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Why you might be better off without a defined-benefit pension plan

By Ted Rechtshaffen

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Some people have all the luck. When they retire, they receive a fixed pension for life from their work.

For those without a defined-benefit pension from work, here is the good news: You might be even better off without it. With good tax and investment planning, you can often earn a better return, pay less tax and maybe even have a solid estate to leave behind - while your pension would simply die with you.

There are two key steps:

1. Determine what you actually need each year from your 'Personal Pension Plan' (PPP). This might require a more detailed financial planning exercise, but the simple version is that after accounting for the Canada Pension Plan and Old Age Security, and deducting what you would need to cover all of your expenses, this will tell you how much you need to draw from your PPP. One of the advantages of the PPP is that you have more control over what you need to draw, and also where you need to draw it from. This will mean that you are better able to manage your annual tax bill than under a traditional pension.

2. Build a portfolio with as close to long-term certainty as you can. Most defined-benefit pension plans only require an average rate of return in the three to five per cent range. While the plan itself may have higher return goals, that is because it needs higher growth to cover all the payouts it has to make even though there may be fewer employees putting money in. If you have a DB pension plan from work, you can opt to take the pension as a lump sum up front instead of as a monthly amount for life. If we run an analysis of the upfront amount (both tax sheltered and taxable), we usually find that you only have to return around four per cent on this money to break even with your pension payouts.

Forty per cent dividend growing stocks: According to a research study by BlackRock's Richard Turnill and Stuart Reeve, 90 per cent of U.S. equity returns during the last century have been delivered by dividends and dividend growth. This means finding companies that not only pay a dividend in the two-per-cent-plus range today, but have a history of growing dividends, and generate consistent and growing income to easily afford to pay their dividends. As a great example, BCE Inc. currently pays $2.73 a share in dividends for a current dividend yield of 4.6 per cent, with a price of about $60. On Jan. 1, 2003 the stock paid $1.20 a share in dividends. The price on an adjusted basis for splits was roughly $30 for a dividend yield at the time of four per cent. The magic of dividend growth is that if you bought the stock for $30 and it now pays $2.73 in dividends, your annual dividend yield, based on your original purchase price, is 9.1 per cent. It didn't hurt that the stock is also up almost 100 per cent over the last 13 years. By ensuring that the stock part of your portfolio is full of dividend growers, you are helping to ensure that your stock prices will be heavily supported by income, and most likely will provide much lower volatility than the stock index.

Twenty-five per cent alternative income assets: Just like the pension funds themselves are doing, you need to find ways to hold assets that produce higher income and lower volatility than traditional portfolios of just stocks and bonds. These alternative assets may be various debt instruments like private mortgages, private debt and factoring. In many cases, these investments can earn six per cent to 10 per cent a year with low volatility. As investment options evolve, there will likely be greater opportunities to invest in income producing real estate or infrastructure like toll roads and bridges. These types of investments provide the steady income streams that pension investors are looking for. There is also potentially room for some well-run market-neutral hedge funds that truly hedge some of the stock market's volatility, and can produce returns in the five to 10 per cent range over the long term.

Thirty per cent bonds and preferred shares: Within this group there is a wide range of income levels and security that can be found. Given that this pension portfolio has 40 per cent in stocks and 25 per cent in alternative income assets, we don't want to take too much risk in this section. Today, preferred shares can easily yield five per cent or more with a combination of fixed-rate and rate-reset shares. There has been more volatility than traditionally seen in the preferred share world, but we believe that, moving forward, this sector will be a solid provider of income with lower volatility than stocks. On the bond side, there is certainly room for both corporate and government bonds, as well as terms to maturity that may vary depending on the prevailing direction of interest rates. This bond part of the portfolio should not likely be expected to generate more than three to four per cent, and should be considered somewhat of a stabilizer and hedge to stock markets - especially on the government bond side. Having said that, there does remain some opportunity to include high yield debt or even leveraged bonds (buying four per cent bonds using money borrowed at one per cent), in order to increase the returns.

Five per cent high-interest cash: It is usually a good idea to have a year's worth of cash available, in large part to relieve some of the short-term pressure on the investment portfolio. If you never feel an urgent need to sell investments to raise cash, you are often a more patient and longer-term investor, leaving you much less likely to sell at the wrong time.

With your own PPP, you can enjoy annual income yields in the four to five per cent range, along with some long-term capital gains from the stock part of the portfolio. There would be significantly lower volatility than a stock index like the TSX or the S&P 500, so you could sleep better at night. The final benefit is that depending on your various assets (RRSP, TFSA, taxable accounts) and cash flow needs, this portfolio and the income drawn can be set up in a way that is most tax efficient, not just on an annual basis but over a lifetime. This can often save someone tens of thousands of dollars on tax alone as compared to a traditional pension.

S0, let them have their fancy DB pension plans. We can do better without them.

Illustration by Chloe Cushman/National Post

Ted Rechtshaffen is CEO of TriDelta Financial. He is hosting a Wealth Seminar Series in the Toronto area. If you are interested in attending please visit www.tridelta.ca/pcss

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