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CYPEN & CYPEN NEWSLETTER for NOVEMBER 13, 2014

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Stephen H. Cypen, Esq., Editor

Never Forget September 11, 2001

and

Always Remember May 2, 2011

1. SAVING PUBLIC DEFINED BENEFIT PLANS: The funded status of public employee defined benefit retirement plans continues to garner great debate in the industry and press. DB plans are the primary vehicle for ensuring retirement income security for public workers, and Callan believes are viable and necessary in this sector. In 2011, Callan published a report to initiate discussions around what went wrong in the past that left many of these plans woefully underfunded. Callan suggested ways to nurse them back to health by promoting DB plans and providing them with ongoing support. Callan revisits the topic in 2014, now with a more urgent goal of saving public pensions amid persistent low funded levels and a burgeoning movement to disassemble them. The following talking points will help to move the discussion forward around the importance of DB plans. Callan expands on each point and supports its assertions with research, data, and actuarial considerations.

- **DB plans serve many purposes beyond providing constituents with retirement income.** Large DB plans are critical to well-functioning capital markets. By their sheer size, they can drive markets, command economies of scale, and also advance social and shareholder rights agendas. Through private investments, they are able to seed new companies and technologies. When retirees spend pension payments, they support state and local economies. These amounts may be critical to sustaining small and rural communities. For state systems that opted out of Social Security, the DB plan is the only means of guaranteed lifetime income. DB plans help to attract and retain valuable workers to public service by guaranteeing adequate retirement income security. Contrary to the belief that younger workers want more mobile benefits, a 2012 survey by Towers Watson showed that a vast majority of employees under the age of 40 now view traditional DB plans as very important. DB plan benefits max out at retirement age, they offer an incentive to retire, thereby refreshing the workforce and advancing careers of younger workers.
- **DB plans are proven to be extremely cost effective and reliable in delivering basic retirement income security, when the rules of DB finance are followed.** Most individuals are neither savvy investors nor disciplined savers. In particular, low-income earners are most at risk when it comes to saving and investing on their own in a defined contribution plan. The Callan DC Index reveals DB plans have outperformed DC plans by an annualized 78 basis points since 2006. Individual investors in the average DC plan tend to pay significantly higher annual fees than DB plans, due to differences between retail and institutional pricing. For the same level of lifetime income, a DB plan costs \$ 0.46 cents for every one dollar contributed to a DC plan.
- **Many public DB plans are underfunded today, but not because of paltry long-term returns. It is primarily because plan sponsors' contributions were neither sufficient nor consistent enough properly to fund the benefits promised.** The vast majority of public pension plans achieved their assumed annual investment returns. Even the worst-performing funds (90th percentile) earned an annualized 9.17% over 30 years ended June 30, 2014. Fully funding pension benefits over the period of employment ensures intergenerational equity,

- which aligns costs of today's services with their beneficiaries.
- **New benefits cannot be funded out of better-than-average investment returns simply because average returns is all one can expect over the life of the plan.** In the long term, periods of outperformance are balanced by periods of underperformance, which eventually causes returns to revert to the long-term average. (Mean).
 - **DB plan funding surpluses and deficits occur as part of the normal cycle of investment market returns.** There is no such thing as an enduring surplus, unless the plan has been systematically overfunded. There are such things as real deficits, and they are invariably much deeper and more persistent than any surplus when the benefits have been systematically underfunded.
 - **Plans that implement an actuarially sound funding policy will achieve 100% funded status over the long run. Over the short term, the plan could veer off course because of market cycles.** Far too many DB pension plans only approach 100% funding at market peaks. Sponsors need to have the discipline to allow for excess funding during good times without giving away surpluses to benefit increases. Surpluses will naturally become deficits at market bottoms. Funds need a positive surplus reserve in good times to prepare for bad times.
 - **Healthy DB plans are underpinned by a sustainable benefit design, a strong governance process, and the sponsor's commitment regularly to fund the plan.** Characteristics of good governance include ensuring that recommended contributions are paid, ensuring trustees have sufficient training and information to analyze risk and being deliberate when making plan changes.

Callan's conclusions are

- Trustees and stakeholders can correct mistakes of the past by going back to the basics: create discipline through good governance and always make necessary contributions to fund reasonable benefits over time. Adherence to these principles and new contributions in a positive investment market cycle has improved funding for most public DB plans over the last three years.
- Investment returns should not be counted on to reduce today's

- underfunding over the long-term. A combination of reducing present value of the liabilities and increasing assets through contributions will be needed.
- Plans should adopt a reasonable investment return assumption for the future based on the long-term capital market expectations for their unique asset allocation strategy.
 - The long-term management objective should be to make the return that is needed for adequate long-term benefit, contribution, and funding policy with the least risk of not making it. Funds that increase investment risk in an attempt to “play catch up” run a grave risk of failure.
 - DB plans are both cost effective and efficient in producing the safety net for retirement income security. DC plans can also play an important role in achieving this goal, but they transfer all of the risks from employers to workers. Risk sharing avoids the potential long-term real and social costs of insufficient income replacement for retirees.
 - Callan believes that DB plans in the public sector are viable and necessary. Government bodies can achieve almost any financial goal given a disciplined strategy and enough time, something that all public pension fund sponsors have. All sponsors need to do is simply follow the rules of DB finance.

This piece from Callan may be the very best we have ever seen. It asks all the right questions and suggests the appropriate answers. Cut this article out and keep it on your person (close to your heart). We have just begun to fight.

2. PROFITABLE PRUDENCE -- THE CASE FOR PUBLIC EMPLOYER DEFINED BENEFITS: Pension Research Council, The Wharton School, has issued a new working paper entitled “Profitable Prudence: The Case for Public Employer Defined Benefit Plans.” The United States public sector plans covering employees of state and local governments have grown to make up a substantial segment of national pension assets and membership. Participants include more than 14 million workers -- 10% of the national workforce -- and six million retirees, as well as other annuitants; all are members of more than 2,000 retirement systems sponsored by a state or local government. These systems have combined assets of more than \$2 trillion and they distributed over \$110 billion in pension and other

benefits; this volume exceeded the entire economic output of 22 states and the District of Columbia! In recent years, public sector pensions have diverged from the private sector pension trend, in that the percentage of public employees participating in a defined benefit plan has held steady at around 90%, while the fraction of private sector workers with a DB plan has plummeted to around 20%. Against the backdrop of 30 years of private pension experience with the Employee Retirement Income Security Act, US public sector pensions evolved prior to, and outside the purview of, this federal legislation. This different experience makes it invaluable not only to learn what effects state and local government pensions have on stakeholders -- including participants, public sector employers, and taxpayers -- but also to glean lessons that the public pension experience may offer to private industry. PRC WP 2004-6.

3. INCENTIVIZING DELAYED CLAIMING OF SOCIAL SECURITY RETIREMENT BENEFITS BEFORE REACHING FULL RETIREMENT AGE: U.S. Social Security Administration, Office of Retirement & Disability Policy, has issued a bulletin "Incentivizing Delayed Claiming of Social Security Retirement Benefits Before Reaching Full Retirement Age". Among Social Security retired worker beneficiaries, nearly half claim their retirement benefits as early as possible, and almost all of them claim at some point before their FRA. Because Americans are living longer but retiring earlier, often with a lack of personal retirement savings, the timing of benefit claiming can be crucial to financial well-being in retirement. Because claiming benefits before FRA results in permanently reduced benefits, many researchers argue that delaying claiming is often the best decision economically. In fact, delaying claiming of Social Security retirement benefits is now recognized as an important way to enhance retirement security. Following the notion that delaying benefit claiming can aid in financial security of older Americans, the National Commission on Fiscal Responsibility and Reform (Simpson-Bowles Commission) urged Social Security Administration to provide information to the public with an eye toward encouraging delayed retirement and to do so by considering behavioral economics approaches. In the bulletin, the authors explore a number of behavioral strategies aimed at incentivizing individuals to delay claiming. SSA's current structure to incentivize delayed retirement benefit claiming involves decreasing monthly benefits if they are claimed before FRA and increasing

monthly benefits if they are claimed after FRA; however, the size of annual increases in benefits after FRA is larger than the size of annual decreases in months before FRA. The incentive structure results in a number of interesting distributional outcomes, and presents an opportunity to introduce policy changes that may affect those outcomes. In keeping with the finding that most individuals claim their benefits before their FRA (with many claiming as early as possible), making the incentives to delay claiming in the months before the FRA more attractive could affect a far greater portion of the retirement age population than do current incentives. As such, the ideas presented aim to shift that reward structure so that individuals are more incentivized to delay claiming in the months and years before reaching FRA. While delaying claiming benefits typically refers to claiming them sometime after the FRA, there are ways to encourage individuals to delay claiming beyond when they would have chosen to claim otherwise, which, for most individuals, is sometime before FRA. Of course, those incentives would be most effective for individuals whose claiming decision is not affected by other factors, such as poor health or job loss, which can force people to retire earlier than they would have otherwise. The authors first describe the design of the current benefit claiming incentive structure. Next, they present the historical context that led to the existing structure. They then provide data on the number and characteristics of people who claim benefits at various ages. Using those data, the bulletin describes the potential usefulness of better targeting the claiming-related incentives to persons who start receiving benefits before their FRA. Next, a number of novel ideas are presented, based on psychological and behavioral research, intended to incentivize workers to delay claiming in the years before their FRA. (Some of these are changing early retirement options; paying lump-sum; rewarding work with bonuses; instituting a lottery; and reforming the earnings test.) Finally, the authors use a modeling projection to examine how potential behavioral responses to one of these ideas could affect retirement and incomes of various groups. Something to think about...seriously. Social Security, Bulletin, Vol. 74 No. 4. 2014.

4. PLANSPONSOR.COM REPORTS ON CORPORATE PENSION FUNDED STATUS:

A. For the typical corporate plan in October 2014, assets

increased 1.5%, trailing the 1.9% increase in liabilities, the BNY Mellon Institutional Scorecard shows. This funded status is down 5.7% from the December 2013 high of 95.2%.

B. Decreases in interest rates used to calculate corporate pension liabilities offset rising equity markets, keeping funded status constant. The collective estimated deficit of \$367 billion as of October 31, 2014 is up modestly by \$15 billion from the estimated deficit of \$352 billion as of September 30, 2014, and up \$131 billion from the beginning of the year, according to Mercer. The S&P 500 index increased by 2.3% during October. Typical discount rates for pension plans as measured by the Mercer Yield Curve decreased by 12 basis points, to 3.98%, driving liabilities upward, and wiping out positive plan asset performance.

5. ASSET ALLOCATION AND FUND PERFORMANCE OF DEFINED BENEFIT PLANS BETWEEN 1998-2011:

Of the \$18.8 trillion of retirement assets in the United States at the end of the third quarter of 2013, \$6.8 trillion was held and managed in traditional defined benefit pension plans, including endowments and foundations. Millions of Americans rely on returns from these investments for current or future retirement incomes. Funding levels of DB plans came under severe pressure during the Global Financial Crisis, putting in jeopardy the financial security of current and future retirees. In such an environment, the investment allocation decisions of DB pension plan managers take on the utmost importance. The performance of any investment portfolio is determined primarily by three factors: allocation of investments across the available asset classes; the total returns generated from investments available within each asset class; and costs of deploying assets through each investment. With respect to allocation of investments across the available asset classes, nearly all DB pension plans hold diversified portfolios that include corporate equities and fixed income securities. Many of these plans also invest in other asset classes, including commodities, real estate, timber, infrastructure and private equity. The portfolio allocations, returns, and costs of investing in available asset classes vary widely across plans, leading to pronounced differences in investment performance of DB plans. A study from CEM Benchmarking Inc. used realized investment performance information of U.S. DB pension funds over the sample period 1998-2011, rather

than investment performance information as measured by broad asset class benchmarks, and examined how that realized performance has been influenced by the asset allocation decisions of the funds. The results are derived from CEM's unique database, which contains detailed information regarding asset allocation, investment performance and investment expenses for large, global institutional investors beginning in 1990. The starting date for the study is 1998, chosen to coincide with addition to the database of publicly traded real estate in the form of stock exchange listed equity REITs. As a separate and distinct investment alternative within the real estate asset class, having information with respect to investment performance and expense of listed equity REITs provides a more complete comparison of the consequences of performance comparisons because that year is the last one from which private real estate returns are available after standardizing for the usual lag and appraisal smoothing in the reporting of these investment returns.

6. WOULD YOU TAKE A HATCHET ATTACK FOR \$27 A DAY?:

Well, according to *LEO Affairs*, Officer Kenneth Healy, the cop who was brutally attacked by a man armed with a hatchet in Queens October 24th, will be eligible only for pension of \$27 per day from the city. Under the recent (and complicated) system, a cop like Healy who had joined after 2009, is eligible for a yearly disability payout of 50% of annual salary (or about \$21,000 per year). However after new legislation, he would be taxed 50 cents on every dollar of the additional Federal Social Security payout money. Ultimately, under the new rules, instead of \$53,000 annually, Healy is eligible for only \$32,000 a year -- in total from the city and the federal government. Healy's attack comes on the heels of the tragic Canadian Parliament attack, which shook the nation. A bill currently sits in the New York legislature to reverse pension amounts to pre-2009 amounts for those injured in line of duty. However, Mayor Bill de Blasio stands against the bill, citing costs to the city that will supposedly surpass \$35 million per year. That figure is disputed by New York's police unions.

7. PUBLIC PENSION FUNDING STUDY: The Milliman Public Pension Funding Study annually explores the funded status of the 100 largest U.S. public pension plans. Milliman collects key sponsor-reported information about each plan's assets, accrued liabilities, investment return assumptions and asset allocations. An independent

investment return assumption independently determined is based on its unique asset allocation and Milliman's current capital market assumptions. Independently determined investment return assumptions are used to recalibrate each plan's accrued liability. This process enables an independent assessment of plans' investment return assumptions relative to the reported returns that sponsors expect to earn on their investments. This study employs a version of the budgeting methodology used by sponsors to fund their plans over a long time horizon as a going concern. This methodology differs from near-term settlement calculation methodologies, often referred to as "risk-free rate" methods that have been used in some academic studies of the health of public pension plans. Funded ratios using the market value of assets increased modestly, largely reflecting strong asset growth. Larger plans in the study tend to be better funded than the smaller plans. The best funded plans, those in the top quartile, account for 34% of the aggregate sponsor-reported accrued liabilities, whereas the worst funded plans, in the bottom quartile, account for only 18% of the aggregate sponsor-reported accrued liabilities. While 13 of the 100 plans have lowered their reported investment return assumption, most plans have left their investment return assumption unchanged. The median investment return assumption reported by plans decreased from 8.00% in 2012 to 7.75% in the 2013, remaining there in 2014. The study's median independently determined investment return assumption decreased from 7.65% in the 2012 study to 7.47% in the 2013 study and to 7.34% in the 2014 study. In the aggregate, the data suggest that for many plans that have not recently lowered their reported assumptions, some decrease in the investment return assumption may be appropriate. Plans should continue to monitor emerging market return expectancies and adjust their assumptions as needed, to ensure that liabilities are calculated using assumptions that are based on best estimate expectations from investment professionals. There are two ways that plans report assets: market value, which is well understood, and actuarial value, which reflects asset-smoothing techniques that are used to dampen year-to-year contribution fluctuations. While there is a multitude of asset smoothing techniques in use, generally speaking, they offset investment gains/losses from a particular year with investment gains/losses from a nearby year. This process means that actuarial values tend to lag changes in the market and can deviate from market value when there are large market movements. The 100 plans

reported assets totaling \$2.75 trillion on a market value basis and \$2.80 trillion on an actuarial basis. By comparison, reported assets in the Milliman 2013 Public Pension Funding Study stood at \$2.58 trillion on a market value and \$2.73 trillion on an actuarial value basis. For most plans, the large market losses suffered during the financial crisis resulted in actuarial values that temporarily were far higher than market values for several years after the crisis; the favorable market returns since 2009 have allowed market values gradually to catch up to, and in some cases exceed, actuarial values.

8. GOVERNING'S TAKE ON JOB GROWTH: Here are summaries of two interesting articles from *Governing* on job growth:

A. The Labor Department's latest job report depicted a bit of optimism for the recovering economy. The nation added an estimated 214,000 jobs in October, and revisions to previous months boosted the monthly average to 229,000 jobs gained so far this year. Meanwhile, the outlook for government employment has not improved much. While most other sectors added lost jobs, the public sector continues to act as a drag on economic growth. Local government employment climbed only half a percentage point over the past 12 months. At the state level, public employment totals remain nearly unchanged. Seasonal changes in education employment, which account for a large share of the jobs, mostly explain the sector's monthly fluctuations in job totals. But over the long term, states and localities have not recovered from steep jobs losses incurred back in 2010 and 2011. Federal employment, while a much smaller piece of the sector, has been hit hardest. Private industry, by comparison, added about 2.5 million jobs over the past 12 months. That increase is about 2.2%, compared to 0.3% for total government employment. The strongest performing industries over that period include construction, mining/logging, professional/business services, transportation and warehousing.

B. U.S. Labor Department data show steady job gains for local government. The sector posted an increase of 11,000 jobs last month, after adding 12,000 positions in April. Monthly shifts in public employee jobs are often driven by swings in education employment, as school districts hire or lay off teachers. That was not the case this past month, though, as non-education local government employment

climbed 18,000, while education related jobs dipped just 6,600. State government employment changed little, losing an estimated 5,000 positions for the month. The federal government, meanwhile, continues to shed workers as agency budgets remain tight. May marked the sixth consecutive month of job cuts for the sector. So far this year, all public sector employment growth has occurred at the local level. The following are job tallies for the year, comparing new estimates to December totals:

- Local government: +48,000
- State government: -2,000
- Federal: -31,000

9. APPLICATION OF ONE-PER-YEAR LIMIT ON IRA ROLLOVERS:

Internal Revenue Service has announced a follow-up to Announcement 2014-15, 2014-16 I.R.B. 973, addressing application to Individual Retirement Accounts and Individual Retirement Annuities of the one-rollover-per-year limitation of § 408(d)(3)(B) of the Internal Revenue Code. Section 408(d)(3)(A)(i) provides generally that any amount distributed from an IRA will not be included in gross income of the distributee to the extent the amount is paid into an IRA for the benefit of the distributee no later than 60 days after the distributee receives the distribution. Section 408(d)(3)(B) provides that an individual is permitted to make only one nontaxable 60-day rollover between IRAs in any 1-year period. That one-rollover-per-year limitation was applied on a case-by-case basis. However, the Tax Court in *Bobrow v. Commissioner*, T.C. Memo. 2014-21, held that the limitation applies on an aggregate basis, meaning that an individual could not make more than one nontaxable 60-day rollover within each 1-year period even if the rollovers involved different IRAs. In Announcement 2014-15, IRS indicated that it anticipated following the interpretation of *Bobrow*, and accordingly that it would withdraw the proposed regulation, but would not apply that interpretation before 2015. The new announcement was intended to address certain concerns that have arisen since release of Announcement 2014-15. IRS will apply the *Bobrow* interpretation for distributions that occur on or after January 1, 2015. Thus, an individual receiving an IRA distribution on or after January 1, 2015, cannot roll over any portion of distribution into an IRA if the individual has received a distribution from any IRA in the preceding 1-year period that was rolled over into an IRA. However, as a transition rule for distributions in 2015, a

distribution occurring in 2014 that was rolled over is disregarded for purposes of determining whether a 2015 distribution can be rolled over under §408(d)(3)(A)(i), provided that the 2015 distribution is from a different IRA that neither made nor received the 2014 distribution. In other words, the *Bobrow* aggregation rule, which takes into account all distributions and rollovers among an individual's IRAs, will apply to distributions from different IRAs only if each of the distributions occurs after 2014. IRS Announcement 2014-32. (November 10, 2014).

10. NINTH CIRCUIT FOLLOWS *DUDENHOEFFER*, REVERSES *AMGEN*: On remand from the United States Supreme Court for reconsideration in light of *FifthThird Bancorp v. Dudenhoeffer*, ([See C & C Newsletter for June 26, 2014, Item 4](#)), the panel reversed the district court's dismissal of a class action brought by current and former employees of Amgen, Inc., and an Amgen subsidiary under Employee Retirement Income Security Act, alleging breach of fiduciary duties regarding two employer-sponsored pension plans. The plans were employee stock ownership plans that qualified as Eligible Individual Account Plans. All of plaintiffs' EIAPs included holdings in the Amgen Common Stock Fund, which held only Amgen common stock. The Supreme Court held in *FifthThird* that there is no presumption of prudence for employee stock ownership plan fiduciaries beyond the statutory exemption from the otherwise applicable duty to diversify. The panel held, therefore, that plaintiffs were not required to satisfy criteria previously required in order to show that no presumption of prudence applied. The panel held that the plaintiffs stated a claim that defendants acted imprudently, and thereby, violated their duty of care, continuing to provide Amgen common stock as an investment alternative when they knew or should have known that the stock was being sold at an artificially inflated price. The panel held that plaintiffs sufficiently alleged that the defendants violated their duty of loyalty and care by failing to provide material information to plan participants about investment of the Amgen Common Stock Fund. Agreeing with the Sixth Circuit, the panel held that defendants' preparation and distribution of summary plan distributions, including incorporation of Amgen's SEC filings by reference, were acts performed in their fiduciary capacity. The panel therefore reversed the decision of the district court and remanded for further proceedings consistent with the opinion. *Harris v. Amgen, Inc.*, Case No. 10-56014 (U.S. 9th Cir. October 30, 2014).

11. STATE STREET HIT WITH GOVERNMENT SUBPOENAS RELATING TO ASSET SERVICING: A report from Reuters says that State Street Corp. is responding to subpoenas from the U.S. Department of Justice and the Securities and Exchange Commission for information regarding its solicitation of asset servicing business of public retirement plans. State Street has retained counsel to review the matters, including use of consultants and lobbyists in solicitation of business of public plans. SEC has expressed its intent to increase enforcement actions in the municipal market, bouyed by recent successes there. Next year SEC will focus on abuses in the pension fund arena, offering/disclosure fraud and broker/dealer abuses. Hang on to your Speedo.

12. VETERANS DAY TEST: Veterans Day having been November 11, 2014, patriots everywhere feel a sense of pride as we again honor all who have served our country. Can you pass Chuck Norris's Veterans Day test? Did you know:

- There are 19.6 million veterans in the U.S.
- There are 9.3 million U.S. veterans who are older than 65.
- There are 1.6 million younger than 35.
- There are 1.6 million female veterans.
- There are 39,890 veterans still alive who served during World War II, the Korean War and the Vietnam War.
- There are 3.6 million veterans with a service-connected disability rating.
- Veterans Day originated as Armistice Day on November 11, 1919, the anniversary of the end of the Great War, now known as World War I. (If memory serves us right, we think the war ended at 11:11 a.m.)
- In 1926, Congress passed a resolution to make November 11 an annual observance.

- In 1938, November 11 became a national holiday.
- In 1954, President Dwight D. Eisenhower signed legislation that changed Armistice Day to Veterans Day to honor those who served in all American wars.
- Veterans Day is commonly confused with Memorial Day, which is why it is important to realize Veterans Day falls on November 11, and honors living service members. Memorial Day is commemorated on the fourth Monday in May, and honors those who have died in service of our country or from resulting injuries.

13. STUFF YOU DID NOT KNOW: Coca-Cola was originally green.

14. TODAY IN HISTORY: In Harvard-Yale game is 1st college football contest with uniforms. (What did they previously wear?)

15. KEEP THOSE CARDS AND LETTERS COMING: Several readers regularly supply us with suggestions or tips for newsletter items. Please feel free to send us or point us to matters you think would be of interest to our readers. Subject to editorial discretion, we may print them. Rest assured that we will not publish any names as referring sources.

16. PLEASE SHARE OUR NEWSLETTER: Our newsletter readership is not limited to the number of people who choose to enter a free subscription. Many pension board administrators provide hard copies in their meeting agenda. Other administrators forward the newsletter electronically to trustees. In any event, please tell those you feel may be interested that they can subscribe to their own free copy of the newsletter at <http://www.cypen.com/subscribe.htm>.

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**777 Arthur Godfrey Road
Miami Beach, Florida 33140
Telephone/Miami-Dade: 305.532.3200
Telephone/Broward: 954.522.3200
Telephone/Toll Free: 800.332.3200
Telecopier: 305.535.0050**

www.cypen.com
info@cypen.com

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