

# Pick Your Pension

Defined contribution plans let you grow – or blow – your pension **BY MOSHE ARYE MILEVSKY**



I recently took part in an unprecedented pension experiment in Tallahassee. Over 600,000 employees of the State of Florida have just been given the option of converting their defined benefit plans to defined contribution plans. And, if they switch, they'll become managers of their personal pension fund. There's also talk of the U.S. implementing a similar scheme for part of its sacred Social Security.

But before you run off to try to convert your pension, you should know there's a downside to defined contribution plans. Along with this new liberty comes the burden of financial risk.

Here's what you need to know. There are two basic categories of corporate pension plans: a defined contribution (DC) structure and a defined benefit (DB) structure. The DB plan defines your retirement benefit well in advance of your retirement date. For example, you might be promised 2% of your salary, for each year of service. After 30 years of work, your annual pension would be 60% of your last year's salary. Of course, if your company has promised you a pension benefit when you retire, it must set aside funds now to pay for those promises in the future, and that's where the actuaries do their magic estimates of how much must be set aside.

In contrast, DC plans are similar to RRSPs. Your employer deposits a percentage of your salary in a tax-sheltered fund. Whatever that pot of money grows to by the time you retire will determine your pension annuity and retirement income.

If the fund does well during your working life, you gain. But if the fund and its investments do poorly, you'll have a smaller pension. The risk is borne by you, the employee.

Within the DC universe, there are self-directed plans, where you control the asset allocation, investments and choices, and trustee-directed plans, where all the decisions are made for you.

Now, to the subject of pension conversions. At first glance, if a DB plan is holding \$200,000 on behalf of your promised pension (known by the actuaries as the accumulated benefits obligation) then giving you management control of the \$200,000, in a DC account, would seem a fair deal. After all, you now make the decisions and you control the asset mix.

However, while you'll probably be investing in the same type of instruments as a professional fund manager, you're taking the risk that your portfolio will tank, leaving you little to live on when you retire. Whereas, if the money remains in a DB-style plan, the plan sponsor or employer will be on the hook for the guaranteed pension annuity if the fund manager screws up.

This chart helps explain the risk. For example, if 6% of your salary is contributed toward the provision of a retirement pension — and the fund earns a fixed 8% rate of return — you will get a pension that is 60% of your final or average wage. However, if your adroit money skills only earn you 7%, your replacement rate will drop to 46% of your salary. Now, that's the risk. The reward, of course, is in the opposite direction. Do you like this gamble?

Florida partially compensated for the lost downside protection by giving participants the one-time option to return to the DB plan if they so desire. In my opinion, similar protection should be given to all employees if given the choice. Otherwise, it might not be worth it to take the money and run. **B**

In 1999, 47% of Canadian families had employee pension plans. The median value of these plans was \$49,300.

## WILL YOU RETIRE WELL?

A DC plan offers no guarantees. Contribute 6% of salary annually at a yield of 8% per year, and your pension will be 60% of salary. But if the yield is only 4% a year, your pension will be a mere 19% of salary

ANNUAL RETURN	5%	6%	7%	8%
4%	16%	19%	23%	26%
5%	22%	26%	30%	35%
6%	29%	34%	40%	46%
7%	38%	46%	53%	61%
8%	50%	60%	70%	81%
9%	66%	80%	93%	106%

Assumes 30 years of contributions and 30 years of retirement; non-stochastic calculation