

# WHY PENSIONS WORK

by Steve Waas, CFP®, EA

The first defined benefit (DB) pension plans in the United States came about in the railroad industry in the late 1800's. The railroads were looking for ways to attract – and especially to retain – quality employees. The success of these retirement systems led to them being adopted by more and more large organizations, including the pension for Houston Municipal employees, which started in 1934. The System was formally established by the Texas Legislature in 1943.

Many workers find DB pensions attractive because they provide a lifetime benefit throughout their retirement, regardless of how long they live. Furthermore, their benefit amount is based on their years of service and salary while they were working, rather than volatile investment returns. Together, these features provide one of the most important keys to retirement success – security.

But are DB pensions the best way to provide for retirement? Some people believe it would be better and cheaper to simply allow workers to save more out of their paychecks and use that savings in retirement.

In fact, DB pensions are a much cheaper way to deliver each dollar of retirement benefit than alternative systems. Consider some of the daunting tasks an individual faces when trying to provide a secure lifetime income *without* a DB Plan.

- An individual worker trying to save enough for his or her entire retirement must calculate how much to save. This is not easy to do. In reality, most people without DB pensions significantly under-save for their retirement.
- A worker must maintain the discipline of continuously saving throughout his or her career. This is also difficult, and the data shows that very few workers are able to do it. Even when provided with good deferred compensation plans for their savings, most workers have sporadic and low contributions. Also, a very large portion of workers "cash out" of these plans when they change jobs, which makes it difficult or impossible to accumulate the amount of savings they need for retirement.
- Workers need to invest this savings so it can grow throughout their working years. But as individuals, they pay "retail" costs for investment management, which are substantially higher than the costs available to large institutions such as pension funds.
- The data also shows that individuals tend to underperform when it comes to their investment decisions. Pension funds provide continuous professional money management, as well as a wider range of investment opportunities than is typically available to individuals.
- As workers get close to retirement, and after they retire, they face heightened risks when it comes to market volatility. When they were younger, it was somewhat easier to tolerate the ups and downs of financial markets, since they had many years to recover losses and were regularly adding to their savings. But now this volatility can be much more damaging. In a DB plan, new participants are coming into the system at the same time that others are retiring, so the fund does not face the same degree of this risk as an individual would.
- Finally, one of the biggest problems faced by an individual retiree is this basic question: how long will he or she live? Without knowing the answer, how can you decide how much to spend each year in retirement? This is called "longevity risk." To reduce the chances of outliving savings, many individuals have to save extra money "just in case." In a DB system, this risk is essentially spread out as large numbers of people are pooled together. For each individual, this risk is eliminated.

The bottom line is that in the absence of a good DB plan, retirement planning and savings tends to entail higher costs, lower returns and additional risks. To off-

set this, and to generate the same retirement benefit as the DB approach, much more of a worker's total compensation would have to be devoted to retirement. Or, failing that, the worker will face reductions in his or her standard-of-living during retirement, which is exactly what many baby boomers who don't have access to a DB plan are beginning to discover.

Furthermore, when DB plans and other benefits are added to salaries, the "total compensation" package for the typical public sector employee is not unusually large, as is sometimes claimed. In fact, when controlling for education, experience and other factors, one study based on US Department of Labor data concluded that "On average, full time state and local employees are undercompensated by 3.7% in comparison to otherwise similar private sector workers.\*"

None of this means that an individual in a DB plan has no need to save money. There are many reasons to supplement a DB plan with savings – to prepare for early retirement, to provide for family members or others, to help retire debt. Deferred Compensation systems (such as the City's 457 Plan) are one way to provide this supplemental savings. While a DB system is ideal for providing the basic benefit that virtually all workers will need in retirement, deferred compensation is ideal for enabling workers to "customize" their retirement benefits for their individual needs.

Also, none of this means that DB systems are infallible. Constant improvement is necessary. When the strong investment markets of the late 1990s and early 2000s ended and a period of rocky markets ensued, many pension systems failed to respond. HMEPS, however, acted quickly. Benefit enhancements that had been implemented during the boom years were halted and a plan was put in place to gradually pay off the unfunded benefits that had already accrued. Various other steps were taken to help significantly improve the pension's funding level.

HMEPS will continue to look for ways to improve services, enhance sustainability and serve the member-

ship more effectively. Still, it's helpful to consider the value of a defined benefit pension plan to participants, who increase their retirement security, and to City residents, who benefit from a quality City workforce in a more cost-effective way.

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\* Jeffrey Keefe, "Debunking the Myth of the Overcompensated Public Employee," Economic Policy Institute.