Defined Benefit and 401(k) Plans
What's the Difference?

With the recent announcements and speculation concerning the future of American Airlines, it's employees and retirees, hundreds of Owasso area residents are unsure of how to deal with their financial future.

Owasso resident Kyle Christensen, has run his own financial planning practice since 1999. He recently moved his family to Owasso to be closer to family members in the local area. Christensen has been following the developments at American Airlines with a professional financial eye.

Christensen said that recently American Airlines stated "We simply do not see a way we can secure the company's future without terminating our defined benefit plans." American Airlines followed by saying "If we receive court approval to terminate our plans, every active employee's and retiree's vested pension benefit will be turned over to the PBGC and guaranteed up to the PBGC's 2011 maximum limits".

Many in the American Airlines family are asking just what does this mean? According to Christensen it means that the guaranteed payment of benefits to current retiree's and promised benefits to current employees is dragging the company into ruin. They simply cannot compete and turn a profit with the current plan in place.

"American Airlines wants to do what Delta and other airlines have done in recent years, they want to get out of promised and guaranteed retirement benefits. To understand why, you have to understand how they work," Christensen observed. "The defined benefit (DB) plan requires employer contributions. Employees cannot contribute, thus it is a non-contributory plan. DB plans guarantee a certain payout of benefits over the life of the employee, and oftentimes over the life of a surviving spouse. Pension plans are regulated by the Federal government and require contributions which vary from year to year, depending on the promised payout and the performance of the underlying investments. It's safe to say that in recent years, the economy has not done well enough to keep up. Therefore required contributions have steadily increased.".

"Employees love defined benefit plans because they guarantee a benefit based on number of years of service and wages. Employees also love DB plans because they don't have to put their own money in them. Lastly, employees love DB plans because all of the risk is on the employer," he said. "Employers however, would love to get rid of defined benefit pension plans. In fact, the number of DB pension plans has been in rapid decline since 1978. There were 128,041 DB pension plans in place in 1978[1]. As of 2009, there are only 26,000 remaining."

Many are asking why does American Airlines want to replace their defined benefit pension plan with a 401(k) plan?

According to Christensen there are three major reasons:

- Reason #1: About 80%[2] of the employees at AA will contribute to the plan. That means that instead of funding retirement for 100% of its employees, American only has to make matching contributions for 80% of them.
- Reason #2: 401(k) plans are not guaranteed. There is no guarantee on the performance of the investments, no guarantee on the payout, and there is no guarantee that the company will continue matching contributions. Suffice it to say that the employer makes their contribution and then the rest is up to the employee.
- Reason #3: The employer contribution, or match, is much less expensive to the employer than DB plans were. Typically an employer will match something like 50% of the employee's contribution, up to a certain percentage of income deferred (i.e. 6%). For example, an employee making $50,000 per year contributes 6%, or $3,000 to the 401(k). The employer matches 50% or $1,500. For that same employee, the employer was likely contributing somewhere around 11-14% ($5,500-$7,500) per year of the employee's wages into the pension plan. You can see why the employer is happy to make the change.

There are much bigger problems related to this change, and this is true for anyone, not just American Airlines employees. In most cases, even if employees contribute to their 401(k) plan, the employees usually do not know what they are doing when it comes to investing in the stock market. Although the administrators of 401(k) plans give packets of information, with beautiful pie charts and sample allocation strategies, the administrators of most of these plans are told not to give investment advice. Why? Because if they do, and you lose money, you can sue them and win. So, they avoid giving advice, leaving the employee on his/her own to figure it all out. The risk is all on the employee participant.

Christensen went on to explain why the 401(k) fails most people. First, most employees are given no real education when it comes to investing. They have never been taught how to analyze corporations, read balance sheets and income statements, research fund managers, or the funds underlying investments. The risk tolerance self-tests are ridiculous and a waste of time. Everyone is a risk taker when people are making money. When they are losing money, everyone is risk averse. Pretty simple.

Even if an employee tries to do his/her due diligence it won't matter. "Has anyone ever really read the prospectus for each of the funds in the 401(k) plan? Probably not. Even if they have, they probably didn't understand it, Christensen stated.

. Arthur Levitt, a former chairman of the Securities Exchange Commission is quoted as saying "As I pored over fund prospectuses, what really got under my skin was that the documents were impossible to understand. At first I was embarrassed. Then it hit me: if someone with twenty-five years in the securities business couldn't decipher the jargon, imagine the frustration for the average investor. Mutual fund prospectuses were written in impenetrable legalese, by and for securities lawyers."[3] The prospectuses for the mutual funds in your 401(k) were not meant for you to understand."

Many employees who contribute to their company sponsored retirement plans are generally confused about their choices, are not proactive managers of their investments, are uneducated regarding the stock market, and are gambling unnecessarily with their financial futures.

Christensen advises that what it boils down to is this. So, you are going to lose your pension benefit. If it doesn't happen now, it will later. Pensions are becoming extinct. And for that matter, so are matching contributions to 401(k) plans. You probably saw it coming for years. You want your employer to be profitable. That's job security for you. You don't want them to go out of business. In that case you would lose your job and every benefit that is tied to it. You now have the opportunity to depend on the one person who cares about your financial security more than anyone, yourself.

"You may not have control over what your employer offers for retirement investing. However, you do have control over what you will do with your money. You are free to choose," Christensen said. "Wall Street would like you to believe there is only one choice. You know that's not the truth. Look around as you drive to work. Nearly everything you see is an investment someone has made.

"Don't jump into the 401(k) just because of the match. Don't jump into it because it's the only thing your employer offers. There is a world of options out there for you. Learn what they are. Learn how to manage your money. Develop and adopt sound financial principles that endure the test of time. Avoid and eliminate debt. Build a team of advisors around you, people who are on the same page with your financial objectives."

He concluded that although things may seem cloudy today, the future is bright. The financial decisions being made today will have a profound impact on your enjoyment of life and the future security of your family. Take the opportunity to become educated.

(Kyle Christensen is a graduate of Utah State University. He is the owner of Unique Advantage in Owasso and has worked closely with attorneys doing estate planning. He has been a LEAP Licensed Practioner for 13 years. LEAP is a personal financial engineering program focused on economic

efficiency and maximization in personal planning. If you have questions about the article above or anything related to your own financial situation, contact Kyle Christensen at 435-770-0959.)