



Being an Opportunist within the Defined Benefit Pension Crisis

November 25, 2016

“The Defined Benefit Pension disaster is the next major financial crisis that will affect millions of contributors, retirees, and ultimately tax-payers.” This paraphrasing captures the essence of the stark warnings from market veterans including Martin Armstrong, Michael Campbell, Bob Hoyer, et al. It’s simply arithmetic over time.

So, will you listen to these early warnings and be an opportunist...or choose willful blindness and then claim to be the victim of the problem? If you’re reading this article, you’re likely an opportunist.

The essence of the Defined Benefit Pension Crisis stems from the following:

- unrealistic investment return expectations on government bond holdings, leading to unrealistic total return assumptions used to calculate contributions and retirement benefits;
- increasing longevity of retirees receiving pension benefits; and
- fewer years of average pensionable service per Member than previous economic eras, especially within non-governmental and multi-employer pension plans

Actuaries have been warning about these issues for several years, though their warnings have been almost universally ignored. Publicly admitting the problem will require painful changes, and – in the case of public-service pensions – union influence and votes would be lost, i.e. ***it’s politically-driven in most cases***. Ignoring facts does not change them, and the longer it takes to address the problem, the more radical the solutions will have to be.

The good news here is that Commuted Value pension roll-out calculations are still near all-time highs since the major up-trend in bond yields - which are a big variable in the Commuted Value calculation – is still in its very early stages. Thus, we are in a unique and temporary environment wherein eligible Defined Benefit Pension contributors can maximize the roll-out value of their Pension. This unique opportunity will change quickly once bond yields really start rising.

Please consider the following realities of staying in a Defined Benefit pension plan:

- Most plans use a 7.5% or greater return assumption, yet are required to hold 40-50% or more in government bonds, which will generate a negative return in a rising interest rate environment. Achieving their return assumption will be next to impossible;
- Pension plans are governed by strict investment covenants and asset allocation restrictions which ***are not adjusted quickly*** to reflect changing economic, interest rate, and financial market factors;
- If the pension cannot generate the projected return, then the plan will be forced to start reducing benefits to existing retirees, often starting with reducing the annual income indexing provision. Current contributors will also be forced to accept higher normal retirement ages and contributions, and lower pension income levels and retirement income indexing. The money has to come from somewhere;
- Pension funds are amongst the biggest investor pools in every country. Being big has the advantage of scale, but being too big limits the ability of pension funds to be nimble, to actively manage currency risk and to invest in small to mid-cap stocks and precious metals...or any other sector that receives major capital flows which drive up prices for excellent returns;
- When you or your spouse passes away, the income stream may be reduced, depending on which option you choose. If you choose an un-reduced option for the survivor, the income stream for the retiree is reduced from day one, and
- ***When the second spouse dies, the capital defaults to the pension plan. You and your Estate do NOT own the capital; you're merely "renting the income."***

You can quickly determine if you are eligible to roll out the Commuted Value of your Defined Benefit Pension by referring to the Pension Member Handbook available to all Members. Look under "Leaving the Plan before Retirement" or similar headings.

If you are past the age deadline for transferring out the Commuted Value, there are other tools available to accomplish the objective of capital ownership and passing on the value of your Pension to your Estate.

If you ***ARE*** able to transfer out the Commuted Value, do you want to remain trapped in this scenario where you have third parties (pension trustees and possibly politicians) deciding on your retirement income, or do you want to ***take control of the situation*** and utilize the investing expertise of qualified professional portfolio managers who don't have the same bureaucratic constraint as pension managers?

If you are contemplating a roll-out of a Defined Benefit Pension Commuted Value, these factors come into play:

- Most - ***but not necessarily all*** - of the Commuted Value will be transferrable tax-deferred to a Locked-In Retirement Account (LIRA), so there may be an up-front tax bill on the non-transferrable portion to consider. This can easily be calculated using financial planning software;
- There will be some annual taxation on the non-registered portion, which can also be calculated easily using financial planning software, as part of a comprehensive Wealth Management Plan <http://integratedwealthmanagement.ca/iwm-wealth-management-process/>
- You have to assume the risks associated with managing the pension proceeds. Usually, a 4.25 to 4.75% annual return will equal or better the Defined Benefit Plan income at retirement. Please refer to this radio interview on solutions to low interest rates, which our managers use to increase the current yield in Client portfolios: <http://integratedwealthmanagement.ca/andrew-ruhland-moneytalks-radio/>
- You no longer have the pension's guarantee re: income levels. Your income is dependent on your portfolio's returns;
- When you are ready to retire, and start receiving income, you will have a one-time opportunity to "un-lock" 50% of the LIRA's value and transfer it tax-free to an RRSP or RRIF. This portion is very flexible in respect of how much can be withdrawn, subject only to the RRIF minimums;
- The remaining 50% that rolls into a Life Income Fund (LIF) will be subject to both a Minimum and a Maximum Annual payment. You can choose an annual income anywhere between the Minimum and the Maximum. The chosen payment can be

received monthly, quarterly, semi-annually, or annually. Thus, you have more control of the timing and level of the income streams, which allows for a “gear-down” into full retirement. This can work especially well if you have a part-time business or the ability to do paid consulting work, or simply work another part-time job during the early stages of retirement;

- When the first spouse passes away, there is no forced reduction of regular income streams. Both Registered and Non-Registered assets transfer to the surviving spouse on a tax-deferred basis, so there’s no immediate tax bill, and
- There will be income tax of various descriptions payable on these assets when the second spouse passes away, but ***any remaining capital becomes part of your Estate***, eligible for distribution to family and/or charitable causes that you decide upon.

Ownership of capital brings both privilege and responsibility. If you are considering rolling out the Commuted Value of a Defined Benefit Pension Plan, you need to have a complete analysis done to determine if this is the right strategy for you and your family. For a framework on how to do this, please refer to this recent article on ***Dealing with Lump Sums***: <http://integratedwealthmanagement.ca/dealing-lump-sums/>

Patience and Discipline are accretive to wealth, health and happiness – so focus on these.

Cheers,

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