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1401 H Street, NW
Suite 1200
Washington, DC 20005
202/326-5800
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Financial Decisions at Retirement

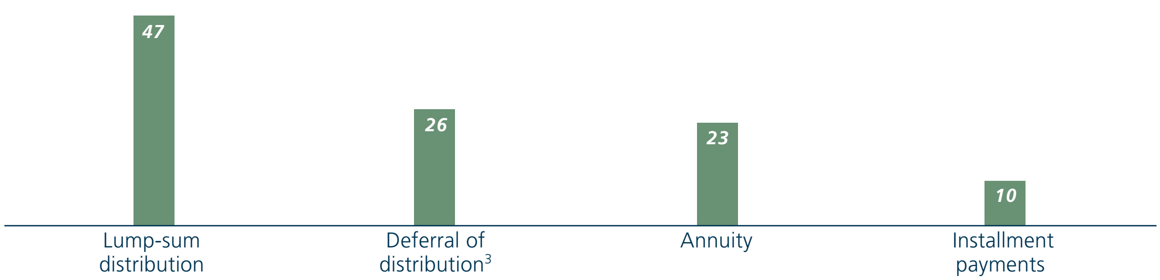
Defined contribution plans require participants to manage their pension assets both while working and in retirement. Research has focused primarily on asset management and accumulation during the working years and has found that participants, in general, are capably handling these responsibilities.[1]

Only recently has attention turned to analyzing participants' pension distribution decisions at retirement.[2] To develop further understanding of distribution decisions, the Investment Company Institute surveyed recent retirees who had been actively participating in defined contribution plans before retirement. The purpose of the survey was to examine how they used their plan proceeds at retirement.[3]

The findings from the May 2000 survey suggested that recently retired participants in defined contribution plans seriously approached the task of managing their financial resources in retirement. They appeared to have carefully

figure 1

Distribution Options Selected at Retirement by Retirees Having More than One Option[1, 2]
(percent of respondents who had multiple options)



[1] Based upon respondents' recall. Seventy percent of respondents indicated they had multiple distribution options at retirement.

[2] Multiple responses included because 29 respondents with multiple options chose to receive a partial lump-sum distribution with either a reduced annuity or reduced installment payments, or chose to defer part of the distribution.

[3] Distributions must begin no later than April 1 of the year following a retired person's attainment of age 70½.

note: Data as of May 2000.

[1] See Jack VanDerhei, Russell Galer, Carol Quick, and John Rea, "401(k) Plan Asset Allocation, Account Balances, and Loan Activity," *Perspective*, Vol. 5, No. 1 (Investment Company Institute, January 1999), pp. 1-19; Jack VanDerhei, Sarah Holden, and Carol Quick, "401(k) Plan Asset Allocation, Account Balances, and Loan Activity in 1998," *Perspective*, Vol. 6, No.1 (Investment Company Institute, January 2000), pp. 1-23; and John Sabelhaus and David Weiner, "Disposition of Lump-Sum Pension Distributions: Evidence from Tax Returns," *National Tax Journal,* Vol. LII, No. 3 (September 1999), pp. 593-613.

[2] See James M. Poterba, Steven F. Venti, and David A. Wise, "Pre-Retirement Cashouts and Foregone Retirement Saving: Implications for 401(k) Asset Accumulation," *NBER Working Paper,* No. 7314 (National Bureau of Economic Research, August 1999); and Alan L. Gustman and Thomas L. Steinmeier, "Effects of Pensions on Saving: Analysis with Data from the Health and Retirement Study," *NBER Working Paper,* No. 6681 (National Bureau of Economic Research, August 1998).

[3] The survey focused on the choice of plan distribution options available to retiring participants in defined contribution plans. For those who took lump-sum distributions, the survey further examined the division of those proceeds between current spending and reinvestment.

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considered the options available to them for withdrawing the assets accumulated during their working years. Indeed, retirees' choices were generally consistent with their financial circumstances, which varied from person to person.

The survey also found that most retirees were not inclined to spend the bulk of their plan assets at retirement. The majority of those taking lump-sum distributions reinvested all the proceeds. Only a small fraction spent the full amount, and in these instances the total distribution amount tended to be relatively small. Finally, among those who both spent and reinvested the proceeds, the vast majority of the lump-sum distributions were reinvested, not spent.

This issue of *Fundamentals* provides a summary of the principal findings from the survey. The details of the survey are contained in the full report, *Defined Contribution Plan Choices at Retirement: A Survey of Employees Retiring Between 1995 and 2000*.[4]

Distribution Decisions at Retirement

Seventy percent of the surveyed retirees indicated that their defined contribution plans offered more than one distribution option when they retired.[5] Of this group, nearly half chose to receive a lump-sum distribution (Figure 1). Twenty-six percent deferred the distribution, 23 percent opted for an annuity, and 10 percent chose installment payments.[6, 7]

- Retirees who opted to receive plan proceeds in a ***lump-sum distribution*** most frequently expressed a desire to manage their own assets. These lump-sum recipients typically had relatively high levels of financial assets and income (Figure 2).
- Retirees choosing to ***defer*** the distribution and leave their balances in the plans said they currently had no need for account assets as income. Similar to lump-sum recipients, those who deferred the distribution were relatively affluent.
- Retirees taking the ***annuity*** option expressed preferences for income security and regular income payments. Annuitants tended to have relatively lower incomes.
- Retirees who elected to receive ***installment payments*** also expressed preferences for income security and regular payments. This group was demographically similar to retirees who selected an annuity, with the exception of having more household financial assets.

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[4] The survey included interviews with a representative sample of 659 individuals who had retired between 1995 and 2000, had participated in and contributed to defined contribution plans before retiring, and had determined how their account balances were invested. Each respondent was either a primary or co-decisionmaker for household savings and investments. Sixty percent were enrolled in 401(k) plans at retirement. Fourteen percent were in college, university, or hospital 403(b) plans; 9 percent in the federal government's Thrift Savings Plan (TSP); 8 percent in state and local government-sponsored 457 plans; and 3 percent in employer-sponsored IRAs. Responses from 7 percent of retirees could not be placed in any of these plan types. To receive a copy of the full report, contact the Institute's Research Department at 202/326-5913; the report is also available at http://www.ici.org/pdf/rpt_distribution_choices.pdf

[5] The number of distribution options reported is based upon respondents' recall and, consequently, may understate the actual amount offered by their plans.

[6] The lump-sum distribution option allows retirees either to withdraw plan balances as cash or roll them over into Individual Retirement Accounts (IRAs). With cash distributions, recipients may spend or reinvest the proceeds, although in either case, distributions can be subject to income taxation. Balances rolled into IRAs are not taxed until withdrawn.

Annuities provide retirees with guaranteed monthly income for life and may include features such as joint coverage for spouses or a guaranteed payment period that extends beyond the death of the annuitant.

Installment payments, like annuities, provide retirees with regular payments made from the plan balance. Unlike an annuity, installment payments are not guaranteed to last for life. Installment payment arrangements include payments for a fixed number of months, payments in a fixed dollar amount until the account is depleted, or monthly payments based on an IRS life expectancy table. Until depleted, the balance remains invested in the plan, typically at the discretion of the retiree.

A deferral of plan proceeds leaves a retiree's plan account balance invested in the plan, maintaining the tax-deferred status of the assets. A retiring employee might choose to leave plan assets with the plan rather than roll them into an IRA, which also would enable the assets to retain their tax-deferred status, for convenience or because plan investment options are acceptable, among other reasons.

The four options are not necessarily mutually exclusive. Plan sponsors may allow retirees to combine two or more of the available options. However, plan sponsors generally are not required to make all options available and may use a single method for distributing account balances to retiring employees.

[7] These percentages add to more than 100 percent because some respondents with multiple options chose to receive a partial lump-sum distribution with either a reduced annuity or reduced installment payments, or chose to defer receiving part of the proceeds.

figure 2

Characteristics of Retirees Having More than One Distribution Option, by Option Selected[1]

	Option Selected			
	Lump-sum Distribution	**Deferral of Distribution**	**Annuity**	**Installment Payments[2]**
Most frequently mentioned reason for selecting option	**Wanted to manage the money themselves**	**Did not need the money at retirement**	**Wanted regular income payments**	**Wanted regular income payments**
Median				
Age at retirement	62 years	62 years	60 years	62 years
Household income[3]	$47,100	$56,500	$41,900	$44,900
Household financial assets[3, 4]	$297,500	$342,700	$133,800	$224,300
Years planning ahead financially	16 years	17 years	16 years	12 years
Percent				
Male	69	59	50	51
Married or living with a partner	87	89	76	76
Currently employed full- or part-time	24	34	32	22
Have college or postgraduate degree	40	46	39	30
Have spouse or partner who currently works full- or part-time[5]	32	39	30	31

[1] Based upon respondents' recall. Seventy percent of respondents indicated they had multiple distribution options at retirement.

[2] Small sample size.

[3] At the time of the survey.

[4] Includes assets held in employer-sponsored retirement plans but excludes primary residence.

[5] Of those married or living with a partner.

note: Number of respondents varies. Data as of May 2000.

Among the 30 percent of retirees reporting only a single distribution option, five in seven received a lump-sum distribution.

Use of Proceeds from Lump-sum Distributions

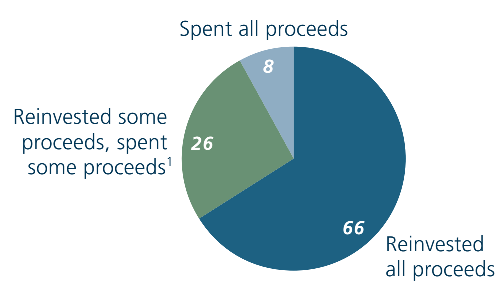
Three-quarters of all retirees who received lump-sum distributions consulted professional financial advisers for investment advice. Seventy-one percent of these recipients said they followed that advice to a great extent.

Nearly two-thirds of retirees who received lump-sum distributions at retirement reinvested the entire amount and 26 percent reinvested some of the proceeds (Figure 3). Only eight percent spent all of the proceeds.

figure 3

Use of Lump-sum Distributions at Retirement

(percent of respondents who received lump-sum distributions)



Number of respondents = 296

[1] The median percentage spent by these respondents is 12 percent. The mean percentage spent is 25 percent, and the dollar-weighted mean is 15 percent.

note: Data as of May 2000.

Nearly all retirees with large lump-sum distributions completely reinvested the proceeds. Three-quarters of recipients of lump-sum distributions of $250,000 or more reinvested all proceeds, compared with 43 percent of recipients of lump-sums of less than $10,000 (Figure 4). However, only 23 percent of recipients of lump-sums of less than $10,000 spent all of their proceeds.

Lump-sum recipients who reinvested some proceeds typically reinvested the vast majority and spent only a small percentage. On average, this group spent 25 percent and reinvested 75 percent of the assets they received (Figure 5).

Only 8 percent of lump-sum recipients spent all proceeds. This group's distributions tended to be small, and its members typically derived a

figure 4

Use of Lump-sum Distributions by Value of Proceeds

(percent of respondents who received lump-sum distributions)

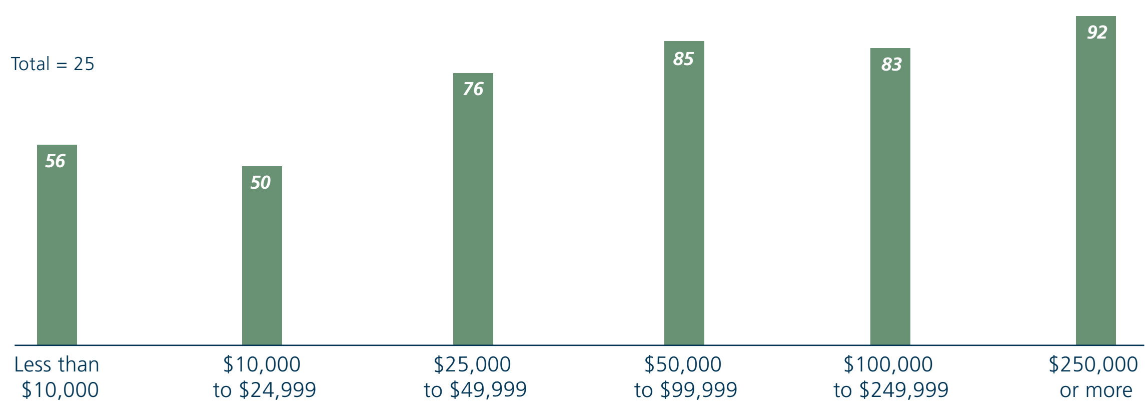
	Reinvested All Proceeds	Reinvested Some Proceeds, Spent Some Proceeds	Spent All Proceeds
Value of Proceeds			
Less than $10,000	43	34	23
$10,000 to $24,999	67	24	9
$25,000 to $49,999	65	23	12
$50,000 to $99,999	66	23	11
$100,000 to $249,999	79	21	0
$250,000 or more	75	25	0

note: Number of respondents varies. Data as of May 2000.

figure 5

Mean Percentage of Lump-sum Distributions Reinvested at Retirement by Value of Proceeds[1]

(for respondents who received lump-sum distributions at retirement and reinvested some and spent some of the proceeds)

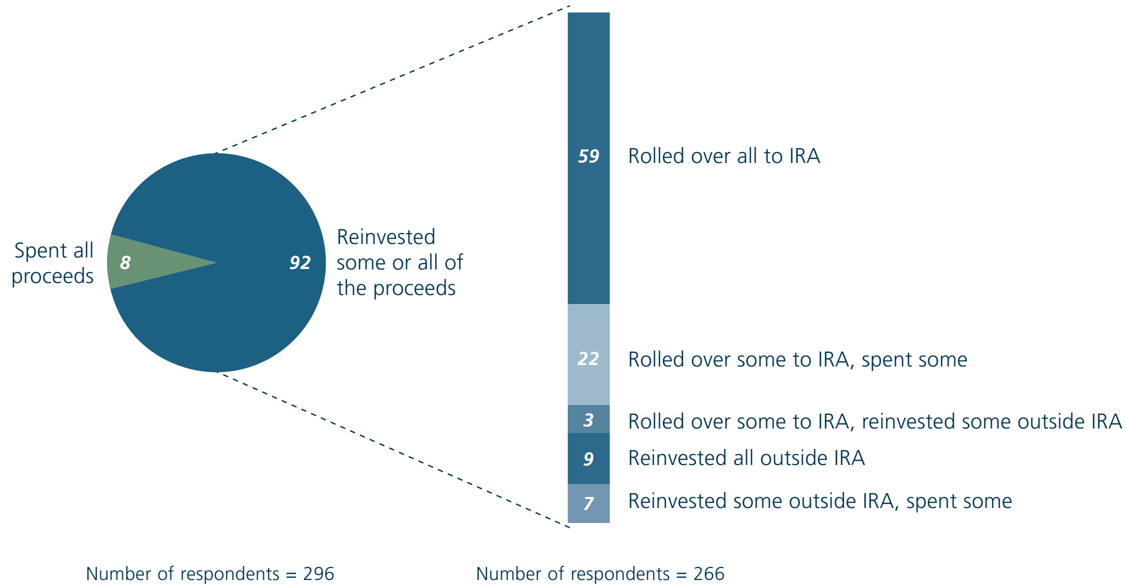


[1] Sample sizes for this analysis are small.

note: Number of respondents varies. Data as of May 2000.

figure 6

Use of Lump-sum Distributions at Retirement



note: Data as of May 2000.

large percentage of their household income from guaranteed sources. In most instances, the proceeds were used for practical purposes, such as a primary residence, debt repayment, healthcare, or home repair.

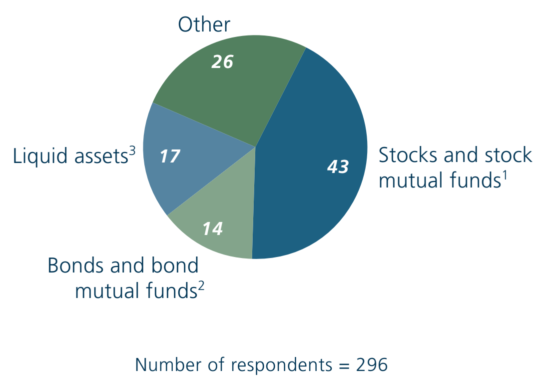
Rollovers into Individual Retirement Accounts

Of the 92 percent of lump-sum recipients who reinvested some or all of the proceeds, more than four-fifths rolled over some or all of it into IRAs (Figure 6). The IRAs established from the lump sums generally were well diversified. On average, about two-fifths of the assets were allocated to stocks, either directly or through mutual funds (Figure 7). Nearly one-third of this group's IRA assets was allocated to liquid assets, individual bonds, or bond mutual funds.

figure 7

Allocation of IRAs Established at Retirement from Lump-sum Distribution Rollovers

(mean percent)



[1] Includes 60 percent of respondents' balanced mutual fund holdings.

[2] Includes 40 percent of respondents' balanced mutual fund holdings.

[3] Includes bank deposits and money market mutual funds.

note: Data as of May 2000.

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