Retirement News Highlights

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End of the road for defined benefit plans? Not quite

While the vast majority of DB plans are frozen, plan sponsors are keeping all options on the table for participants.

By Baily McCann
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WHEN TALKING ABOUT DEFINED BENEFIT PLANS, it's mostly in the context of how plan assets are being managed with the understanding that the vast majority of these plans are closed to new participants, and plan sponsors are probably considering a risk transfer or lump-sum payouts at some point in the future. But are defined benefit plans truly a thing of the past?

Not entirely, says Emily Hylton, an Atlanta-based senior vice president and investment consultant at Callan. Some employers are still offering defined benefit plans as a means of attracting and retaining talent. Others have shifted to cash balance plans, a type of defined benefit plan that defines the promised benefit in terms of a stated account balance.

Offering defined benefit plans can be a boon for companies that want to attract talent and are willing to take on long-term obligations. In a survey of both Millennials and Baby Boomers, the National Institute on Retirement Security found that the majority of respondents from both groups believe having a pension is important and said they would stay at a job that offered such a benefit. That finding is notable, given that Millennials entered the workforce at a time when pensions were not typically offered. The data suggest that plan participants understand the need for and desire lifetime income but are not totally sure how to achieve that on their own.

"I think what we're seeing is a recognition that the current system doesn't work that well," explains John Lowell, an Atlanta-based partner in retirement consultant October Three. "Even within older age groups that might still have a defined benefit, those participants are working longer and/or may not be able to retire for a whole host of reasons. The first age group that was defined-contribution-only is also now nearing retirement, and many of them are faced with the same issue: Account balances aren't enough, and when they look at annuities, for example, the lifetime income offered is much less than they anticipated it would be."

Curves ahead

These dynamics put plan sponsors in a tricky position. Currently, closed defined benefit plans will still be paying out benefits to participants for many decades to come and are unlikely to be reopened. Retirement consultants say plan sponsors are hesitant to take on new long-term obligations because of the associated cost and regulatory hassles . But plan sponsors may end up with a different set of headaches by focusing just on defined contribution plans. Older employees may choose to stay in positions longer, which could limit new hiring opportunities. Younger employees may feel less loyalty to employers if there is no long-term benefit to staying in a role.

There are also issues with sunsetting existing defined benefit plans. Pension risk transfer, liability-driven investing and lump-sum payouts are all tools plan sponsors can use, but each requires certain funded status and often takes a significant amount of time to implement.

“There are trillions of dollars in defined benefit plans right now, and even coming off a big year for pension risk transfer, that solution only represents about 3% of the market,” explains Ari Jacobs, a senior partner in and the global retirement solutions leader at Aon. “I don’t think you can say all defined benefit plans are eventually going to end at a risk transfer. There are too many factors at play, and the plan sponsors we are working with are leaving all options on the table. The other thing to remember is: Each plan is unique, and plan needs will change over time, so we’re seeing plan sponsors try to be as flexible as they can.”

Lifetime income

Arguably, the chief advantage of a defined benefit plan is lifetime income. Whether that income is delivered through the plan itself or eventually through an annuity, the predictability gives participants peace of mind.

However, offering participants lifetime income in defined benefit plans that have lower coverage can be challenging. Risk transfers or lump-sum payouts may solve the equation for plan sponsors, but they can create a new set of issues for plan participants. October Three’s Lowell notes that annuities have a bad reputation with many participants, and lump-sum payouts put participants that were in defined benefit plans in the unique position of having to create a fixed income for themselves, similar to participants in a defined contribution plan.

Hylton notes plan sponsors are faced with a bit of a conundrum.

“I don’t think there’s an appetite to reopen a lot of these plans, but there is a greater recognition that something needs to be done in terms of lifetime income,” she says.

Matt McDaniel, a partner in and the U.S. pension strategies and solutions leader at Mercer, agrees.

“I don’t want to go so far as to say we’re at an inflection point,” he says. “But there are questions about long-term obligations, and we’re also getting data from the first generation of workers that were defined-contribution-only showing that the account balances really aren’t sufficient enough to retire with. As more people retire and that problem grows, I think we could see the tide start to shift back toward something that looks more like defined benefits, but it’s hard to say what that ultimately looks like.”

SECURE 2.0 and the Future

Provisions in the recently passed SECURE 2.0 Act of 2022 seemed to pick up on this dynamic. Lowell notes that cash balance plan-focused provisions fix some of the tax and regulatory hurdles that have kept plan sponsors from offering cash balance plans in the past.

"These provisions haven't gotten the same attention as others in the [law], but they are important," he says. "They give plan sponsors the option to do a market-based rate of return such that the assets and liabilities are moving together without the kind of volatility we have seen in the past. That makes it easier for CFOs to model these plans, and when you have cost stability, that makes it more palatable to plan sponsors."

Other provisions in the law will make it easier for plan sponsors to offer annuities and synthetic annuities to plan participants. Although work may yet need to be done to overcome the hesitancy that plan participants have about adopting annuities, consultants say.

Looking ahead, these provisions offer a base from which plan sponsors can continue to make refinements based on feedback from participants. Mercer's McDaniel says that rates of product adoption typically determine which solution set becomes the most widely used.

"The retirement space tends to move incrementally," he says. "If you look back 30 years ago when defined benefit pension plans were common, there wasn't one single moment when the whole industry shifted to defined contribution. It was an accumulation of changes over time. I think plan sponsors are going to continue to weigh their options and get feedback from participants, and we'll see more incremental change. So it's possible we could look up 10 or 15 years from now and things are very different, but it won't be one moment where everything shifts back to defined benefit. It's more likely that we end up with something that looks like more of a mix of defined benefit and defined contribution features."

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Will US Public Pension Plans Ever Get Back to Full Funding?

This century has been unkind, but maybe some can squeak by with only modest improvements.

By Larry Light
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Will America's public defined benefit pension plans ever roll their Sisyphean rock all the way up that steep hill? In a century marked by three massive market downturns and limited employer contributions, the task of restoring their ability to pay 100% of what they owe current and future retirees sometimes seems insurmountable.

It's not for want of trying to boost funded status. They are "making a reasonable heading" to overcome their "degradation," says Tom Toth, a managing director at Wilshire Associates, in an interview. But some are very, very far from that treasured 100% funded status, which many once enjoyed.

Meanwhile, getting above 60%—the generally acknowledged red line between adequate and troubled plans—might be the best they can manage. Severely underfunded retirement caches in Illinois

(estimated fiscal 2022 level: 44.1%) illustrate that possibility. Those in New Jersey (51.1%) show that hope is possible, even though a lot of obstacles still stand in the way.

“The worst ones can stay poorly funded in perpetuity,” says Jean-Pierre Aubry, associate director of state and local research at Boston College’s Center for Retirement Research. They just have to juggle well, in his view. How they will fare long-term is a bigger question.

Nationally, the public pension funding level is low: It averaged 74.2% as of fiscal year 2022 (which ended June 30, 2022), down from 77.5% in the previous year—and way down from public plans’ lush levels at the start of the century, when the number exceeded 100%, according to CRR .

U-Turn Into the Mire

After the halcyon years of the late 20th century, the fortunes of public pension funds changed radically. They endured one mishap after another. First, the dot-com bust of the early aughts and the financial crisis of 2008 and 2009 combined to sap their investments. Funded statuses tumbled deeply into the red, meaning assets fell short of what’s required to pay retirement benefits to all beneficiaries. The slide bottomed out at an average of 73% in 2012, and some plans had a funded status far lower than that.

The average funded level crept up during the teens, powered by strong market performances: In fiscal 2021, for example, the median public fund return was 25.8%, a survey by consulting firm Callan found. Then the plans ran into more grief: Last year’s poor investment performance stymied them anew—the S&P 500 fell just over 19%, and its bond counterpart, the Bloomberg U.S. Aggregate, dropped roughly 13%.

The grim news: Investment gains needed to replenish plan coffers were not sufficient on aggregate to shrink the funding gap meaningfully. CRR says that, while public funds’ average targeted return is 7%, over the past 10 years, the actual results were about 5.5%.

The other major source of fund growth, contributions from governments, has also not been enough to close the gap. (Public employers contribute almost four times as much on average as their workers do, an Equable Institute study found.)

The government contributions were low in the century’s first two decades because, among other reasons, many plans assumed that investments would burgeon and take care of the deficiency. Since then, contributions have inched up nationally, albeit with some big exceptions. In fiscal 2022, they were 27.9% of payroll, up from 26% the year before. CRR projects that, if current trends continue, that could hit 39.3% by decade’s end.

Some states held up fine despite last year’s market turmoil, with Iowa, Tennessee, New York, Nebraska, Wisconsin and South Dakota more than 90% funded, per another Equable study.

The punishment from 2022’s sinking markets whacked almost all plans’ funded status, but many still stayed well above the 60% line. For instance, the California Public Employees’ Retirement System, the country’s largest public pension, saw its portfolio lose 7.4% in the downturn; hence its status suffered, dropping to 72% from 81.2% the prior year.

The Glidden Cure: A Turnaround How-To

Life has been somewhat easier for corporate DB plans, which tend to have fewer beneficiaries than public programs and don't need to deal with meddling politicians. Unlike public sponsors, corporate allocators also can annuitize their plans, or parts of them, by buying insurance policies to cover liabilities, thus lightening the corporations' obligations. Still, company retirement funds had their own lean period, with the Milliman index for the 100 largest corporations falling to 60% in 2010, on the heels of the financial crisis. As of January 2023, however, the index was flying high at 109%.

The master class in fund turnaround can be given by Jonathan Glidden, Delta Air Lines' CIO, who assumed the finance helm after the carrier had gone through bankruptcy. Glidden convinced company management to let him go outside the traditional box to employ portable alpha and other sophisticated investment approaches.

"Derivatives and alternative investments are the tools that unlock well-balanced portfolios that beat their benchmarks," he says now, looking back. To convince an investment committee that such daring strategies are worthwhile, he advises, "it is imperative to intuitively define and measure success—and be consistent with the definition—and build guardrails around yourself in the form of thoughtful risk and liquidity management programs."

How successful was Glidden? Very. When he became CIO in 2011, the Delta plan was 38% funded. Most recently, it was at 99.4%.

Rough Roads

That kind of boldness is tougher the public arena, where governors, legislators and unions can thwart the canniest strategies. Still, many allocators in that area are moving into alternatives, which they hope will improve their performances. At CalPERS, for instance, a shift is underway to move into private equity, an asset class that the giant fund once had been leery of. PE has (until recently) had a strong run, and many say it will do well going forward.

Not every plan has CalPERS' financial heft and enormous member pool, of course. All sorts of permutations exist amid the U.S. patchwork of state and local public plans. Some plans encompass state employees only, such as in Illinois. Other places—New Jersey is an example—contain both state and local employees. Some participants in state employee plans are eligible to join Social Security; others are not.

Regardless, one common objective among public plans nowadays is to improve their funded status. The idea, says CRR's Aubry, is to amass as many assets as possible "to be held in trust," before they are thwarted by politicians who prefer to spend money for other items than beefing up retirement kitties. Plus, he says, a full-funding goal at least forces policymakers to "not underestimate the cost of a promise."

History shows how ambitious retirement promises to public workers can be forsaken. Let's consider two big programs in a pickle, how they got that way and what they are doing about improving their lots.

Namely, those of Illinois and New Jersey. Illinois's average annual retiree payout is more generous, at $35,520. New Jersey's equivalent is $22,100. Pensions are calculated, in part, on active state workers' pay, among other factors such as years of service. Small surprise that New Jersey's public workforce was the third best paid in the U.S., as of a 2018 study by the website Stacker, using a U.S. Census study; Illinois' employees were No. 11.

On a per capita basis ranking unfunded liabilities, Illinois has the second largest liability at $41,656, and New Jersey at $39,849 comes in fifth, per American Legislative Exchange Council think tank.

Illinois: “Been Down So Low Long …

“… It Looks Like Up to Me.” That’s the title of Richard Fariña’s classic picaresque 1966 novel about a hippie’s happy-go-lucky life, an idyllic existence that ends up taking a dark turn (he is drafted to fight in Vietnam). That arc seems to track Illinois’ experience: sunny intentions, then comes the nightmare.

The Illinois State Board of Investment oversees assets of almost $110 billion as of last September 30, according to the state Commission on Government Forecasting and Accountability, an official watchdog group. Among the five state-level funds ISBI invests for, the Teachers’ Retirement System is the largest and the State Employees’ Retirement System is in second place. Their funded ratios are close to one another—low. ISBI did not return requests for comment.

Using SERS as a proxy for the entire bunch, the funded level has just gotten worse over time, Boston College data indicate (the institution’s stats don’t cover the other plans). In 2001, at least, SERS topped 60%: It sat at a 65.1% level. From that point, the funded status skidded to a low point of 33.9% in 2014. Since then, state government efforts have finally managed to elevate it a bit, to an estimated 44.1% as of mid-2022.

At the root of the Illinois funds’ woes was a long-ago official pledge to guarantee lush benefits for state workers, says Sarah Wetmore, research director and acting president of the state Civic Federation, a nonprofit that studies Illinois government. In 1970, the legislature and the voters cemented this in the state constitution. In 1995, the legislature passed a 50-year funding law that laid out generous payments for retirees, coupled with an inflation-linked feature. From that juncture, the retirement plans “never have been well-funded,” Wetmore declares.

Beginning in 2015, a three-year battle in the legislature broke out, with no budgets passed and spending (a lot of it to pay pension benefits) outstripping revenues. The demands of fat pension benefits still meant the state did not have the money it needed to meet its obligations. The state tried to paper over its shortcomings by issuing billions in “pension obligation bonds.” This is expensive debt, typically yielding twice what other municipal bonds do, investment firm Raymond James finds. Along the way, Wetmore says, the state had numerous “pension holidays,” during which it paid the bare minimum required.

One glimmer of hope is that Governor J.B. Pritzker, a progressive Democrat who took office in 2019, has tried to get the pension mess under control. His last two budgets mandated full pension payments and added a supplemental $500 million allocation. That has been largely responsible for Illinois SERS’ small improvement in its funded status, up three percentage points in fiscal 2022, to 44.1%. Previously, the state has moved to limit benefits for new hires, notably by trimming the plans’ inflation-adjusting feature.

Will such reforms make a difference? Not with the state constitution enshrining sweet benefits for retirees, wrote Joe Tabor, director of policy research Illinois Policy Institute, a Libertarian-oriented research outfit. Axing the constitutional mandate, he wrote,” could let the state regain fiscal sanity.”

New Jersey: Less Bad

By contrast, the Garden State's pensions have not been as weak as those in Illinois. As recently as 2017, the New Jersey Public Employees' Retirement System, the state's largest public union, was 60% funded. In 2007, right before the financial crisis, it was at 75%.

What happened to ruin this record? Other than investment reverses affecting all its seven major retirement funds (run by the state Division of Investment), New Jersey's pension programs suffered from a long spell of lagging state government contributions. In 2015, then-Governor Chris Christie won a battle before the state Supreme Court that allowed him to slice $1.6 billion from pension funding. Christie billed the savings as fiscally responsible—and his critics charged that he was only trying to burnish his conservative bona fides in his quest for the 2016 Republican presidential nomination.

Democrat Governor Phil Murphy, who succeeded Christie in 2018, pushed to reverse that. To the dismay of Republicans and business organizations, Murphy, a former Goldman Sachs executive and outspoken liberal, has made two consecutive full state contributions to the state's umbrella pension fund, $5.8 billion for fiscal 2021 and $6.9 billion for fiscal 2022.

Those payments marked the first full actuarially determined donations in more than 25 years. Much of the funding for the richer contributions came from a state surcharge on corporate taxes that the governor pushed into law and intends to scrap with state revenues improving.

A report from the Pew Charitable Trusts praised New Jersey's contribution max-out as a realistic response to a genuine menace. Murphy's bigger donations, Pew said, headed off a threat to "the sustainability of the state's pension plans."

In general, where are the underfunded plans bound for? Maybe not all will attain the 100%-funded nirvana or come close. But higher interest rates should ultimately buoy pension incomes, argues Wilshire's Toth: "There is a silver lining."

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Institutional investors lean into active management, despite trend toward passive

A Cerulli report shows how the so-called smart money is generally increasing exposure to active strategies.

By Jeff Benjamin
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Amid all the hoopla over the flow of assets into passive indexed strategies and out of more costly, actively managed mutual funds, the foundational appeal of active management is being overlooked, according to Cerulli Associates.

Despite a steadily narrowing gap between the amount of money in active and passive strategies, Cerulli's research shows active management has a growing attraction that might have something to do with the rockier outlook for the financial markets.

Five out of six categories of institutional investors are on track to increase their portfolio allocations to active equity strategies over the next two years, and four of six are planning an increase to active strategies on the fixed-income side, the research shows.

On the equity side, the insurance company category is boosting active exposure to 62% from 59%, nonprofits are increasing it by a percentage point to 52%, corporate defined-benefit plans are also adding a percentage point to 49%, the health care category is increasing it by two points to 52%, and Taft-Hartley plans are increasing it by seven points to 47%.

The lone outlier is public defined-benefit plans, which plan to decrease their exposure to active equity by one percentage point, to 52%.

On the fixed-income side, insurance companies are increasing exposure to active management by two percentage points to 61%, public defined-benefit plans are adding two points to 56%, the health care category is adding three points, to get to 53%, and Taft-Hartley plans are adding two points, to 41%.

Meanwhile, nonprofits plan to trim active fixed income by four points to 49%, and corporate defined-benefit plans are cutting eight percentage points to get down to 54%.

It's not uncommon for active management to gain appeal during periods of market volatility, but even with the general ebb and flow of market cycles, active management has been experiencing a shrinking share of the overall pie.

The decline in the gap between active and passive management is illustrated by Morningstar data showing active strategies with $1.17 trillion more in assets than passive strategies at the end of 2022. That compares to a gap of $1.77 trillion just six months earlier, and a $2.95 trillion gap in 2021.

"While the outlook for active investment strategies may look bleak, there are indications that institutional investors will continue to provide a strong market for active investments," said Chris Swansey, author of the Cerulli report.

Of those institutional investors planning to increase allocations to active equity strategies, 32% plan to increase exposure to U.S. stocks, followed by global stocks at 21%, and emerging markets equity at 18%.

On the fixed-income side, 13% of institutional investors will be increasing their exposure to U.S. investment-grade debt, followed by U.S. high-yield debt and bank loans at 10% each.

"It remains to be seen whether active funds can recoup some of the flows they have lost over the last 10 years in a significantly new market environment," Swansey said. "For now, at least, institutional investors have signaled that they will continue to provide a backstop to active fund flows."

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