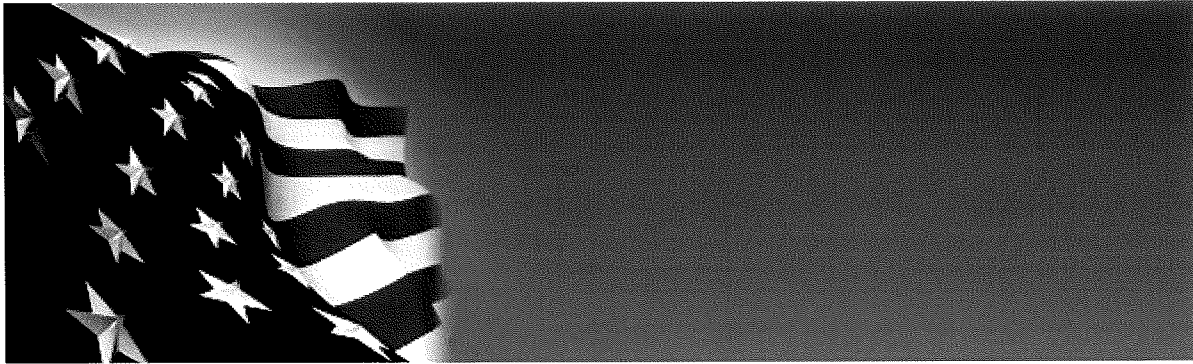


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CYPEN & CYPEN NEWSLETTER for DECEMBER 11, 2014

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Stephen H. Cypen, Esq., Editor

Never Forget September 11, 2001

and

Always Remember May 2, 2011

1. DB PENSION PLANS STILL BETTER BANG FOR THE BUCK: National Institute on Retirement Security has issued an update on the “Economic Efficiencies of Defined Benefit Pensions.” Over the past three decades, private employers have shifted away from defined benefit pensions that provide employees with a steady retirement income stream, towards defined contribution retirement accounts – like 401(k) -- in which individual workers manage their own investments. Since the 2008 financial crisis, public employers have faced pressures to make a similar change. However, DB plans are inherently more cost-efficient than DC plans. A seminal NIRS study released in 2008, entitled “A Better Bang for the Buck,” found that a typical large DB pension plan provides a given level of retirement benefit at about half the cost of a DC plan. In this updated comparison of DB and DC plan costs, the authors take into account key developments in the retirement benefits landscape with regard to fees, investment strategies and annuities, while building an “apples to

apples" comparison through a uniform set of demographic and economic assumptions. Highlights include the following:

- ***A typical DB plan provides equivalent retirement benefits at about half the cost of a DC plan, and 29% lower cost than an "ideal" DC plan modeled with generous assumptions.***
- A DB plan, modeled with the typical fees and asset allocation of a large public plan, has a 48% cost advantage compared to a typical individually directed DC plan.
- The DB pension costs 29% less than an "ideal" DC plan that features the same low fees and no individual investor deficiencies.
- Annuitizing DC account balances does not erase the DB pension cost advantage. Annuities offered by private insurance companies would only modestly decrease DC funding requirements at historical average interest rates, and would increase costs at 2014 interest rates.
- ***DB plans have three structural cost advantages compared to DC plans: longevity risk pooling, the ability to maintain a well-diversified portfolio over a long investment horizon, and low fees and professional management.***
- **Longevity risk pooling.** In order to provide lifelong income to each and every retiree, DB plans only have to fund benefits to last to average life expectancy. In a DC plan, an individual must accumulate extra funds in order to self-insure against the possibility of living longer than average. They can also buy a life annuity from an insurance company, but it comes at a cost.
- **Asset allocation.** DB pensions are able to maintain portfolio diversification -- specifically, stay invested in equities -- over time, while DC participants must shift to lower-risk, lower-return investments as they age. Thus, over a lifetime, DB pensions earn higher gross investment returns than do DC accounts.
- **Low fees and professional management.** Due to economies of scale, DB plans feature low investment and administrative

expenses as well as management of investments by professionals. An "ideal" DC plan can theoretically achieve the same fees and investment returns, for a given asset allocation, by removing individual choice. When the authors use more realistic assumptions -- industry average fees and a modest "behavioral drag" on investment returns resulting from well documented tendencies in individual investor behavior -- they find that the DB plan has a large advantage in net investment returns.

- ***Given the cost efficiencies inherent to DB plans, employers and policymakers should carefully continue to evaluate claims that DC plans will save money.***
 - For a given level of retirement income, a typical individually directed DC plan costs 91% more -- almost twice as much -- as a typical DB plan.
 - Consequently, shifting from a DB plan to a DC plan and maintaining the same contribution rate will generate significant cuts in retirement income. The consequences could be dramatic for employees, employers and taxpayers.

Sounds pretty dramatic to us.

2. NEW INVESTING AND FUNDING STRATEGIES MAY BE ON TAP FOR PUBLIC DB PLANS: With some equity markets near historic highs and interest rates in the U.S. poised to rise, achieving returns going forward may be more challenging for public defined benefit plans than the past few years. According to plansponsor.com, public DB plan sponsors will also need to consider a number of other important factors as they contemplate investment strategy and asset allocation in 2015 and beyond. New accounting standards from the Governmental Accounting Standards Board will move the valuation of assets from an actuarially smoothed methodology to a market value framework. The new GASB rules were finalized in 2012, but are just now starting to go into effect. From now over the course of 2015, public DBs will start new reporting. For valuing assets, the new rules move to mark-to-market accounting. Previously, public DBs used an actuarially smoothed asset value, for which gains or losses were spread over a period of time -- generally five years. The new rules mandate public DBs to use market value assets. On the liability side,

historically plans had used as a discount rate their expected return on assets assumption, but under new rules they will only be able to use the expected benefit payments for which they expect to have assets to cover. For expected benefit payments that are unfunded, they must use the municipal bond rate. The upshot is, moving to mark-to-market on an asset side, will introduce a lot more volatility to that side of the equation, so funded status will be more volatile. On the liability side, blending the expected return on assets assumption and municipal bond rate will reduce the total discount rate for some plans, so it will increase liabilities and decrease funded status in those situations.

3. PENSION PLANS' FUNDED STATUS RISES: The funded status of a typical U.S. corporate pension plan increased 0.4 percentage points to 89.9% in November, as assets increased faster than liabilities, according to the BNY Mellon Investment Strategy and Solutions Group. Public pension plans increased (0.7%), as did endowments and foundations (both 0.6%). Separately, Wilshire Consulting reported that the aggregate funding ratio for U.S. corporate pension plans was unchanged at 84.8% for the month of November, 2014.

4. MOST AMERICANS' RETIREMENT IQ EQUALS DUMB AND DUMBER: In survey after survey, Americans have not scored well on retirement literacy tests, according to *USA Today*. But a new survey of Americans ages 60 to 75 shows 80% failed a retirement income literacy test. The poll was conducted with interviews of over 1,000 people 60 to 75 years old, with at least \$100,000 in household assets. They were asked 38 retirement literacy questions on basics, such as Social Security, life expectancy, IRAs, life insurance/investments and how bonds work. Only 2 in 10 had passing grades. Among the highlights of the new report:

- Only 1 in 4 have a written financial plan, even though a written plan leads to better financial planning and financial decisions.
- A significant minority have never tried to figure out how much they need to accumulate to retire securely.
- Only 31% know that \$4,000 is the most they can afford to withdraw per year from a \$100,000 retirement account to make it last for 30 years.

- More than half underestimate the life expectancy of a 65-year-old man, which suggests they may not realize how long their assets must last.
- Only 54% realize that Social Security benefits increase each year one delays up to age 70, and a similar percentage know that it is best to wait until age 70 to claim Social Security if you expect to live to 90.

And we expect these people to accumulate a retirement nest egg on their own, manage it and live on it for life? Very sad.

5. PUBLIC PENSION PLANS SHOOTING CRAPS?: State and local pension plans invest roughly twice as much in risky assets as would a prudent individual saving for retirement, says an opinion piece in the *Wall Street Journal*. Indeed, the Society of Actuaries, which represents the actuarial profession, recently pointed to public pension investment practices that go against basic risk management principles. With \$3.7 trillion on the line, risk-addicted pensions need an intervention. If Gamblers Anonymous cannot do it, who can? Many individuals follow a rough “100 minus your age” rule to determine how much risk to take with their retirement savings. A 25-year-old might put 75% of his savings in stocks or risky assets, the remaining 25% in bonds and other safer investments. A 45-year-old would hold 55% in stocks, and a 65-year-old, 35%. Individuals take this risk knowing that the end balance of their IRA or 401(k) accounts will vary with market returns. Now consider the California Public Employees’ Retirement System, the largest U.S. public plan, and a trendsetter for others. Typical participant is around age 62, so a “100 minus age” rule would suggest that CalPERS hold about 38% in risky assets. In reality, CalPERS holds about 75% of its portfolio in stocks and other risky assets, such as real estate, private equity and until recently, hedge funds, despite offering benefits that, unlike IRAs or 401(k)s, it guarantees against market risk. Most other states are little different: Illinois holds 75% in risky assets; the Texas teachers’ plan holds 81%; New York state and local plans, 72%; Pennsylvania 82%; New Mexico 85%. Managers of government pension plans counter that they have longer investment horizons and can take greater risks. But most financial economists believe that the risks of stock investments grow, not shrink, with time. Moreover, while governments may exist forever, pensions cannot take forever to pay off their losses. New accounting

rules promulgated by the Governmental Accounting Standards Board and taking effect this year, will push plans to amortize unfunded liabilities over roughly 15 years. Even without these rules, volatile pension investments translate into volatile contribution requirements that can and have destabilized government budgets. Yet, public plan managers may see little option other than to double down on risk. In 2013 nearly half of state and local plan sponsors failed to make their full pension contributions. Moving from the 7.5% return currently assumed by CalPERS to the roughly 5% yield on a 38%/62% stock and bond portfolio would increase annual contributions by around 50% -- an additional \$4 billion -- making funding even more of a challenge. But the fundamental misunderstanding afflicting practically the entire public pension community is that taking more investment risk does not make a plan less expensive. It merely makes it less expensive today, by reducing contributions on the assumption that high investment returns will make up the difference. Risky investments shift the costs onto future generations, who must make up for shortfalls if investments do not pay off as assumed. SOA recently noted that public sector plans in the U.S. are unique in that they have taken additional risk as the plans have become more mature, compared to private sector plans in the U.S. and private and public sector plans in Canada and elsewhere, which have taken less risk as plans have matured. The reason: GASB accounting rules let U.S. public plans credit themselves with the higher returns on risky assets before those returns are earned, creating an artificial incentive to take risk. U.S. corporate pensions and public plans overseas may credit themselves only after investment risks pay off, and thus better balance risk and return. Public pensions are addicted to risk, and because they are effectively too big to fail, require an intervention. One idea is to tighten standards of practice for public plan actuaries, requiring additional disclosures and allowing less discretion. Tying actuaries' hands may be the best protection against pressure from plans. Another possibility: the Securities and Exchange Commission could be empowered to demand accurate disclosures of pension liabilities that do not artificially credit plans for taking investment risk. The political challenges to pension reform are daunting, but the economic risks of failure are no less so. The author, Andrew G. Biggs, is with the American Enterprise Institute. (But, of course.)

6. NCPERS JOINS PROTEST OF DELAWARE RULING: National

Conference on Public Employee Retirement Systems has joined eight unions representing public and private sector workers in protesting a Delaware Supreme Court decision that in essence allows corporations to immunize themselves from investor lawsuits -- eviscerating investor rights and potentially threatening the retirement security of millions who are covered by public and private plans. Because Delaware is the corporate home of the majority of Fortune 500 corporations, the court's decision impacts shareholders not only across the nation, but around the world. In *ATP Tour, Inc. v. Deutscher Tennis Bund*, for the first time, the directors of a corporation may unilaterally adopt immunity-granting bylaws requiring all investors who bring suit against a corporation to be personally liable for all of a corporation's legal expenses, unless the investor is entirely successful on virtually every claim alleged. Even when an investor is successful on most but perhaps not all counts alleged, that investor still faces substantial financial liability to the wrongdoers. So even when an investor wins, the investor loses. Since the May 2014 decision, at least 34 additional corporations have adopted bylaws that are identical or even more extreme. Even in cases involving undeniable violations of federal or state law, no responsible investor can risk facing this type of uncontrollable and unpredictable financial exposure. Pension plans are among the largest and most active institutional investors. Approximately 70% of the typical public pension plan's funding comes from investment returns. As shareholders, pension plans must ensure the integrity of their investments. But as fiduciaries, pension plans cannot expose their capital, and their beneficiaries, to unreasonable financial risk. NCPERS and its coalition partners sent a letter to the Governor of Delaware, demanding swift action to restore shareholder rights and to prevent corporations, their directors and their officers from immunizing themselves from accountability to their shareholders. To leave the court's decision intact would not only damage confidence in Delaware's corporate law, it would deprive investors of the crucial protection of our nation's securities and corporate governance laws. The coalition includes AFL-CIO, AFSCME, AFT, IBEW and NEA. We recently published John Coffee's column on the subject ([See C & C Newsletter for December 4, 2014, Item 2](#)).

7. OLD PRIVATE SPDs SAVED...FOR NOW: Pension Rights Center and the New England Pension Assistance Project applaud the Pension Benefit Guaranty Corporation, the National Archives and

Employee Benefits Security Administration of the Department of Labor for saving an extensive microfiche collection of summary plan descriptions. SPDs are plain English summaries of employee benefit plan rules, which can be critical in helping retirees, widows and widowers prove that they are entitled to benefits from their pension plans or from PBGC. Years ago, private plans were required to file their SPDs with EBSA, but a 1997 law granted EBSA authority to destroy old documents. Paper files dating from 1991-1997 were destroyed, and this microfiche archive, dating from 1975-1991, was next in line. At urging of the Pension Rights Center and New England Pension Assistance Project, government officials held off until a permanent solution could be found.

8. WHO IS ADVISING ON SOCIAL SECURITY?: The vast majority of advisors (90%) offer some sort of Social Security guidance, but only 36% recommend specific Social Security claiming strategies, according to financialplanning.com. And this fact mirrored a study in which almost two-third of advisors claim to have a fiduciary relationship with their clients. The sad reality is that too many advisors fail effectively to plan for Social Security benefits, and fewer still coordinate them with the overall retirement portfolio. The result is simple: an advisor cannot claim to be a fiduciary and then not properly account for his clients' Social Security. Oft-repeated statistics from the Social Security Administration find that among beneficiaries, 52% of married couples and 74% of unmarried people receive half or more of their income from Social Security. Even more shocking, 22% of married couples and 47% of unmarried people rely on it for 90% or more of their income! Demographics are driving demand, and as baby boomers continue to retire, those figures will likely increase. It means more people are relying on Social Security for a greater portion of their retirement portfolios. How can an advisor possibly claim to be acting in his clients' interests if he ignores what is quickly becoming their largest retirement asset? The answer is, he cannot.

9. STATES THAT BENEFIT MOST FROM FEDERAL SPENDING: *Governing* writes about a report that shows federal spending accounts for nearly one-fifth of the nation's economic activity, with the impact wildly varied from state-to-state. Federal spending totaled \$3.1 trillion last year -- the equivalent of about 19% of all economic activity across the states. Mississippi potentially benefited the most from federal

money: the \$34.3 billion spent there was equal to a full third of that state's Gross Domestic Product in 2013. California received the most federal money last year, nabbing a little more than \$1 out of every \$10 spent by Uncle Sam on the states. On the other end, federal spending in Wyoming was equivalent to just 12% of that state's GDP. It was also the state where the fewest amount of federal dollars (\$5.2 billion) was spent. The following shows the data for Florida (in millions):

Retirement benefits	\$76,959	(9.7%)
Nonretirement benefits	\$66,541	(8.4%)
Grants	\$19,062	(2.4%)
Contracts	\$14,089	(1.8%)
Salaries/wages	\$14,180	(1.8%)
Total	\$190,831	

10. FLORIDA CANNOT MANDATE SUSPICIONLESS DRUG TESTING OF ALL APPLICANTS SEEKING WELFARE BENEFITS:

Section 414.0652, Florida Statutes, mandates suspicionless drug testing of all applicants seeking Temporary Assistance for Needy Families benefits. Lebron sued the Secretary of the Florida Department of Children and Families, claiming that the statute violates the Fourth Amendment's prohibition against unreasonable searches and seizures, applied against the states through the Fourteenth Amendment. After the U.S. Eleventh Circuit Court of Appeals affirmed entry of a preliminary injunction barring application of the statute against Lebron, the State halted the drug testing program. Since then, the district court granted final summary judgment to Lebron, and declared the statute unconstitutional, and permanently enjoined its enforcement. On appeal, the appellate court once again affirmed. On the record presented, the State failed to meet its burden of establishing a substantial special need to drug test all welfare applicants without any suspicion. Even viewing the facts in light most favorable to the nonmoving party, the State has not demonstrated a more prevalent, unique, or different drug problem among welfare applicants than in the general population. The ordinary government interests claimed in this case are nothing like the narrow category of special needs that justify blanket drug testing of railroad workers, certain federal Customs employees involved in drug interdiction or who carry firearms, or students who participate in extracurricular activities because those programs involve "surpassing safety

interests,” or “close supervision of school children.” Moreover, on the first appeal, the court held the State cannot circumvent constitutional concerns by requiring that applicants consent to a drug test to receive welfare payments. When a government benefit is conditioned on suspicionless drug testing, voluntariness of the program is properly viewed as a factor baked into the special needs reasonableness analysis, not as an exception to it. *Lebron v. Secretary of the Florida Department of Children and Families*, Case No. 14-10322 (U.S. 11th Cir. December 3, 2014).

11. WHERE THE WEALTHY GO TO SCHOOL: Where do the wealthiest people in the world -- those with at least \$30 million in net assets -- go to school? Half of the 10 universities with the most ultrahigh-net-worth graduates are in the Ivy League, according to financial-planning.com. The others can be found in California, New York, Massachusetts and Illinois. Here is the ranking of the top universities by number of ultrahigh-net-worth alumni:

10. Cornell University 560
9. Yale University 570
8. Northwestern University (shocker) 575
7. University of Chicago 665
6. Massachusetts Institute of Technology 670
5. New York University 860
4. Columbia University 940
3. Stanford University 1,240
2. University of Pennsylvania 1,580
1. Harvard University 3,130

Now, who says that education is not worth the money?

12. DILLERISMS: Cleaning your house while your kids are still growing up is like shoveling the walk before it stops snowing. - Phyllis Diller

13. STUFF YOU DID NOT KNOW: What do bulletproof vests, fire escapes, windshield wipers and laser printers have in common? All were invented by women.

14. TODAY IN HISTORY: In 1985, Dow Jones closes above 1,500 for the 1st time (1,511.70).

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>.

17. REMEMBER, YOU CAN NEVER OUTLIVE YOUR DEFINED RETIREMENT BENEFIT.

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