DB Marries DC?

By Rodney H. Alldredge

What if you were to combine the two types of entities that generally define the separate constructs of retirement plans in America? Could you get a better animal? The answer depends on whether you do some "genetic alteration" to give birth to an offspring that contains the best of both the parents.

One of the main problems with these two systems of retirement savings is that they are set up around the question, "who will be liable if it doesn't work?" The very name of a Defined Benefit plan implies a promise to an employee that if he completed a career at ABC Company then he would at least have something pre "defined" to retire on. This puts a large liability on the plan sponsor; consequently, good plans were defined by conservative investment. In fact, in most cases, they invested so conservatively that, alone, they really couldn't provide enough return to ensure a comfortable retirement for a participant.

Even if DB plans invested more aggressively, ABC Company had to regularly show that, under normal actuarial assumptions, it had enough money set aside to meet the obligations for all its employees and retirees down the road. If it doesn't have the money in the plan, it has a choice: be officially underfunded or write a potentially very large check out of corporate profits to the DB plan, to be used solely for the benefit of plan participants. Thus, DB investment philosophy tended to be guided by whatever strategy was perceived to offer the best opportunity to write a smaller check to the plan. In boom times, plans have an incentive to become more aggressive to achieve gains, and in bad times, to become more conservative to pare losses. Thus, DB plans are generally one step behind the market, which means they rarely achieve real investment success, so they still end up underfunded and still needing to write a big check.

It is no wonder, then, that a plan was developed to shift some of the responsibility and liability for a comfortable retirement away from the company and toward the employee. Thus, the Defined Contribution plan was born.

Conceptually, the defined contribution plan seems like a great idea for plan sponsors: Put the responsibility for a well-funded retirement back into the hands of those who would be retiring. The problem with DC plans was that, conceptually, you are asking people who, in most cases, don’t know anything about investing to take part of their hard-earned check and wisely build an investment portfolio, usually a choice of mutual funds with obscure and often overlapping investment philosophies. Regardless of intent, it could truthfully be said that most early defined-contribution plans did not ultimately function primarily for the benefit of participants. While some plan participants have done well with their defined-contribution investments, few would argue that in most cases, success was just a matter of dumb luck.

A recent development in the industry may help provide a “better” retirement plan solution. A type of fund has gained popularity in recent years, largely because it solves many of the problems of traditional Defined Contribution plans related to participants making prudent investment choices. The continued difficulty in educating Defined Contribution participants has led to the development and widespread popularity of Target Date Funds, a type of fund that represents a complete investment portfolio. These funds utilize multiple asset classes in predefined portfolios allocated based on a participant's time remaining until retirement. During the participant's career, the highly diversified “Target Date” portfolio adjusts from an aggressive portfolio in the early years to a more conservative portfolio as the employee nears retirement. The schedule of these allocation changes is known in the industry as the “Asset Allocation Glide Path”. One major controversy surrounding target-date funds is how aggressive the funds should be as an employee nears retirement. One camp says the employee should be aggressively allocated to have enough money to last throughout retirement. Another group says that an overly aggressive portfolio increases the risk of a large market downturn near retirement, which could jeopardize the participant’s ability to retire at all. As we have recently seen, that risk is very real. It is even more important to realize that target-date funds cannot make up for insufficient participant and employer contributions over the employee's career.

Perhaps many of the problems with DB and DC plans could be solved by rethinking the basic structure of retirement plans. Realizing that Plan Sponsors are highly regulated in plan construction and averse to being the first marine on the beach in the litigious world of retirement plans and investment results, this discussion is only theoretical but hopefully deserving of some thought. One good thing that could come from the current market environment is that it could help us rethink some basic retirement plan concepts that have stood untested for too many years.

All of the above lead me to look closely at the following facts:

Some of the pros of a Defined Benefit Plan for the potential retiree:

1. A guaranteed result.
2. Contributions are indirectly made on his behalf from the time he is vested in the Plan.
3. A large pooled physical investment that allows for low cost of operation.
4. The retiree has the option of taking a monthly dollar amount as opposed to a lump sum distribution.
5. Even if a participant retires and takes a lump sum distribution at the worst of times, there is enough money remaining in the fund for normal capital gains to cover the loss over time.

Some of the “Cons”:

1. Structure makes it necessary for plan sponsors to constantly balance projected payout liabilities and expected asset growth to determine the necessary contribution.
2. Caution about the guaranteed payout to retirees can lead plan sponsors to an overly conservative investment position.
3. Periods of Market upswing can lead to an over-funding of the plan on paper and thus omission of contributions.
4. As a result of number 3 above, periods of Market downswing can then lead to an under-funding of the plan.

Pros of a Defined Contribution Plan using a Target Date type of investment.

1. Assets and liabilities are automatically very reasonably matched, even as employees are hired, fired, and retired.
2. Assets are accounted for on an individual dollar basis for each participant. So he knows how much he has at any given time.
3. Target Date investments ensure broadly diversified portfolios wherein risk is regularly adjusted to match the time remaining until retirement. This eliminates the need for meticulous and comprehensive employee investment education.
4. Employer contributions can greatly enhance results.

Allowing that many of the “Cons” of a regular Defined Contribution plan that have to do with poor investment choices either by the sponsor or the participant. Those risks can also be greatly mitigated by using well-designed Target Date Funds; however, the remaining “Cons” might include:

1. If a participant retires at a market low, his dollar amount is locked in unless he rolls the distribution to an appropriately aggressive investment or leaves it in the plan. Either choice can be difficult psychologically, especially after losing a large portion of one's retirement assets.
2. Poor contributions or a late start in the plan can greatly reduce the likelihood of a DC plan providing much help toward a meaningful retirement account.
3. Poor employer contributions can also greatly limit the participant’s results in a DC plan.

Hypothetically, what if you constructed a Plan wherein:

1. The vested participants were automatically accounted for as being invested in one of a series of target date investments based on time remaining until retirement and an income fund/index after retirement. Each participant would represent a percentage of the total plan rather than a dollar value, which could then be rolled up to a single investment with a specific asset allocation based on the combined asset allocation of the individual Target date investments.
2. The Pooled investment was managed based on the combined asset allocation, which could then be unitized.
3. Individual employee contributions would purchase shares in the pool, which would automatically be invested according to the individual's assigned target date investment.
4. Employer contributions could be a base contribution for all employees to be invested according to the combined target date fund allocation. See Illustration 1.

Illustration 1.

	Age	Years to Retirement at 65	Weight in Plan*		Target Date Fund as of:2010	% Stocks	% Bonds	% Cash
Participant A	35	30	35%	→	2040	80%	15%	5%
Participant B	45	20	40%	→	2030	70%	25%	5%
Participant C	55	10	25%	→	2020	50%	45%	5%
						↓	↓	↓
Weighted Total			**100%**			**69%**	**27%**	**5%**

*Even though there would actually be many more participants, the concept would be the same.

Some advantages of such a plan would be:

1. Costs of Management would be lowered, and savings would be used to pay administration costs.
2. Each participant would participate in a broadly diversified, age-appropriate investment.
3. It would be possible for the plan sponsor to safely offer to retirees who stayed in the plan after retirement a base level guaranteed payment that stepped up from time to time. The total plan could make up short-term losses over time. The distributions could even increase after retirement.

In the past, such a plan may have been unfeasible because of administration costs, but now, with advanced computer programs, it could be cost-effective and vastly improve how we save for retirement.