towards increasing dispersion among industry managers and increasing fund complexity as investors reach 40-50 years old.

There is no one size fits all age to use as a trigger. Nonetheless, for the reasons outlined above, 45 appears to be a reasonable trigger age for many participants. Decision makers should ensure they take into account the specific demographics of the plan in question, as individuals and subgroups of individuals can and do differ from the norm.

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