Dude, Where's my Pension?

This year we have heard a good deal of political talk about the funding and management of Social Security, but another, more important source of retirement income for many Americans is also at risk. A series of high-profile corporate bankruptcies have begun to focus public attention on the state of pension funds in the United States. As part of their plans of reorganization, United Airlines and US Airways have terminated under-funded pension plans, a step that releases them from heavy retirement obligations. Northwest Airlines Corp., Delta Airlines Inc., and auto-parts maker Delphi may seek to follow their example. Plans terminated in this way become wards of the Pension Benefit Guaranty Corporation (PBGC), sort of an FDIC for pension funds. PBGC insurance gives the plans' participants some protection, but PBGC benefits have caps, so many retirees receive significantly smaller payments than their employers had promised.

Congress established the PBGC in 1974 as part of the Employee Retirement Income Security Act (ERISA), now our basic pension law. Pension plans pay premiums into its insurance fund. If an under-funded pension plan goes through a "distress termination" (in a bankruptcy, say), the PBGC takes over the plan. For years, the PBGC's fund was sufficient to cover the liabilities it assumed from the plans it took over. But the PBGC's most recent financial report indicates that its assets are now worth some $22 billion less than the liabilities it has committed to fund.[1] Its funding has been a victim of the accumulation of failed plans and the insufficiency of the insurance premiums it can charge. If the present trend continues, the PBGC's funding has the potential to become another public crisis that could throw millions of retirees unexpectedly onto government coffers.

Published reports generally have it that US pension plans have an aggregate funding shortfall of some $450 billion. Congress has taken note of the issue, and the Bush Administration is pushing legislation it says would require corporate sponsors of traditional pension plans to shore up their plans' funding.[2] The original bill faced opposition from

[1] Marcy Gordon, "Pension Agency Reports $22B Shortfall," AP wire report, November 15, 2005. See http://biz.yahoo.com/ap/051115/pensions_shortfall.html?.v=2
[2] For the Administration's official position on this legislation, see Elaine L. Chao, John W. Snow, and Carlos M. Gutierrez, "Rescuing Your Retirement," op-ed in the New York Times, November 21, 2005. Available at http://www.treas.gov/press/releases/docs/nyt.pdf

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businesses, which warned that if the requirements were too tough some would stop offering pensions altogether. Interestingly, organized labor has tended to side with business here, fearing the demise of an important benefit. In mid-November, the Senate passed a compromise bill, but critics argue that this version would actually *weaken* funding standards.

Are Pension Plans Dinosaurs?

The pension landscape in the US has changed dramatically in recent years. Twenty-five-years ago 40% of American private-sector jobs offered traditional Defined Benefit (DB) pension plans. DB plans promise employees a lifetime retirement pension reflecting their total years of service, ending salary level and retirement age. These plans especially benefit employees that stay many years with the same company. Today, only about 20% of US private-sector jobs offer DB plans.[3] Instead, more companies offer a type of plan called a Defined Contribution (DC) plan. The most familiar DC plan is a 401(k). The Employment Policy Foundation reports that defined contribution plans now cover more than 40% of US workers, up from less than 20% in 1980[4]— the mirror image of the shift in DB plan coverage. DC plans have some advantages, particularly to younger workers that expect to change jobs frequently during their careers. But they have advantages for employers, too. 401(k) plan participants have a defined portfolio of assets, rather than a defined benefit for life. This arrangement limits the company's obligation to the employee. In a DB plan, the plan bears the fund's investment risk, and the risk of paying benefits to long-lived retirees. In a DC plan, the risk of poor investment performance, and of outliving the retirement assets, falls on the participant.

Despite the risks, a more mobile workforce may still prefer DC plans. The shift from DB plans to DC plans may also reflect other changes in the economy. Under ERISA the compliance costs of maintaining DB plans are substantial. As a result, small and mid-sized employers are less likely than large ones to maintain DB plans. Smaller employers are also more likely to drop existing DB plans. The staff of the California Public Employees' Retirement System (CalPERS) points out that the big decline in the number of DB plans in the US has occurred almost entirely among plans with fewer than 1000 employees.[5] So the ideal environment for a DB plan is a large company with a stable workforce. As the economy has shifted away from old-line industries that fit that description, the notion of long-term, company-sponsored retirement benefits has become less prevalent.

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[3] Roger Lowenstein, "The End of Pensions," *The New York Times Magazine,* October 30, 2005.
[4] Employment Policy Foundation, "Shifting Trends in Pension Coverage," Fact Sheet April 28, 2005. See http://www.epf.org/pubs/factsheets/2005/fs20050428a.pdf
[5] California Public Employees' Retirement System, "Pension Debate: The Myths and Realities of Defined Benefit and Defined Contribution Plans," Research Brief, January 2005.

ARE EMPLOYEES TODAY BETTER OFF?

We've talked about some advantages DC plans offer today's employees. Most DC plans are portable; if you change jobs you can generally take your 401(k) balance, or at least your own contribution, plus the vested part of any company match, with you. Vesting in a typical DC plan occurs relatively quickly. That means you can accumulate retirement savings throughout your career, even if you change jobs several times. In contrast, DB plans favor long-time employees. Short-time employees receive small, or no, pension benefits. If you have changed jobs or plan to change jobs, you are likely to be better off with a DC plan.

But are you well enough off? The employer's contribution to a DC plan provides benefits to most employees, while the DB plan pays most generously to those that retire after long service. Thus a fixed employer contribution just can't provide as much in benefits per recipient in a DC plan as in a DB plan. Pensioncube.com has a useful illustration of this phenomenon. They compare the value of the benefits a hypothetical 25-year veteran of a public employer, retiring at age 60, might receive from a DB plan and a DC plan, assuming similar contributions and investment rates of return. In their illustration, the DC plan balance at retirement is just 68% of the value of the DB plan's benefit.[6] If you plan to work at the same place for most of your career, you're probably much better off with a DB plan.

Pensioncube.com's example assumes similar investment returns in the hypothetical DB and DC plans. Unfortunately, that's a generous assumption. The investments in a traditional DB plan typically reflect a level of risk appropriate for a very long investment horizon, the pooling of uncertainty across a large number of plan participants, and the backing of the sponsoring corporation. In addition, DB plans typically have full-time, professional management. DC plan participants must choose their own investments, often from a limited menu, and often without much help. Worse, in some 401(k) plans the employer matches employee contributions with company stock, increasing the participants' portfolio risk. In extreme cases, such as the collapse of Enron, this can be a catastrophe. And finally, in many DC plans the investment choices available to participants are high-cost mutual funds, whose expense ratios act as a constant drag on participants' returns. The CalPERS research brief asserts that mutual fund costs, on average, amount to 1.35% of assets per year for individual investors, against the approximately 0.18% of assets that CalPERS spends on its own investment management.[7] In the end, the assumption that a DC participant can produce the type of returns a DB plan earns is optimistic. A 401(k) may be better for you because you have changed jobs several times, but it's a mistake to assume that your 401(k) savings will replace a traditional pension dollar for dollar.

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[6] Pensioncube.com, "The Search for Cheaper Benefits: Defined Benefit *vs.* Defined Contribution," http://www.pensioncube.com/Stories/DBvDC1_1.htm. Also cited in the CalPERS study, *op cit.*
[7] CalPERS Research Brief, *op cit.*

The Demise of Paternalism and Rise of On-Your-Ownership

The troubles in the DB world and the perils of the DC landscape may leave you feeling like you're on your own. Compared to a loyal retiree collecting a pension annuity from a well-funded DB plan, today's worker faces increased risk both in the workplace and in decreased support from corporate retirement benefits. The governmental insurance backing pension plans never guaranteed more than partial protection, and even that is under strain. Public programs — especially Social Security and Medicare — are under scrutiny and subject to change. Growing pension uncertainties, along with the risk of corporate bankruptcies and large-scale layoffs, combine to erode the security of historical retirement benefits for millions of workers. Many people may arrive at retirement and find that they just don't have enough, and neither their employer nor the government will have anything for them. They will be on their own.

In fact, to an increasing degree we're all on our own with respect to retirement. On our own, at least, in that if the trends continue, a comfortable retirement will be virtually impossible for those without sufficient additional savings. From an investment perspective, this is the worst possible situation. It has no good solution. Some people in this situation will take excessive risks with their existing assets, often at great personal cost. Some may expose themselves to fraudulent investment schemes in the hopes of making higher returns. Others will find that they need to continue to work past the age when they would like to retire, to the detriment of their comfort, and perhaps their health. Many may squander their limited dollars gambling or playing lotteries. At the extremes, individuals become a burden to their families, to their communities and to social services. How do we approach the challenge of avoiding an outcome like that?

Protecting your retirement

To retire comfortably, you will need to replace most of your pre-retirement income. If your retirement accounts are not enough to provide the necessary cash flow, then you'll need additional savings. It is that simple. The money that you are able to put aside — beyond your retirement plans and IRAs — will likely be an indispensable resource in your retirement. Increasing your level of after-tax savings has other advantages as well. After-tax savings increase your ability to make the most of the tax features of retirement accounts.

Prior to retirement, it's important to coordinate your tax-deferred accounts (those 401(k) accounts and IRAs) with your after-tax savings. Generally speaking, if your circumstances dictate that you should invest in a mixture of stocks and bonds — and most people's circumstances do — you'll want to shift your tax-deferred savings toward bonds, and your after-

tax savings toward stocks.[8] This is the investment structure that, in most cases, best takes advantage of the tax characteristics of equity investing, and the tax deferral in your retirement accounts. In many 401(k)s, this has an additional benefit. If your 401(k) investment choices are mutual funds, chances are that the expense ratios embedded in the fixed income choices are lower than those in the equity choices. With a coordinated approach, you can minimize the disadvantages of having a restricted menu of choices in your 401(k), and find the most cost- and tax-effective vehicles for your remaining after-tax investments.

After-tax savings can also give you more flexibility when the time comes to make withdrawals from your retirement accounts. Under current law, withdrawals from traditional 401(k) plans and IRAs are taxable as ordinary income. Withdrawals prior to age 59-1/2 carry additional penalties. But current law does not *require* you to make withdrawals until age 70-1/2. If you retire before 59-1/2, after-tax savings allow you to avoid the penalty. No matter when you retire, if your after-tax savings can support you until about 70, then your retirement assets can grow, tax-deferred, for as much as eleven extra years. Those extra years of compounding could make the difference in offsetting the risk of outliving your retirement savings.

Most of us still expect to collect some Social Security. It won't be nearly enough to support a comfortable retirement, but it should help. Many can still look forward to receiving traditional pension benefits, whether from a DB plan or a DC plan. Like Social Security, what might happen to these benefits is beyond your control, but you can and should monitor how much they are likely to provide, and watch for developments that might impair them. For most of us, the reality is that pensions will not be enough. What we are able to save from what we earn may ultimately become our most significant asset in retirement.

Conclusion

The recent bankruptcy filings of Northwest, Delta, and Delphi, and the strain their under-funded pension plans may place on the Pension Benefits Guaranty Corporation, highlight one force behind a larger trend away from traditional defined benefit pension plans for long-term employees. They obviously affect the employees of those firms most, but they highlight underlying forces that increase the uncertainty in traditional retirement programs. Policy responses are underway in the Social Security debate and in the Congressional debate on pension funding rules. But the general tenor of the trend is away from a paternalistic system of defined benefits and toward a world in which we must each increasingly rely on our own resources.

[8] I've written about this before. See Jonathan Tiemann, "Be Tax-Smart with your Tax-Deferred Accounts," Tiemann Investment Advisors, LLC, June 3, 2004. Available at http://www.tiemann.net/AssetLocat0604.pdf

Whether you are a successful business owner, an entrepreneur, or a wage earner, today's environment requires you to evaluate your own retirement situation critically and realistically, and create a coherent savings and investment plan. This plan should coordinate after-tax savings with your pension accounts, income stream and other assets (even your home), to provide the future cash flow for a comfortable retirement. Watch for excessive costs. Too many layers of fees can, by themselves, hold you back from an adequate retirement. Finally, if you care about protecting your assets for loved ones after you have gone, you should contact a professional about creating an appropriate estate plan for your assets and be sure that you've organized your investments to fit with that plan. If all goes well, there will be plenty there to help those you care about face whatever uncertainties assail the next generation.

- Jonathan Tiemann
Menlo Park
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