Cash Balance Plan Investing Considerations

Investing within cash balance plans takes a thoughtful approach that differs from traditional retirement strategies, with a focus on delivering steady, predictable outcomes, in lieu of maximizing returns.

For advisors, understanding these dynamics can help support well-balanced strategies that align with client goals while enhancing overall plan efficiency. We aggregated popular questions and provide guidance to give an understanding of investment implications within cash balance plans. If you would like additional information on cash balance plans in general, you can reference our Cash Balance Plan FAQ Overview.

Q:

What factors are considered when investing cash balance assets?

Cash balance investing is more subtle than the 401(k)-investment process and are treated as defined benefit plans, which provide a specified benefit to participants.

Actuarial alignment is critical. The actuary determines the employer contribution based on an assumed rate of return from the plan assets known as the Interest Crediting Rate (ICR), If the actual rate of return is higher than the assumed return (ICR) the employer contributions may be reduced. Conversely if the rate of return is lower than the interest assumption additional employer contributions may be required.

Q:

What investment strategies do we see oftentimes within a cash balance plan?

Unlike 401(k) investment strategies, which typically seek to maximize returns, cash balance assets are invested in a more conservative manner designed with the goal of providing a more consistent rate of return.

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Q:

Why are conservative investment strategies used with cash balance plans?

Since cash balance plans are defined benefit plans, unlike 401(k) plans, the plan sponsor bears the risk of investment losses. The plan sponsor's contributions and deductions are based on various conservative assumptions regarding the overall rate of return. Ideally, the investment return is consistent with the interest rate assumption.

Q:

What happens if the cash balance investment results exceed the assumptions?

Based on the nature of the actuarial calculations, if actual rates of return exceed the assumed rate of return the allowable employer contribution is reduced.

Q:

Who is responsible for investment losses in a cash balance plan?

Because cash balance plans are defined benefit plans, the plan sponsor bears the risk of investment loss. In other words, regardless of investment performance the plan sponsor is obligated to pay stated benefits.

Q:

Can the cash balance investment management be outsourced to an Outsourced Chief Investment Officer (OCIO) or a 3(38)?

Yes. Many cash balance plan sponsors outsource investment management to an investment professional.

Q:

Can our 401(k) investment menu be used with our cash balance plans?

In 401(k) plans, participants make their investment choices from a menu of investment options. No participant self-direction is permitted in a cash balance plan, rather, all investment decisions are made by the plan sponsor. This means plan sponsors select a portfolio of investments that are appropriate for cash balance plans, not for each individual participant. The 401(k) investment menu would not be appliable to a cash balance plan.

Q:

What is an appropriate benchmark for cash balance investments?

There are two benchmarks to consider for cash balance plans:

1. A cash balance plan's overall targeted rate of return is set by actuarial assumption and should be between 3% and 6% annually. Rates above and/or below this range create problems with contributions amounts, deductions and cash flow.
2. The individual investments within the cash balance portfolio should each have benchmarks to track and evaluate performance.

Q:

What does interest credit rate mean and what are the methods?

The interest credit rate is the predetermined rate used to calculate the annual growth of participants' account balances. There are three methods used to determine the interest crediting rate:

Fixed Rate – A set annual rate, typically 4%, 5%, or 6%

Variable Rate – A rate tied to the yield of the 10 year or 30 year treasury bond

Actual Rate – A rate based on the plan's actual investment performance, subject to minimum and maximum return limits

Q:

Does the interest crediting method (fixed or market) impact the cash balance investment strategy?

Regardless of the interest crediting strategy, the underlying investment portfolio should seek a consistent return of 3–6% annually.

Q:

What is more appropriate for cash balance plan investment, a mix of traditional low fee indexed funds or absolute return oriented funds?

Traditional low fee indexed funds' primary purpose is to mirror returns of their stated benchmark (low tracking error). The benchmark itself, however, can be susceptible to higher volatility and fully participate in market downturns.

Strategies that are absolute return oriented potentially benefit from reduced volatility, downside mitigation, and lower correlation to the movement of the broader market. Given the investment goal of a cash balance plan is to be conservative and target a return of 3-6%, absolute return-oriented funds that focus on consistent returns are better suited for these types of retirement plans.

Q:

How does the investment time horizon differ for cash balance plans vs 401ks and IRAs?

Time horizons for 401ks and IRAs can be 50 years or greater, an investor's full life cycle.

With cash balance plans, the time horizon can be marked to market on each calendar year basis. This means the 3–6% targeted return may be evaluated over as short a period as one year.

Q:

Are there restrictions on what type of investment vehicles can be used?

There are no restrictions on the types of securities that can be utilized. While mutual funds are widely used, individual stocks, bonds, and alternative investments are all acceptable in a cash balance plan. Cash balance plans can even invest in closed end interval funds.

Additional consideration should be taken for any platform restrictions and availability set by a broker dealer, custodian, or recordkeeper.

Q:

For simplicity, can a money market fund be used as the entire investment portfolio?

It is possible for a money market fund to be the sole investment of a portfolio given its yield could match the targeted rate of return. However, there are two important considerations we believe should be taken into account:

1. While current yields might look ideal, future yields and subsequent returns could be too high or low in matching the target return.
2. Also important, business owners are typically reluctant to invest only in money market funds when these contributions can be a substantial amount of their overall retirement and investable savings.

Q:

What is the typical asset allocation mix of equities to fixed income?

It is common to see asset allocation mixes between 10% equity/90% fixed income, all the way to 70% equity/30% fixed income. As markets go through cycles, different economic and interest rate environments, and geopolitical risks alter capital market assumptions and should be used to determine an appropriate forward-looking asset mix. A large consideration for this is dependent on whether the targeted return rate is at the low end of 3% or on the higher end of 6%.

Q:

Are there typical asset styles and other investment characteristics that should be considered as components of the portfolio?

While this is not a stated recommendation, for equities, styles that offer lower beta and low upside/downside capture are frequently seen in cash balance plans. A mix of domestic and international equity is preferrable as markets go through cycles. The portfolio should limit exposure to high volatility styles and asset classes.

For fixed income, there is no requirement for securities to have a certain level of credit quality and duration. An appropriate allocation to lower quality, low duration fixed income in addition to higher credit and longer duration debt instruments is a frequently used allocation strategy.

Q:

What are ways to construct portfolios?

There are many ways to construct portfolios and here are 5 examples:

1. A model portfolio that has individual mutual funds invested in various individual asset classes for broad diversification.
2. A managed account program that offers a conservative asset allocation.
3. A Collective Investment Trust (CIT) built with a sub-advised multi-fund asset allocation or a combination of individual CITs investing in a broad range of asset classes. CITs are generally reserved for record keeper platforms only.
4. A single risk based mutual fund or balanced fund. These can lead to issues in the event a replacement or reallocation is desired. The single asset allocation fund or balanced fund would need to be replaced.
5. A combination of all of the above.

Q:

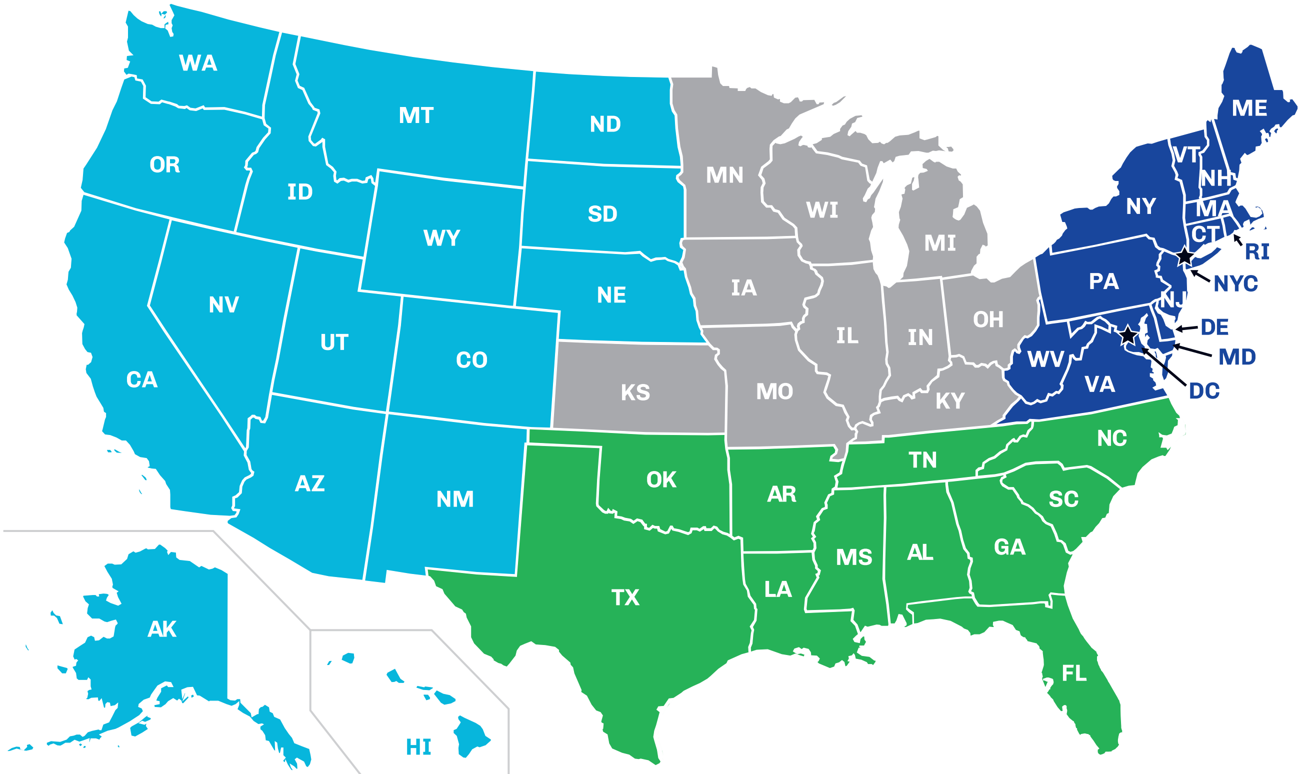
How often can the investments be replaced and traded?

There are no restrictions to the frequency of rebalancing or replacing funds. However, as markets go through periods of extreme outperformance or underperformance of long-term averages, reassessing allocations to positions at the extremes is a prudent exercise.

Q:

Who should an advisor contact to get started?

Please reach out to your respective senior retirement consultant or you can call our sales desk at 800-747-2008.



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Disclosures

All investments involve the risk of loss of principal.

Diversification does not guarantee investment returns and does not eliminate the risk of loss.

A Cash Balance Plan (CBP) is a type of defined benefit retirement plan that defines the benefit in terms of an account balance, similar to a defined contribution plan, but with the employer bearing the investment risk and providing a guaranteed benefit.

Defined Benefit (DB) plans is a retirement plan where the employer promises a specific monthly benefit at retirement, based on factors like salary and years of service, rather than contributions to an individual account.

A Defined Contribution (DC) plan is a type of retirement plan in which the employer, employee or both make contributions on a regular basis. Distribution Phase is the stage where the accumulated funds are managed and withdrawn in ways that provide the biggest benefits and advantages to the retiree.

A **Collective Investment Trust (CIT)** is a pooled investment fund maintained by a bank or trust company, available exclusively to qualified retirement plans (like 401(k)s) rather than the general public.

Beta is a measure of an investment's price volatility relative to that of the overall market.

An **upside capture ratio** over 100 indicates a portfolio generally has outperformed its benchmark during periods when the benchmark was generating positive returns.

A **downside capture ratio** of less than 100 indicates that a portfolio has fund has lost less than its benchmark in during periods when the benchmark was generating negative returns.

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