# Corporate Finance Matters

Cost management. Workforce management. Risk management.

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# Defined Benefit Plans Outperform Defined Contribution Plans Again — Should We Care?

"After equity markets peaked in 2007, DB plan sponsors started reducing their holdings in equities."

2011 was a good year for defined benefit (DB) plan investment returns. Towers Watson's analysis of more than 2,000 pension plans found that the median investment return for DB plans in 2011 was 2.74%, while the median return for defined contribution (DC) plans was a disappointing –0.22%.

The nearly three-percentage-point difference in performance is the widest margin since 1995, when we began comparing the annual investment returns of the plan types. DB plans have now outperformed DC plans in 13 out of the 17 years analyzed. The 2011 gap is in contrast to the previous five-year period (2007 through 2011), when the investment return gap between DB and DC plans narrowed by nearly 50%, primarily driven by strong DC investment results in 2009.

At a time when many employers are considering shifts in their retirement plan strategy, and evaluating the relative merits and drawbacks of DB, DC and the various hybrid plans, it's important to put these investment return trends in context. What's behind the narrowing spread between DB and DC plans in the recent past? What can we expect in the future? And what are the implications for finance executives tasked with making efficient use of their benefit budgets?

From 1995 to 2011, DB plans outperformed DC plans by an annual average of 76 basis points. This performance gap shrank to only 39 basis points from 2007 to 2011 (see table on next page). Two factors explain most of this shrinkage. One is the stock market boom of 2009, when the Russell 2500 Index increased by 34% and returns from DC plans reached 20.86% — their highest level since 1995. DC plans beat DB plans by 5.4% in 2009.

The other factor is a shift in asset allocation between the two plan types. After equity markets peaked in 2007, DB plan sponsors started reducing their holdings in equities. By 2009, there was a considerable difference in holdings, with DB equity allocations down to approximately 48% and DC equity holdings up to around 62%.

As DB plan sponsors reduced their equity holdings, they turned to more fixed-income and alternative investments. For example, many invested in long-duration bonds as a hedge against mounting liabilities as interest rates steadily declined. This move paid off in 2011, when equity markets experienced losses and long-duration bonds performed strongly, helping to re-widen the performance gap between the plan types.

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## Implications for the Future

DB plans have long been hailed for their ability to deliver benefits efficiently. Also, it's generally less expensive to provide benefits via a DB plan than to provide the same level of benefits via a DC plan. This is due to the effects of better investment results, lower investment fees, longer time horizons and professional management. But for a variety of reasons, there's been steady movement from DB to DC over the last decade. Today, most newly hired American workers count on a DC plan as their primary or only employer-provided retirement benefit.

As the 2011 DB/DC performance gap illustrates, the shift toward DC brings with it significant workforce issues. The lower level of benefits typically offered in such plans, combined with weaker investment returns, means that fewer employees are likely to be prepared for retirement and that we'll see a growing population of the "working retired."

To address this concern, DC plans have been taking on more characteristics of DB plans. For example, some DC plans have options for auto-enrollment and automatic increases in participants' contributions. And some allow participants to opt for professional investment management, with investments in target-date funds.

All of these things can help plan participants improve their investment returns, which will become even more important as more workers without DB plans approach retirement. If no steps are taken to help employees secure an adequate retirement income stream, it will become increasingly difficult for employers to manage the flow of talent and maintain orderly retirement patterns. Such difficulties can have untold impact on any organization's bottom line.

**Asset-weighted median rates of return for DB and DC plans, 1995 – 2011**

| Year | N | DB | DC | Difference |
|---|---|---|---|---|
| 2011 | **2080** | **2.74%** | **–0.22%** | **2.96%** |
| 2010 | **2584** | **12.79%** | **11.81%** | **0.98%** |
| 2009 | **2655** | **15.46%** | **20.86%** | **–5.40%** |
| 2008 | **2464** | **–23.44%** | **–26.12%** | **2.68%** |
| 2007 | **2246** | **7.49%** | **6.77%** | **0.72%** |
| 2006 | **2331** | **13.07%** | **11.89%** | **1.18%** |
| 2005 | **2584** | **7.57%** | **6.69%** | **0.88%** |
| 2004 | **2583** | **10.94%** | **9.78%** | **1.16%** |
| 2003 | **2514** | **21.00%** | **19.63%** | **1.37%** |
| 2002 | **2085** | **–8.88%** | **–10.96%** | **2.08%** |
| 2001 | **2239** | **–4.02%** | **–6.07%** | **2.05%** |
| 2000 | **2058** | **–0.16%** | **–2.76%** | **2.60%** |
| 1999 | **1472** | **13.23%** | **14.41%** | **–1.18%** |
| 1998 | **2958** | **14.22%** | **15.24%** | **–1.02%** |
| 1997 | **2931** | **18.80%** | **19.65%** | **–0.85%** |
| 1996 | **3034** | **14.36%** | **13.91%** | **0.45%** |
| 1995 | **3063** | **20.99%** | **18.72%** | **2.27%** |
| | **Average** | **8.01%** | **7.25%** | **0.76%** |
| | **Average last 10 years** | **5.87%** | **5.01%** | **0.86%** |
| | **Average last 5 years** | **3.01%** | **2.62%** | **0.39%** |

Source: Towers Watson

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## About Towers Watson

Towers Watson is a leading global professional services company that helps organizations improve performance through effective people, risk and financial management. With 14,000 associates around the world, we offer solutions in the areas of benefits, talent management, rewards, and risk and capital management.

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