The Investment Portion of the DB Formula Really Does Work

By Chris Greco: Partner, Sawgrass Asset Management

The success of defined benefit plans rests upon a simple formula: Contributions + Investment Returns = Payment of benefits. The key to making the formula actually work requires the addition of a few words to: **Consistent** Contributions + **Long Term** Investment Returns = Payment of benefits. While much has been written about DB plans for the corporate and municipal sectors over the years, there have been many short term decisions made that impact these long term programs. The plan must utilize the proper measurement tools for investment returns and an understanding of market volatility must be applied.

A defined benefit plan has an extremely long life expectancy, and we need to make sure that the proper measurement tool is being used to capture the investment return portion of the formula. When you attempt to measure the distance between two cities you use miles, not feet, as the unit of measure. The same is true for investment returns; we should be looking at return patterns of 20+ years, not the most recent quarter or even 3 year returns. These short term measurement periods can be very misleading as to the strength and viability of investment returns. Investment results can vary from quarter to quarter so greatly that it could lead a plan sponsor to make decisions based upon short term return data for a long term investment formula. A striking example of this was recently observed during this past year when comparing returns with an end point of September 30 (most fiscal year ends) to December 31st. The S&P 500 had a 3 year average return of 1.22% as of 9/30/11, which was very disappointing to pension plans across the country, however, the 3 year return of the S&P 500 is now 14.1% as of 12/31/2011. This is a significant return differential over a very short period of time, and this type of endpoint sensitivity should encourage longer term measurements for decision making.

Many people often ask to define “long term” returns, and we need to put this recent market into perspective as a short term event that is part of the long term life cycle of a fund. Most plan participants work for 25+ years and then live for another 25 years on average, so a 30 year measuring stick would seem like a fair one for this DB formula. When looking at the stock and bond markets over the past 30 years, we see that the S&P has had an average return of 10.9% per year and the Barclays Capital Aggregate (the bond market) has had an average return of 9% per year. These asset classes are the key building blocks of most investment allocations in pension plans, and these returns should remind us that the investment return portion of DB formula has worked over the past 30 years despite encompassing a near financial meltdown during the worst decade since the Great Depression. Going forward, it is important to put short term investment events into perspective and remind all interested parties that long term investment returns must be understood to make the plan work. Using the proper measuring tools, miles not feet, will help us all understand how to create and manage a successful investment program.