



**CYPEN & CYPEN**  
**NEWSLETTER**  
**for**  
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Never Forget September 11, 2001  
and  
Always Remember May 2, 2011

**1. DEFINED BENEFIT PLANS, 10 NEW DEFINITIONS FOR 2018:** As the world evolves, our language needs to evolve with it. As changes occur in the defined benefit plan landscape, our business language needs to keep up. Here are terms rendered outdated by change. In each case there is a more robust, accurate and current

definition. Outdated terms may lead to excessive risk taking and time wasted on short-term issues that have little or no bearing on pension plan success. These new definitions can help improve how sponsors, consultants and managers address pension plan challenges. Update these definitions in your lexicon and consider the impact these revisions may have on your “investment strategy” — a term that has been redefined, according to [www.willistowerswatson.com/en/insights/2017](http://www.willistowerswatson.com/en/insights/2017).

### 1. Fiduciary duty:

- **Traditional:** Actions taken are documented and reasonable.
- **Modern:** Actions taken are subject to a higher level of scrutiny as more parties are considered fiduciaries and are being held to higher standards, which require subject matter expertise.

### 2. Full funding:

- **Traditional:** Having assets that equal or exceed accounting liabilities.
- **Modern:** Having assets that equal or exceed the organization’s desired funding target, which could reflect market cost required to settle obligations, signify the ability to run them off over the very long term or support future benefits for employees.

### 3. Time horizon:

- **Traditional:** The very long period of time until the plan makes its last benefit payment.
- **Modern:** A series of time frames that vary in length depending on sponsor objectives, plan liability profile and the desired approach to delivering retirement benefits over the long term (either through the plan or through settlement). In some cases, the time horizon can be very short.

#### 4. Investment strategy:

- **Traditional:** The plan's static asset allocation and investment manager lineup.
- **Modern:** The dynamic process of achieving a series of risk allocations that vary with market conditions and reflect the plan's progress toward its funding and settlement objectives.

#### 5. Interest rate risk:

- **Traditional:** A financial risk to the plan sponsor that can result in significant gains or losses relative to the liability in the event that interest rate changes occur within the time horizon. Plans with interest rate risk often maintain a large and risky "short position" relative to the liability, potentially larger than other risks in their portfolio or even their core business.

- **Modern:** A liability valuation factor where increases are already priced into the forward curve, meaning potential gains from taking this risk are lower than one might expect. It is often the most significant risk for pension plans, extremely difficult to time and vital to portfolio construction.

## 6. Liability-driven investing (LDI):

- **Traditional:** Extending interest rate exposure of plan assets, primarily through long duration fixed-income investments.
- **Modern:** Making any investment decision that takes the unique profile of the liability into account. This can extend beyond long-duration fixed-income assets as long as the decision was made to manage risk in an asset/liability context.

## 7. Diversify

- **Traditional:** Allocate across various regions (e.g., U.S., non-U.S., emerging markets), investment styles (e.g., value, growth, momentum), managers and asset classes in the portfolio.
- **Modern:** Use a greater variety of return drivers to help enhance return and/or potentially reduce total portfolio risk. For example, [look beyond traditional beta, alpha and interest rate exposures into the potential risk premia from illiquidity, complexity or difficult implementation.](#) When new investment ideas arrive down the road, avoid constraining them

with traditional asset-class buckets.

## 8. Implementation

- **Traditional:** Execution of investment ideas by a part-time fiduciary committee that meets infrequently.
- **Modern:** Proactive, timely and transparent portfolio management and execution within cost and risk budgets. This is supported by a deep resource structure, internal or outsourced, that empowers committees to focus on their strategic goals for the pension.

## 9. Delegation

- **Traditional:** Outsourcing just your manager selection activity to a third party or outsourcing a whole lot more, including strategy setting.
- **Modern:** Enhancing your ability to make strategic decisions and achieve strategic goals by outsourcing their execution to third parties. Delegation aims to improve efficiency of implementation, reduce costs and manage risks within the context of your defined investment strategy and allow you to reallocate resources toward your core business.

## 10. Success

- **Traditional:** Achieving the desired return, whether this is articulated as “manager outperformance of its benchmark,” “meeting a forward-looking target or hurdle rate” or “beating peers.”
- **Modern:** The ability to execute the firm’s objectives, including those related to funded status and risk management, and to ultimately secure benefits for all plan participants (via various combinations of obligation retention and settlement strategies). Oversight and monitoring of the strategy focuses on progress relative to objectives, with less emphasis on short-term investment return goals.

## **2. PARTICIPANTS SAY MORE INFORMATION ABOUT PLAN**

**INVESTMENT FEES WOULD BE USEFUL:** *Plansponsor* says that in its first report on retirement plan investment fees, The Pew Charitable Trusts says it found nearly seven in 10 survey respondents in employer-sponsored retirement plans said they were at least somewhat familiar with their plan’s fees, while 31% were not at all familiar with the fees. Roughly two-thirds had not read any investment fee disclosure in the previous year. Even among those who said they were very familiar with their fees, 33% had not read any fee disclosures in the past year. During a media briefing, the director of Retirement Savings Project at The Pew Charitable Trusts, said this was the most surprising finding of the research. It raises the question of what the word ‘familiar’ means to respondents. Maybe they are just familiar with how fees over time affect retirement savings. Perhaps

they can be familiar without reading disclosures, but believe people are overstating their knowledge. Of the one-third who had read a fee disclosure, nearly seven in 10 said they found the information understandable, but only 25% of all respondents said they had read and understood a disclosure about retirement account fees. Roughly four in five participants said it would be at least somewhat useful to have additional information about investment fees. This suggests that although many participants say they are familiar with retirement plan fees, they understand the limits of their knowledge and could use more information. Asked what plan sponsors and advisers can do to help retirement plan participants better understand plan fees, it is suggested that just raising the issue of plan fees helps participants. Pew hesitates to give advice based on our research, but plan sponsors are required by law to provide disclosures, and they can use this opportunity to discuss fees with participants and let participants ask questions. There are a number of ways employer might help employees, but the key is to seek opportunities to motivate them to raise their awareness of fees and pay attention to disclosures. Pew's research found Hispanics, women, younger workers, respondents with lower levels of education and low-income workers were among the least likely to be familiar with the fees in their plans. Pew's report notes that on average, workers in these groups are less likely than other workers to be financially literate or to have experience with the financial system. The reason women have less familiarity with fees can be explored further. He speculates that since women have less opportunity to participate in plans, they may be less familiar with

investing, but he also speculates that men might be overstating their knowledge. Pew cannot tell by our research. Younger workers would benefit most from more familiarity with plan fees since they have a longer time horizon for saving and investing. The research also found that participants who had engaged in retirement planning at some point were more likely than those who had not to be familiar with their retirement plan fees. In addition, those who were more confident about investing were more likely to say that it would be helpful to have more information about fees. Note Pew's survey only covered employees at small and mid-size companies, which are not always given the full range of services a large plan sponsor would get from service providers. Small and mid-size companies also do not always have the same size of benefits or human resources staff as large companies that could answer questions. So, it is possible we could see more familiarity with plan fees at larger companies, but at the same time, this is a difficult concept for employees at any size employer, so we probably would find unfamiliarity among many workers at large employers. The Issue Brief, "Many Workers Have Limited Understanding of Retirement Plan Fees," may be downloaded from <http://www.pewtrusts.org/en/projects/retirement-savings>.

[Caveat, consider the source.]

**3. TWENTY-ONE PERCENT OF INVESTMENT MANAGERS PLAN TO LOWER FEES:** Twenty-one percent of investment managers plan to lower their fees in 2017, the Callan Institute found in its 2017 Investment Management Fee Survey. *Plansponsor* reports that only

69% of assets in retirement plans are in actively managed funds, down significantly from 84% in 1996. The most common objection active investment managers hear from sponsors is whether they are providing the value-added services to justify their fees, cited by 49% of these investment managers. The median fee that retirement plans pay for investments is 38 basis points (bps). By asset class it is 21 bps for fixed income, 34 bps for U.S. equities, 45 bps for non-U.S./global equities and 90 bps for alternatives. U.S. equities and non-U.S./global equities had the most dramatic movements between 2014 and 2016, with U.S. equity fees dropping 4 bps and non-U.S./global equity fees increasing 5 bps. Investment managers are allocating a lower percentage of their revenue to bonuses: 18%, down from 24% in 2014. However, the amount of revenue allocated to cover the cost of operations increased from 42% to 60%. This may be why profit margin expressed as a percentage of revenue decreased from 34% in 2014 to 22% in 2016. The percentage of investment management firms that offered performance-based fees dropped from 75% in 2014 to 64% in 2016. The types of funds that always use performance-based fees are all alternatives: hedge funds (60%), private equity (54%), infrastructure (38%), real estate (29%), hedge funds-of-funds (20%) and high yield fixed income (8%). It is a common practice for investment managers to negotiate their fees, with 83% undertaking this practice, although this is down from 91% in 2014. Callan's report is based on responses from 59 asset managers representing \$1.1 trillion in assets. Survey results also incorporated responses from 279 investment management organizations,

supplemented by Callan's Investment Manager Database of more than 1,600 firms. The full report can be downloaded [here](#).

#### **4. WHY PERFORMANCE AND FULCRUM FEES ARE BANNED**

**FOR MOST FINANCIAL ADVISORS:** As financial advisors feel increasing pressure to differentiate themselves, a recently emerging trend for those who (actively) manage client portfolios is the idea of charging clients not an AUM fee that is a percentage of assets, but instead, a performance-based fee that is a percentage of upside (or outperformance of a benchmark index), where the advisor's fee is forfeited if the advisor fails to achieve the required threshold or hurdle rate, reports [www.kitces.com](http://www.kitces.com). Such a compensation structure would compel active financial advisors to eschew closet indexing and really, truly, try to outperform their benchmarks – which can be a very compelling proposition to prospective clients. However, the reality is that performance fees have a very troubled past. Because while a performance-based fee does incentivize the advisor to *not* be a closet indexer and own a substantially different portfolio than the benchmark, one of the “easiest” ways to do so is simply to take on more risk and amplify the volatility of the portfolio. After all, if the markets rise substantially – as they do on average – a high-volatility portfolio will often provide a substantial performance fee in a bull market. In when the inevitable bear market occurs, the “worst case” scenario for the advisor is simply a year of zero fees. In fact, this “heads the advisor wins, tails the client loses” asymmetry of performance fees is why when Congress created the Investment Advisers Act for RIAs in 1940,

it *banned* most financial advisors from charging performance-based fees at all to retail investors (and of course, brokers under a broker-dealer cannot charge performance fees because they are not serving as actual investment advisers in the first place!). It was only in 1970 that Congress partially relented and allow RIAs serving as investment managers to mutual funds to charge performance fees, and only then if it was a “fulcrum fee” where the advisor participates in both the upside for outperforming *and at least some of the downside for underperformance*. In turn, it was not until 1985 that the SEC began to allow RIAs to charge performance fees in certain situations to *retail* clients, and even then the offering must be limited to “Qualified Clients” who meet one of three financial tests... either: a) \$1M of assets under management with the RIA charging a performance fee; b) a \$2.1M net worth (and thus are presumed to be financially experienced and “sophisticated” enough to understand the risks inherent in performance fees); or c) be an executive officer, director, trustee, or general partner of the RIA, or an employee who participates in the investment activities of the investment adviser. In addition, it is notable that research over the years on incentive fees in the context of mutual funds has failed to find any sign that incentive fees are actually associated with better risk-adjusted performance anyway. Instead, the research finds that – perhaps not surprisingly, given the problematic history of performance-based fees – mutual fund managers compensated by incentive fees tend to just generate higher returns by taking more risk, and then amplify their risk-taking activity further once they fall behind their benchmarks. Ironically,

though, the researchers *did* find that mutual funds with incentive fees *are* more likely to attract client assets, suggesting that substantial consumer demand remains for paying investment managers via performance fees. Nonetheless, the real-world operational challenges of executing what would be a more complex billing process, the revenue volatility that financial advisors introduce to their businesses (particularly if they use a fulcrum fee structure which means if the advisor underperforms, they really *do* take the risk of seeing their fees cut substantially), the limitations of only offering a Performance Fee structure to affluent Qualified Clients in the first place, and the conflicts of interest that must be managed, suggests that a widespread shift towards performance fees for RIAs is not likely in the near future... especially as many firms seek to shift their value propositions *away* from being centered around the investment portfolio and towards financial planning and wealth management instead! But for those RIAs who want to pursue charging performance fees on investment portfolios, it *is* an option... at least for their Qualified Clients who want to take the risk.

## **5. FIVE WAYS TO STOP LIVING PAYCHECK TO**

**PAYCHECK:** Earning a good income does not mean you are able to save. In fact, millions of people do not have enough in their bank accounts to cover a \$1,000 emergency should something go wrong. Others have scant retirement savings or their net worth is in the red due to debt. It does not matter how much you make if you spend every available dollar that you bring home. To break out of the

paycheck-to-paycheck cycle, you must look at your situation, take steps to change your habits and prioritize saving over spending. Here are five steps you can take to help break the cycle and start building your savings right now.

A. Address Why You Are Living Paycheck to Paycheck: There are countless reasons why you might be stuck living paycheck to paycheck, but here are some of the most common:

- Overspending on things you do not need
- Mindless spending – you do not know how much you spend or on what
- Your expenses are higher than your income
- If the last reason describes your situation, it is time to work on earning more money. You can only cut your budget so much, but your earning potential is infinite.

If your problem is mindless spending—you overspend or just do not pay attention to your cash flow—it is time to change your habits. You can stop living paycheck to paycheck, but it will take commitment to putting savings over spending. That might be a little easier to do if you take the time to understand what you actually value.

B. Focus on Your Priorities and Adding Value

- Think saving money means you need to stop spending and deprive yourself? Not exactly. It is more about spending your money in a way that adds value to your life and cutting out the costs that do not. To do this, you need to understand your values. What is important to you? What do you find meaningful?
- Now, look at your spending. Do nights out on the town every weekend align with what you value? If you value friendship and community, maybe, but you need to consider other lower-cost ways to spend time with your friends.
- Honestly evaluate each transaction you made in the last few months: Did they add value to your life? How? Was there a less expensive alternative? Do you regret any transactions?

### C. Revise Your Budget

- Now that you know what you actually value and took the time to cut out the expenses that did not align with what you find important or meaningful, update your budget to reflect the changes. When you do, make sure to include your savings or investment goals as a line item and fund those goals first each month. If you still cannot make room for savings, put more costs on the chopping block.
- Again, you do not want to deprive yourself. The point is to create a budget that reflects your values. You should feel free to

use your money in a way that makes you happy. That happens most often when we spend on experiences or services that provide us with more time in our day, like hiring someone to do chores or errands you hate.

- Focus on cutting costs that revolve around what you buy to impress other people, not to enjoy for yourself, and other material goods. These purchases simply don't provide lasting happiness, and there are more important things to make room for in our budgets.

#### D. Track Your Spending

- Once you understand the root of the problem, it is time to move forward with a sound spending plan. You will want to set up not only a budget, but something that allows you to track your spending, too. After all, a budget does not do you much good if you still do not know what you spend on or if you're overspending in certain categories.

#### E. Crush Lifestyle Creep

- To stop living paycheck to paycheck, you must spend less than you earn. This is why the paycheck to paycheck problem is one that applies to countless people, regardless of income.

- You can make an incredibly good living earning hundreds of thousands of dollars, but the problem is not how much you make, it is how much you spend. Too often, we increase our spending anytime we get the opportunity: when we get a raise, a new job, a big client for our business, etc.
- When this happens, you suffer from lifestyle creep. It is when you *always* spend as much as you can and just break even every month. Your lifestyle keeps getting upgraded, but your savings? Well, you're consistently behind on your goals.
- Stop lifestyle creep before it happens. It is always easier to keep your spending stable than it is to let it spike then cut out luxuries you are used to enjoying.
- Whenever you get a raise or start earning more money, consider investing 50% of it. Or increase your existing contributions to your employer-sponsored retirement plan or an [IRA](#). Create an automatic contribution so that you never see that "extra" money, and are not tempted to spend it.
- Avoid the temptation to add in more expenses every time you earn more money, and you'll break the paycheck to paycheck cycle you feel stuck in now.

**6. NEW OFFICE ADDRESS:** Please note that Cypen & Cypen has a new office address: Cypen & Cypen, 975 Arthur Godfrey Road, Suite 500, Miami Beach, Florida 33140. All other contact information remains the same.

**7. CRAZY STATE LAWS:** *Good Housekeeping* reminds us that there are crazy laws in every state. In Virginia you cannot go trick-or-treating if you are over 12 years old. In Chesapeake City, children over the age of 12 are banned from trick-or-treating due to mass complaints of older teens wreaking havoc on Halloween. The ordinance also prohibits those over 12 from wearing masks in public any other day of the year.

**8. INSPIRATIONAL QUOTE:** I am not a product of my circumstances. I am a product of my decisions. – Stephen Covey

**9. LEXOPHILES:** A boiled egg is hard to beat.

**10. FUNNY TOMBSTONE SAYINGS:** To get Mike Clark's info, login to this headstone with your username and password.

**11. TODAY IN HISTORY:** In 2004 longtime Jeopardy champion Ken Jennings finally loses. He finishes with the largest game show winnings of all time of \$2,520,700.

**12. 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.

**13. 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>.

**14. REMEMBER, YOU CAN NEVER OUTLIVE YOUR DEFINED RETIREMENT BENEFIT.**