BARENAKED MONEY PODCAST: EPISODE 16

Pension Plans, Pt. 1 - Defined Benefit

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Welcome to the next edition of Barenaked Money

Due to the magic of show business. No idea what number this one will be, but it is the next one. And the one that has been requested of us, we're going to talk today about pensions because time and time again, we bumped into clients who have a pension and it seems to be this magical mythical monster that lives in the corner and is going to look after them at some point in the future.

But pensions are a little more complicated and they might be worth paying attention, right Josh?

I think there might be some details here, people would be interested in.

Yeah that's right, and I think magical mythical monster, probably more like a magical mythical fairy because these things are they're seen as the panacea of retirement planning.

They're these guaranteed things. And we're going to debunk that a little bit that are going to pay out some magical amount for the rest of your life. No matter how long you live and no matter how the investments do over time. So we'll poke a couple holes in this, but we're really gonna focus on the defined benefit pension plans today.

So Colin, why don't you give me the 30,000 foot view of a defined benefit pension plan and what that means?

Sure Josh, and I'll start with what people feel it means is I've done my retirement. And that's how it's interpreted, but it's a little bit more nuanced than that. So let's get into it a little bit.

Cause this is a very big topic and we could spend a lot of time on it. Let's start by saying that there's different classes of defined benefit pension plans. Many of them are government related because they are very sticky, icky, and difficult to deal with. Unless you're a really large institution having a defined

benefit plan is not likely, there's been almost no new defined benefit plans launched in the last few years.

It's a bit of a rare thing to find, but basically the way it works is that you start work with your employer and after a period of time, or some of them it's right away, you become a member of the pension plan. And at the day that moment there's a little bell that goes off and they start counting your time.

This is your serviceable time. All right. And it gets calculated to five decimal points. Cause it's an important, okay. And they calculate every year. What your serviceable time is. Now that can be a bit of a calculation, but we'll leave that aside for now. But for every unit of participation, you earn a percentage of your earnings in real time.

Now again, that's most often done as an average of your five best years of income. That's again, just an example can be done differently than that. So basically for every year you work, you can gain a percentage of your earned best earned years that would be paid to you in retirement. So the ways you can tell you're in a defined benefit program is that they don't ask you for any investment choices.

So if you're enrolled in the pension plan through your employer, and there's no up question as to how you would like the money, invest it, then there's a good chance that you've enrolled in a defined benefit pension plan. That's the other key indicator is if there's some kind of formula attached to it as to, for every year you work, you get X number of years credit.

So a reasonably standard number would be for every year you work, you get somewhere between one and a half and two. Of your annual earnings. So let's say for example, you work for an institution that pays you 2% per year. After 35 years, you would get 70% of your earnings paid to you in retirement forever. That's a long time.

Yes, it can be. So anyway, that's the defined benefit pension in a nutshell, Josh, did I hit enough of that? Yeah. Yeah, I think for sure. So just to highlight one thing at the end. If you're getting 70% of your pre-retirement earnings, that's not like the cumulative amount of your pre-retirement earnings there.

Like you said earlier, usually taking the percentage over your five best or your three best or your five last earning years, whatever your average salary is over that period of time. That's what you're going to get paid out in retirement on an annual basis.

All right. So Josh, that's what it is. How do they do this magic?

How can they make these promises? What is the dark force that is going to create all this future money? How do they do it?

Yeah. I think I'm going to probably disappoint a few people out there, it's not magic. It's not some dark force. It's not some wizardry. It actually is that the company is just taking the money that is going into that pension plan.

And they're investing. So if you have a sponsor, which is the company or the organization that you're employed with, whether you see the earnings coming off of your paycheck and going into a pension plan, or the company is doing that in the background effectively, what they're doing is redirecting some cash, some ongoing investments to their pension, right?

And what happens when it's in the pension plan? It gets invested. It gets invested in stocks. It gets invested in bonds. It gets invested in alternative investments and their goal. This company's goal, his sponsor, his goal is to earn enough on the investments over the 35 years that you work there to pay it.

Your pension benefits in retirement. So if they're promising you $70,000 per year in retirement, they need to invest money over time and get a level of rate of return. that is building up enough assets in that plan. So they can pay that amount out to you when you retire again for the rest of your life forever ever.

As you said, Colin, and they're doing this for tens or hundreds or thousands of members of these pension plans and cumulatively, they're hoping that yes, we have enough assets to pay all of our liabilities as they are called when people.

And yes, in order to do this, they have to make some assumptions.

Now, everybody knows what assumptions are, but there's some pretty material assumptions that need to be made. They need to do some kind of calculation on the average life span of the people in the pension plan. So there's a mortality assumption and because pensions often have a spousal benefit to them.

And also there's quite a range of choices. Many people can make and taking a pension. There's some volatility in choices that are being made, but they have to assume a mortality amount. They further, they would have to assume a rate of return, a hurdle rate, if you will, that they're expecting on the contributions in the plan.

And again, these are both hugely important. The 10 or 20 basis point difference in the number of can mean a dramatic difference in the overall amount that is. From time to time, these assumptions are disappointed and then you are faced with a situation that the future promises that were made get a little bit unstable.

Yeah. So not only are they making assumptions for the rate of return and the mortality, but also the number of people in the plan versus. Retired in the plan. So people that are contributing versus non-contributing members of the plan. So there's a lot of moving parts, is what we would say.

No, and it's very complicated.

There's people called the actuaries that specialize in nothing but that, that calculation, the pension plans are required depending on jurisdiction. I'm not going to get into that cause it gets murky. It can be three years in between valuations done on pension plans because they tend to move glacially.

If they're not a quick moving. Now from year to year, they can be in a materially different position from a funding perspective, but you only really get that snapshot when the actuary really goes in and lifts up the hood. And does that mortality calculation, it does all the other detailed math that's necessary.

And then they generate a pension report that they send out to the members and explained to them what's going on in such a way that virtually nobody reads, but it's information that is indeed up.

Yeah, so you've alluded to it. I've alluded to Colin, but I think one of the misconceptions with a defined benefit pension plan is, Hey, I got this guaranteed, but there's not all aspects of this are guaranteed, right?

No, but I, and again, this is prior to where the perception is. I got a pension. I'm good. I'm glad that helps you sleep at night. I really am that. That's important to be nice and relaxed about little things. Now, if you're in a federal government pension, Yeah, the political cost to the federal government disappointing pensioners is big.

And even if the pension plan is not completely solvent, it's reasonable, maybe reasonable to expect that if it's possible, the government could jump in and aid or top things up. Yeah. It's still difficult to hitch your horse to that for the next 35 or 40 years of that's your time horizon, because we could reach a point where even that's not feasible, even major companies have had issues with regards to pension funding.

We do not want to get into a game of holes, snakes, and ladders with you. This is not intended to, try to scare anybody into anything, but we felt it was important in our role as educators to, make sure that we help people develop a reasonable view of what a pension is, but to call them guaranteed.

That's that's what we're examining today and how that's not really entirely. Yeah,

not only are we educators, but we're bare-naked educators. So, it's important to go through all these details. But Colin, you mentioned one word there that I think would be worth flushing out a little bit is solvent is a pension solvent or not.

So what do you mean by that? And why is that something that people want to pay attention to?

It's funny because we had a conversation before we started recording because pension plans can obviously things, but one thing that you want to look for is the funding. So pensions are considered in one of three states, either underfunded, fully funded or overfunded.

And depending on the jurisdiction, again, in the people's Republic of Canada, we have, 10 individual provinces that have their own pension legislation. Then we have federal legislation. But there are limits on how far underfunded or even how far overfunded, pensions are allowed to maintain their reserve.

There's a lot of language around funding level. So basically it's we have these obligations. How much of it do we have in reserve? And if we don't have as much as we need to have, that's a deficit. So there's a problem. So Josh, maybe you could run through some of the options available to a pension fund if it finds itself in the underfunded category.

Yeah. I think we can start to understand why there are so few organizations out there that are offering. Defined benefit pension plans today. Cause you, you mentioned a lot of the smaller organizations that are out there are not going to do this, but even the large profit-seeking enterprises these days are not so much offering, defined benefit pension plans.

And for most Canadians, the first large organization they might think of is one of the large Canadian bank. To my knowledge, not a single large Canadian bank is offering defined benefit pension plans to new employees today. Whereas they have been offering that over a long period of time. And the reason is because as soon as you hit that underfunded position, what these companies need to do, or these organizations need to do is add more money into the pension plan.

So this underfunded status, basically what they're saying. They haven't got enough rate of return on their investments to be able to finance all the payments that they're going to have to make to retirees when they retire. So the pension legislation imposes extra deposits on those organizations into the pension plan.

And when you have to make extra deposits into these pension plans, that necessarily hurts the profitability of these organizations. They don't like that shareholders don't like that. So they've started to move away from these defined benefit pension plans altogether. But you had a great example from Nova Scotia of a situation where overfunded is also a thing.

Been around since well, there were dinosaurs I've gotten to watch pension plans operate for awhile. So to build on Josh's point a little bit, the other option that's available to institutions to alleviate an overfunded or overfunded status is to change the benefits. So you'll see things.

And there's pension plans that have either taken indexing off of a pension plan or added indexing to a pension plan. Because again, from an actuarial standpoint, those are ways to either reduce or increase the liability depending on the situation. So there was a time back last century now where the pension plan back home was overfunded.

And once you go beyond 120% funding, you're all blue. To reduce that. Now, as funny as that sounds, they were obligated to reduce the over-funding. So they did a couple of things. One was, they gave a holiday to everybody in the plan that they weren't going to have to pay for the service that they accumulated over.

It ended up being about 24 months. You were still giving credit for a year that you worked, but you didn't have to contribute anything to the plan to get it out. The other thing was they added index benefits to people who are already retired. Who were very happy. Didn't understand why their pension check had gone up, but they were very happy.

So of course, it's gone to the other side now that we're now underfunded. So those beautiful days that we, threw a bunch of money up against the wall to make it go away. We now wish we had back. So from a pensioner standpoint, and this is important to understand that people think that they've got a pension calculation, that they can take all the way into retirement.

That is one of the ways, and that is one of the levers that's available to a pension administrator in order to get them back on site. All right. So you can make seemingly small changes that make a big difference in the reserve that's required because of increased life expectancy. Indexing is a very expensive thing.

So they may not be that they take away indexing entirely that's there, but perhaps it gets capped or perhaps it's, over every three years or, they can make Siemens. From their perspective, small changes that are very material to the, the pensioners or the people earning a pension.

So again, this goes back to my retirement plan is I have a pension now just be careful if you're counting every little nickel that's there, there can be situations where that just doesn't work out. But that's ancient history. There's more current examples, right? Josh?

Yeah, there sure is. You mentioned indexing and I just want to make sure we highlight that for people, not every defined benefit pension plan, is it.

Indexing makes a huge difference in, in terms of your sort of projected total receipts from that pension plan. So again, indexing just to explain exactly what it is. Indexing is adjusting the payments, the receipts from that pension plan for inflation over time. And some pension plans are fully indexed.

Some are partially index, some are not indexed at all, and that could make a big difference for your retirement project.

Yeah, that's fairly topical right now. Cause we recently put out something on inflation and you know what's going on with inflation right now. Because again, for the longest time we've lived in a relatively low inflation environment, but if you're looking at a 35 or 40 year retirement, that can be a thing.

So again, it's something else that you need to keep your eye on.

Yeah, pension plans have got their selves into issues with low rates of return on the investments. That's one problem, especially over the last 20 or 30 years, they've also got themselves into issues with mortality assumptions as well.

Like they're trying to project how long people live on average and what we've seen, let's say over the last 30 years, The actuarial projections are coming in shorter than expected. So let's say we're projecting that people live to 88 and we have more medical progress than expected. And people actually live in 89 or age 90 on average.

And I was just making up those numbers. They're not exactly right, but it just gives you the idea there. So all of these things can lead to issues with the funding status of a pension plan and a great example. I

think the one that you're alluding to is actually an investment industry related plan, we are licensed and overseen by an organization called IIROC.

And the mutual fund side of the investment business is overseen by an organization called the MFDA, the mutual fund dealers association. And that pension plan is actually under funded. And it's quasi public, this plan, I would call it quasi public and it's it's a little bit startling to see, Hey, here's an investment related business that's not keeping up with their expectations on the pension plan.

It is the duality of being human. Material like a really large important thing, but almost completely invisible day to day. So it's one of those things that can, for a period of time, get swept under the rug until it gets to a point where it comes out and it's just completely unattainable. And, there are different organizations that have gotten to that level.

Can we jump to the one that really started this whole podcast? And I can run through some numbers. The Genesis for this whole idea came well. When somebody highlighted for me that the Nova Scotia teacher's pension had released string and report on the guy that clicks on it. And I just wanted to see how the teachers and the people's Republic of Nova Scotia were doing.

So here are some stats and I've highlighted some there's more for those who want to go digging. So they are currently as of the end of 2020, 79% funded, which means they are 21% under funded. And you think they could make that up over time. They cause some time to work it out.

They have currently 13,853 retired members currently drawing pension. And then we've got a further 6,000 Inactive members, meaning those are people who have not yet started drawing benefits, but are no longer working as teachers. So you're saying as long as there's more people than that working, they can work their way out of it.

Current active teachers, 13,066, there are way less teachers currently working than expectations of the pension. And the pension is sitting 21% underfunded. And Josh, this is completely cold, everybody. So this is Josh thinking on his feet. Josh, the rate of return for 2020 was 6.7, 8% after management fees, which is better than the actuarial rate that they were aiming for of 5.7% percent. So what do you say about a 5.7% assumed rate of return on a pension fund? That is very tightly, regulated?

Probably over the next 20. Maybe 20 is a little bit aggressive, but probably over the next 10 years, I'd say that's a bit ambitious. So one of the things with these pension plans, they like certainty and in their returns.

And generally, that means they want lower volatility, lower risk investments. And so that means that probably a higher percentage of their investments are going to be in bonds, which are generally considered a safer, more predictable return stream, a 10-year government of Canada bond. And I'll give people an idea of one we're filming this.

Cause as of today it's been moving a lot, but it's about 1.15% as of today. So let's say. 20% of your portfolio is invested in government of Canada bonds or government bonds of some sort. So 20% of your portfolio is going to be getting slightly over 1% return over the next 10 years, you can increase that by going into this on corporate bonds, you can increase that a little bit more by maybe going into some alternative investments and maybe a little bit more than that by going into some stocks.

But it seems to me on the surface that you'd have to have a. High percentage of your portfolio invested in stocks to be able to get that over the next 10 years. And even then, I'm not sure that you would get it because the valuations on stocks today are high, which means your return expectations over the next 10 years.

Gotta be a little bit lower than it has been in the past. So good luck getting that 5.7% Nova Scotia teachers. I'm not betting on it, my money's not on you.

And unless the, unless they're starting to hit the 8% or 9%, they're not going to be chunking away in any material way at this deficit that they have.

So they have a little bit of an issue and I would, jump on the bandwagon that Josh started. It's not that, pensions, prefer not to take risks. The legislation demands, they take less risks. They are very tightly regulated and taking any kind of chances is the only thing worse than the pension.

That's only 79% funded. Inactive is one that's way, underfunded and closed. Like our port friends who worked for Nortel or Sears are other two examples that we have dug into now, Josh and I have both done independent research, I think, into these two topics. So I think we may have two different or maybe it's the same information on those two particular funds because once the company has gone, there's no way to come back from a deficit.

Yeah, unfortunately, and it's pretty sad because both of these underfunded pensions and one, the company goes out of business and whatever I said, when a pension is underfunded, that organization has to put more money in from their profits. If they're not making any profits, then there's no more money going in there.

So at that point, the the pensioners are, tough luck and I feel especially bad for the Nortel Folks, because they tied up a lot of their wealth and either the Nortel pension or the Nortel stock or both of these things. And as much as they were excited about the Nortel stock for a while, we all know how that ended.

Again, that comes back to one of the things that I say to all my clients. Never tie your investments up where you work, if your company is doing well. Then your paycheck's going to do on your career's going to do well. If they're doing poorly well your career is going to do badly, your investment should be somewhere else, you work for coke own shares in Pepsi.

It's just a basic risk management tool, but there's a couple of things. And I feel like I'm throwing in snakes to the hole here, but I really don't. This is not what I'm trying to do. I just want to really make sure people understand this, drive this home. So in the Sears, Canada, which again, as a company, you know the Sears Christmas wish book.

This is a huge Canadian company. There was a court case that was fought because the pensioners were going after assets in bankruptcy. And the courts held that they were last, they were behind all of the banks, they were behind all of the other creditors. So basically the pensioners in that situation we're left holding the bag and so again, the whole idea is if my company goes bankrupt and they're going to have to pay this pension, somebody is going to have to pay this pension court cases have been fought both for Sears and for Nortel and the pensioners were left holding the bag and I as a human, yeah I think that's terrible. I think that's absolutely wrong; I just want to dissuade anybody out there. Who's going even if they went bankrupt, we would be fine. Cause they would know there's there's no magical bailout. In the case of Nortel, there was a court case fought cause Ontario actually has a little bit of a fun put together

to help underfunded, pensions, but it's nowhere near the scale required of the shortfall. And they actually had to go to court and fight over it because province, Ontario felt that given too many assets and one at some of the back. And again, it gets into a whole thing because this is not exciting. Front page stuff.

There's all kinds of things that happen that when you really look at them with a little bit of a flashlight, you go, that's just wrong, but it doesn't get enough attention to it. We'll behind it to make some difficult decisions for people in retirement. And again, the point of this podcast is just to maybe show you that pensions are wonderful, but they shouldn't be your whole life.

No, these are just some of the cases that we've seen recently that have ended in ways that are really disappointing to us as human beings. But have been held up in the courts as being those

liberals. Yeah. I got to kill some snakes calling because there's a lot of fantastically run public pensions out there, especially, and some private pensions too.

The, I think some of the cases that we're highlighting, just to be clear for everybody, it's the minority of cases. It's a small percentage of cases that, that really get into issues like this. And especially the majority of public pensions run by, provincial or federal governments. If they are underfunded, it's a tax collecting institution organization.

That's going to be able to most likely add some of our tax, paying dollars back into that pension plan to shore it up and make those people whole. So it's not dire, you shouldn't run scared if you have a defined benefit pension plan or anything like that, or think that you need to double the amount of assets that you have saving for retirement or something.

All of these attributes, I think the most important attribute of governments is they don't go to business. You don't have that risk with a government pension plan. And again, you've got the political will, but I think that, paying attention to the funding level of your pension is important.

When that report comes out, you should look at it and very quickly, you should have to tell whether you should be expecting that your pension is going to be more generous with you or potentially going to be a little less generous with you. Again, to Josh's point. This doesn't mean you need to double your savings, but it's worthwhile having some financial independence that's built outside of a pension plan.

Having a pension plan is not a retirement. Yeah. And that's a fair comment and what you do want because something that defined benefit plans, lack to some extent is flexibility. And that's what you want in your retirement plan. You want flexibility because things will change over time. And one of the things that we're going to be talking about and teaser for our next podcast is commuted values and how that can work, what that looks like for you and what it means relative to a defined benefit pension plan over time.

Yeah, because in a nutshell, you need taking money out of a pension plan. Isn't necessarily just turning on a fire. There can be options, right? And it can be that, by legislation you're supposed has got a right to some of your pension. So that's important. So there's joint pensions, there's joint pensions with different pamphlets to survivors.

And if you leave early enough and your pension plan allows for it as Josh alluded to. So there's a community value, which is here's a big bag of money that we were saving for you. Good luck. And again, that what goes into making the decision as to whether on a commuted value or what kind of option you should.

On your pension is definitely part of something that you want to build into your financial plan. And apparently, we're going to do another whole podcast on that, that we're not going to know the number of them we've recorded because of. I hope over the last, however many minutes, this got edited down to that.

You learned something about pensions. Our intention was to educate, not scare. This was not a holes, snakes and ladders. This was just education. And it's predicated on the idea that we've bumped into maybe a few too many people that think pensions are just magical, mystical, wonderful things that always happened. And we maybe wanted people to have a little bit more skepticism when it comes to their pension expectations.

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based on observation. It seems that the time an investor is most likely to move his or her portfolio to a new advisor is when the old advisor dies. Let us go on record as saying that having a pulse is not a great reason to trust someone with your entire financial future. Stop putting your life in the hands of still breathing Wealth planners.com and call us.