Defined Benefit Plans

Ryan ALM, Inc. Truths

- Defined Benefit (DB) plans are the best Retirement vehicles.

- They exist to fulfill a financial promise that has been made to the plan participant upon retirement.

- The primary objective in managing a DB plan is to SECURE the promised benefits at a reasonable cost and with prudent risk.

- The promised benefit payments are liabilities of the pension plan sponsor.

- Liabilities need to be measured, monitored, and managed more than just once per year.

- Liabilities are future value (FV) obligations – a $1,000 monthly benefit is $1,000 no matter what rates do. As a result, they are not interest rate sensitive.

- Plan assets (stocks, bonds, real estate, etc.) are Present Value (PV) or market value (MV) calculations. We do not know the FV of assets except for bonds at maturity.

- In order to measure and monitor the funded status, liabilities need to be converted from FV to PV – a Custom Liability Index (CLI) is absolutely needed.

- A discount rate is used to create a PV for liabilities – ROA (publics), ASC 715 (corps), STRIPS, etc.

- Liabilities are bond-like in nature. The PV of future liabilities rises and falls with changes in the discount rate (interest rates).

- The nearly 40-year decline in US interest rates beginning in 1982 crushed pension funding, as the growth rate for future liabilities far exceeded the growth rate of the PV of assets.

- The allocation of plan assets should be separated into two buckets – Liquidity (beta) and Growth (alpha).

- The liquidity assets should consist of a bond portfolio that matches (defeases) asset cash flows with the plan's liability cash flows (benefits and expenses (B&E)).

- This task is best accomplished through a cash flow matching (CFM) investment process.

- The liquidity assets should be used to meet B&E chronologically buying time for the alpha assets to grow unencumbered to meet future liabilities.

- The Growth assets will consist of all non-bonds, which can now grow unencumbered, as they are no longer a source of liquidity.

- The pension plan's asset allocation should be driven by the plan's funded status.

- As the funded status improves, port alpha (profits) from the growth portfolio into the liquidity bucket (de-risk) extending the cash flow matching assignment and securing more promises.

- This de-risking ensures that plans don't continue to ride the asset allocation rollercoaster leading to volatile contribution costs.

- DB plans are a great recruiting and retention tool for managing a sponsor's labor force.

- DB plans need to be ***protected and preserved***, as asking untrained individuals to fund, manage, and then disburse a "benefit" through a Defined Contribution plan is a poor policy.

- Unfortunately, doing the same thing over and over and… is not working. A return to pension basics is critical.

You've made a promise: measure it – monitor it - manage it – and SECURE it…

Get off the pension funding rollercoaster - *sleep well!*