

401(K) INVESTMENTS

Marrying Investment Policy with Funding Policy in DB Plans

One of my earliest defined benefit (DB) clients, in the early 2000s when actuaries still had broad discretion over interest rate assumptions, was using 8 percent as the discount rate for liabilities. As a quick explanation of what this means, an 8 percent assumption implies a dramatically cheaper funding cost than, say, a 6 percent assumption, because it costs less to accumulate assets over time if you earn more interest. As it turned out in the “lost” decade, anything over 6 percent was too high.

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The actuary in this case loftily defended the 8 percent assumption by saying, “We actuaries deal in very long time frames, and 8 percent is a perfectly reasonable assumption for a 40-year time horizon.” When I asked how he interacted with the trustee and investment advisor, who controlled plan investments, he replied, “I have nothing to do with them—I work directly with the CFO.” (He may have sniffed disdainfully when I said the words, “investment advisor” but perhaps that was just my imagination.)

As it happened, the trustee, against the advice of his investment advisor, had responded to the 2000-2002 bear market by moving entirely to fixed income and was determined to follow a more conservative investment policy permanently—no more than 30 percent stocks. The actuary’s assumption that “the market” would return 8 percent was therefore out of synch not only with market realities but with the actual investment policy being followed by the trustee. The CFO in this case (the actuary’s primary contact and the person he viewed as his customer) was focused almost exclusively on minimizing current funding cost, and seemed not to feel that his part in managing the plan (keeping cost down) required consultation with the

trustee, who was the business owner. In fact, it was from this actuary that I first heard the old actuarial joke (yes, there is such a thing) about the CFO who called his actuary and asked, “What’s my funding cost this year?” And the actuary responded, “I don’t know. What do you want it to be?”

Admittedly this is an extreme example, and actuaries are generally quite scrupulous about ensuring their calculations are not performed in a vacuum and steering their clients toward rational decision-making, but this case highlights a weakness in how some DB plans are managed: the actuarial and investment functions are often divorced from one another. This is the opposite of how a DB plan should be managed: investment policy should be wedded to funding policy.

What Is Funding Policy?

The term “funding policy” is statutory:

ERISA §402(b), Requisite features of plan
Every employee benefit plan shall—

- (1) provide a procedure for establishing and carrying out a **funding policy** and method consistent with the objectives of the plan and the requirements of this subchapter...
[Emphasis added]

To satisfy this statutory requirement, most plan documents include some language like the following excerpt from a typical volume submitter document (a volume submitter is a form of plan document that is more flexible than a prototype document but less costly than an individually designed plan):

(b) **Funding policy and method.** The Employer shall establish a “funding policy and method,” i.e., it shall determine whether the Plan has a short run need for liquidity (e.g., to pay benefits) or whether liquidity is a long run goal and investment growth (and stability of same) is a more current need, or shall appoint a qualified person to do so. If the Trustee (or Insurer) has discretionary authority, the Employer or its delegate shall communicate such needs and goals to the Trustee (or Insurer), who shall coordinate such Plan needs with its investment policy. The communication of such a “funding policy and method” shall not, however, constitute a directive to the Trustee (or Insurer) as to the investment of the Trust Funds. Such “funding policy and method” shall be consistent with the objectives of this Plan and with the requirements of Title I of the Act.

Funding policy is about putting money into the plan; investment policy is about what you do with the money once it’s in the plan. Here is my own attempt at a working definition:

ERISA Funding Policy: An employer’s strategy for ensuring a plan is properly funded, which may include guidelines on the calculation, frequency, timing, and amount of contributions as well as the calculation and use of funding targets.

Naturally this is almost exclusively a DB concept—if funding policy has applicability in a defined contribution (DC) plan, it refers to the policy for ensuring contributions owed to the trust are remitted on a timely basis. Not an insignificant issue, but not one that requires a detailed study of funding policy, which was included in ERISA with DB plans in mind.

Some case studies should help illustrate the concept.

Case No. 1: Funding Policy Divorced from Investment Policy

In the example above in which the trustee and CFO were not communicating, the funding policy was “minimize current year contributions.” Not a great ERISA funding policy, but not an uncommon business imperative, especially in rough economic times. The plan had been invested in 70 percent stocks prior to 2000, making an 8 percent interest assumption somewhat reasonable at the time based on historical market returns. Bonds were at the end of a 20-year run in which very high yields gave way to low yields, creating additional total return for bonds in the form of capital gains. “The market” (stocks) was still viewed

at that time as reliably delivering 10-12 percent per year, long term. A portfolio of 70 percent stocks and 30 percent bonds might, therefore, reasonably be expected to return 8 percent—but not a portfolio of 100 percent bonds, which the employer moved to in a panic, or 70 percent bonds, which became the new long-term allocation target after the advisor persuaded the trustee that the end was not, in fact, nigh.

It is easy, in the light of hindsight, to cast aspersions on this sort of thinking, because we know that a decade of poor market performance can wreck virtually any investment policy. And low bond yields combined with forecasts calling for continued low yields (as the forecasts did at the time) should have led the trustee to conclude that he needed a lower return target. For example:

30 percent stocks × 8 percent total return	=	2.4 percent
70 percent bonds × 5 percent total return	=	3.5 percent
Fees	=	-1.0 percent
Conservative Target	=	4.9 percent

One could argue that fees should be listed elsewhere, but this is a moot point because the fees get added to the funding cost no matter when you choose to add them. The bottom line is this: in attempting to determine funding targets and estimate costs, the plan fiduciaries needed to be on the same page but were not. Either the trustee needed to keep more stocks to justify a higher interest assumption or the CFO needed to direct the actuary to use a lower interest assumption that reflected the actual investment strategy. In this case, they needed both.

Case No. 2: The Young Doc/Old Doc Conundrum

A medical practice has two partners: Old Doc, age 63, and Young Doc, age 43. Old Doc intends to take a lump sum from the DB plan when he retires in two years. Young Doc only recently finished paying off his medical school tuition loans and wants more aggressive investments to help minimize the long-term cost of the plan. The plan is, therefore, invested 65 percent in equities. The problem is that a large lump sum can leave Young Doc holding the bag on an underfunding problem when Old Doc retires, whereas Old Doc is guaranteed to get his full lump sum so long as the plan meets the minimum funding threshold. Old Doc gets guaranteed money at relatively low cost.

One way to solve this conundrum of the competing interests of older versus younger owners is to overfund the plan while Old Doc is still working. For example, if the fiduciaries adopt a funding target of 125 percent,

the partners will have to make larger contributions in the short term and, therefore, get lower incomes during those years. In essence, this means Old Doc will pay a premium in exchange for the guarantee—he leaves Young Doc with the ongoing funding liability, but he also leaves Young Doc with some extra cash as compensation for taking the risk. The additional funding stays in the plan and Old Doc gets no part of it, whereas Young Doc benefits from the overfunding over time in the form of lower contributions.

A proper marriage of investment policy and funding policy in this case might take the following points into account:

- Funding target of 125 percent (*i.e.*, the plan will have 25 percent more money than it needs to fund liabilities).
- Balanced investment policy focused on maximizing long-term returns at an appropriate level of risk.
- Careful accounting for major cash flows: in this case there is a glaring need to match a large liability (the impending lump sum for Old Doc) with an asset of appropriate duration (bonds with low duration).
- An appropriate interest rate for valuing the liabilities. In the post-PPA world, actuaries have little flexibility in determining interest assumptions, but there is still some. In this case, assume the plan is a cash balance plan: the interest rate should be a blended rate that includes a large chunk of assets in the “first segment” corresponding to short-term bonds. [The Pension Protection Act of 2006 established funding guidelines that included a division of liabilities into “segments” based on the duration of the liabilities.]
- In effect, the plan could be divided into two parts: the short-term piece corresponding to the impending lump sum for Old Doc and the long-term piece corresponding to investments for Young Doc and the rest of the staff. The investment strategies for these two parts are different.

In point of fact, the actual client on whom this scenario is based did not properly balance these factors in a combined funding/investment policy approach. Instead, they invested all of the money in a balanced portfolio of 65 percent stocks, focused on returns, and failed to hedge the large lump sum by matching it to short duration bonds. The simple version of what ensued is that Old Doc got his guaranteed money at very low cost in light of market realities, and that cost

was paid, in essence, by Young Doc. Had the partners instead overfunded the plan, with Old Doc bearing a larger share of the cost of the overfunding (easily done based on the mathematics of DB plans and the typical method of cost allocation used by medical practice accountants), Old Doc would have paid a more appropriate price for his guaranteed investment.

Two Approaches to DB Investment Policy: Return-Driven (MVO) and Liability-Driven (LDI)

The higher the rate of return in a DB plan, the lower the cost of employer contributions over time. A return-driven approach, therefore, seeks to maximize the return for a given level of risk via portfolio optimization. Generally speaking, the trustee uses mean variance optimization (MVO) to build a portfolio that efficiently delivers the desired risk/return profile. This is traditional DB investing as many people conceive of it—the old 60 percent stocks, 40 percent bonds “all weather” portfolio. The percentages may vary, but the philosophy centers on return versus risk, with risk being defined as volatility in the value of *assets*.

A liability-driven approach, by contrast, seeks to match assets with liabilities to minimize volatility in *funding cost*. This strategy goes by two primary names in the marketplace: asset-liability matching (ALM) and liability-driven investing (LDI). A pure LDI strategy matches every cash flow to a bond of equivalent maturity. For example, if the plan expects outflows of \$1 million 10 years from today, the plan holds a 10-year, \$1 million bond.

As a practical matter, no plans are fully “hedged” in this way. Instead, an LDI strategy usually involves matching cash flows to assets for a period of 10–30 years, and may or may not “hedge” or match every cash flow. LDI investors are not slaves to asset-liability matching; instead, as Pentegra Retirement Services’ Chief Investment Officer, Scott Stone, says, “I prefer to call it asset-liability management, not asset-liability matching.”

Stone’s \$3.5 billion DB portfolio generally hedges between 85 percent and 105 percent of projected cash flows for a full 30 years, and this dedicated pool of assets represents roughly 40 percent of the portfolio. This strategy appropriately addresses the Old Doc/Young Doc example above, in which a large lump sum must be set aside in the form of a bond of appropriate maturity or duration. Of course, in most practical applications there is not just one lump sum; there are instead tens of thousands of individual future cash

flows, most of which (but not all) are matched to bonds of varying risk and appropriate duration. The concept is the same whether we use one large cash flow or many small ones.

And here is the key: whether you follow a predominantly returns-driven policy or predominantly liability-driven one, the reality is that neither approach is pure—real DB investors blend the two approaches—and *this is not possible without marrying investment and funding policy*. ALM or LDI are not strategies that some DB investors use and others do not—no DB investor can escape the need for some form of asset-liability matching. It is not prudent to ignore cash flows, and DOL regulations say as much. [29 C.F.R. § 2550.404a-1(b)(2)(ii)(B)]

A Happy Marriage

When funding policy is properly wedded to investment policy, plan management looks something like this:

- Actuaries, administrators, trustees, and investment advisors/managers talk regularly and work together as a team.
- In particular, the actuarial function must be joined at the hip with the trustee function, with the estimate of future cash flows being the critical piece of information the trustee cannot live without.
- The employer's tolerance for both funding volatility and asset volatility are important to both funding and investment policy and should be assessed together and applied together in executing both policies.
- The team develops funding targets. These can be simple—such as 125 percent funding for our Old Doc/Young Doc plan—or complex, such as a multi-year strategy for bringing an underfunded plan back to full funding, then to a 110 percent permanent funding target, according to a trajectory that is realistic for the employer.
- The team manages to the funding targets. For example, during the years of underfunding, a slightly more aggressive strategy might make sense, giving way to a more conservative investment strategy once the 110 percent target is reached.
- Some portion of the plan is asset-liability matched. Generally, even the most aggressive plans will match at least five years' worth of cash flows. I explain it to clients this way: by setting aside X years of cash flows, we give the rest of the portfolio

plenty of time to capture the long-term potential of the markets. You can afford the ups and downs when your cash flows are hedged.

- The asset-liability match need not be perfect so long as there is plenty of liquidity, but the principle of ensuring cash is available when needed, with reasonable certainty, is at the heart of DB plan management.
- The combined funding/investment policy takes contributions into account. For example, if we expect a normal cost of \$400,000 in 2015 and we have \$400,000 of outflows in 2015, we do not need to match the 2015 liabilities to any assets—they are matched to the contributions. This saves the employer a little money because we do not sacrifice any yield by using unnecessarily short durations for this piece of the portfolio.

The result of making the effort to work as a team to balance these factors is greater precision and control with fewer surprises.

How to Structure the Marriage to Ensure Happiness

Just as I suffer from the bias that my beautiful daughter's future marital bliss is more likely to be assured if she limits the suitor pool based on factors such as employability and number of piercings, my bias for DB plans is for arrangements in which a happy policy marriage is *structurally likely*. Indicators of the likelihood that a DB team is truly operating as a team include:

- The players (*e.g.*, investment advisor, actuary, employer) know each other and work well together;
- There is an automated, routine exchange of key information such as cash flows and funding levels, and all team members know what the information is for and what to do with it; and
- The plan has a plan: perhaps a half page “statement of funding and investment policy” that gives a big picture view, but at least a verbal understanding of all the parties. (Some attorneys would counsel against a written statement because it could arguably become a “governing document of the plan” as described by ERISA Section 404(a)(1)(D), creating a new fiduciary requirement that must be monitored. It might be best to ensure clarity via team meetings without drafting such a document.)

- Sample: the plan's long-term funding target is 105 percent of liabilities based on reasonable assumptions. The intent is to hedge at least 20 years' worth of liabilities with fixed income assets of appropriate duration, and to pursue a balanced strategy with the remainder of the portfolio. The primary objective of both the funding and investment policies is to pay benefits when due.

Contrast this with a common scenario in which an employer hires an investment advisor, who never talks to the actuary and only receives actuarial information if he or she bothers to ask for it. The advisor invests the money based solely on conversations with the employer, and the actuary only hears about the investments if he or she bothers to ask the employer about them. A marriage of funding and investment policy is *structurally unlikely* in this arrangement.

Conclusion

The key to a successful pension program is a marriage of funding and investment policy made possible

by teamwork and processes whereby the two halves of policy are routinely and effortlessly integrated. A pension plan is not a boxed product on a shelf; it is a complex organism whose care and feeding require an interplay of cash flows, return volatility tolerance, funding volatility tolerance, assumptions, funding targets, employer cash flow realities, and other factors. An investment advisor who is not fully plugged into these concepts and to the rest of the team can only take a plan so far, just as an actuary who has nothing to do with the advisor is limited in the utility of the advice he or she can give. They, the employer, and the plan fiduciaries have to work as a team.

Defined benefit pensions continue to grow less common in the United States yet are still a force to be reckoned with, with over 40 percent of all funded retirement assets being DB assets. And those of us who continue to offer pensions to our employees know the truth—they are worth it. There is no better benefit on the planet, and employees prize them. ■