

# Market volatility highlights the value of defined benefit plans

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*A DB plan is not something every employer chooses to offer its workers, but following a year like 2008, those that do should be especially proud...*

There are some years when the burden of sponsoring a defined benefit (DB) plan does not seem so heavy. And there are some years...well, some years like 2008. In 2008, most plans saw their assets plummet; as a result, contribution demands will increase (with the full impact of that increase only marginally delayed by the contribution relief for corporate plans that passed Congress in December<sup>1</sup>) and pension expense in the corporate accounting statement will go up. But there is a flip side to this coin.

While the pain of sponsoring a DB plan is particularly acute right now, equally acute is the value to participants of being in such a plan. In DB plans, it is the sponsor who carries the investment risk, enjoying lower costs when returns exceed expectations and bearing the burden when returns are poor. Plan participants have not always fully appreciated just how valuable a benefit is being provided by the plan sponsor in carrying that risk.

Protection from investment risk is not the only way in which a DB plan is especially valuable to participants in tough times. As well as shielding plan participants from the direct impact of market volatility, a DB plan also places no decision-making burden on individual participants to invest their retirement assets<sup>2</sup>. In a DB plan, responding to market challenges is the responsibility of a trust board, required by law to meet a prudent expert standard<sup>3</sup> and with access to professional advice when needed. Such boards are well-placed to steer a prudent long-term course.

Historically, DB plans have outperformed DC plans by an average of 1% or more a year, and a large part of that has been attributed to the avoidance of behavioral mistakes such as pulling out of markets at the bottom.<sup>4</sup>

<sup>1</sup> A description of the relief offered by the Worker, Retiree and Employer Recovery Act of 2008, which was signed into law by President Bush on December 23, 2008, is outlined "Pension funding relief" by James Gannon.

<sup>2</sup> Increasingly, defined contribution plans are reducing the emphasis placed on individual decision-making through greater use of packaged Qualified Default Investment Alternatives such as target date funds – but plan participants still must choose whether to accept the plan default or to take another course, a choice that is not necessary in a DB structure.

<sup>3</sup> The phrase "prudent expert" is widely used to refer to the requirement of the Employee Retirement Income Security Act of 1974 that trustees act "...with the care, skill, prudence, and diligence, under the circumstances then prevailing, that a prudent man acting in like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims."

<sup>4</sup> For example, one study by The Center for Retirement Research at Boston College reports that "over the period 1988 through 2004, DB plans outperformed 401(k) plans by an average of one percentage point a year. This outcome occurred despite the fact that 401(k) plans held a higher portion of their assets in equities during the bull market of the 1990s." The study identifies "poor timing and other investment mistakes" as a major contributor to that return differential. *Investment Returns: Defined Benefit vs. 401(k) Plans*. Issue Brief Number 52 (September 2006).

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While many individuals are able to avoid over-reaction to market events, many others are not. DB plans don't leave employees wondering what to do in response to extreme market volatility—and possibly making the wrong choice at the wrong time.

A third advantage of a DB plan is that, in the post-retirement years, a known income is provided for life. In DC arrangements, participants face the challenge of longevity risk: i.e., deciding how to manage their investments in the face of uncertainty about how long those investments need to last. That challenge is compounded when investment returns are volatile. In a DB plan, the sponsor underwrites the longevity risk.

A DB plan is not something every employer chooses to offer its employees<sup>5</sup>, but, following a year like 2008, those that do should be especially proud, and participants in a pension plan should recognize the value this benefit can provide for their retirement security.

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<sup>5</sup> From the perspective of the participant, DB plans also have certain disadvantages, most importantly the relative lack of portability between employers and the heavy bias of the value of benefit accruals toward higher ages, which reduces the attractiveness of these plans to younger employees.

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