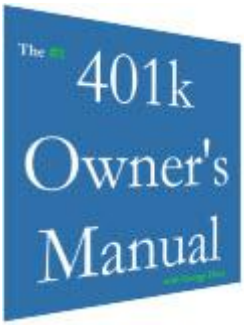

Episode # 6

How You Ended Up With 401k Plans Anyway

The Complete Transcript

Hi this is George Huss. A friend of mine insisted I share a conversation we had around what ever happened to the to the pension plan - the retirement benefit that my father and your father probably had. You know, you work for a company for 30 years, get the gold watch and start collecting a monthly pension until the day you die. Usually like 80% of the salary you were making by the time you retired. What happened to that? Why do we have a 401k now - where you are responsible to put **your** money in AND are responsible for being your own investment expert?

Basically what happened was in your Father's Day, companies contributed some amount of profits every year to a retirement pool to be paid out to employees when they retired. It was called a defined benefit plan, because the benefit was known - well at least

the formula was know - the key elements usually being years of service and an something like the average of your last 5 years salary - the idea being that once you retired you would end up with about 80% of your salary to be paid out over your lifetime. It was a pretty common benefit to attract good talent.

So anyway basically what what you had was the smartest guys in the room - members of an executive committee, maybe a few outside members of the Board of Directors - smart, well educated, A-type personalities, experienced in management, who knew how to delegate and were results driven. The most qualified guys to get the job done. They were responsible for overseeing this pool of money.

In the process, because they were smart enough to know what they didn't know, they hired the best investment professionals to invest the money for the benefit of the employees; and, they hired record keepers to keep track of how much money would be owed to individual employees and former employees already drawing benefits out of the pension plan; and, they hired CPAs to keep an eye on all of it.

Now the CPAs yeah because they're very good at numbers started looking at the amount of money in these pools - in fact they had been looking into the issue of accounting for the cost of pension plans since the mid-to-early 50s and the idea that this liability - the moral and legal obligation to pay current and future retirees - this liability did not appear in the audited financial statements - anywhere.

In this regard, the CPAs mission was to provide the USERS of financial reports consistent information to determine the status of an employer's pension arrangements with employees SO THAT it

could be used to determine the effect on the company's financial position and results of operations.

The point being pension benefits were a cost of doing business - a labor cost - which was not being reflected on the books and records of the company. For USERS of financial statements this information would be useful not only to judge the company on its own; but, to compare it to its competitors.

So the CPAs pressed for the disclosure of the liability at least in the notes to the financial statements. Up until that point, none of this information was previously required. This was all "off balance sheet" stuff at the time. If I remember correctly, that was around the end of 1985 - Look up www.fasb.org Statement no. 87. "fasb" is short for the Financial Accounting Standards Board.

But what was the right number? What was the cost to the company for this off balances sheet labor cost? So they brought in other experts called actuaries, they all sharpened their pencils and made a number of assumptions like the expected return on investment on the assets in the plan and the expected lives of retirees and other assumptions and calculated a present value of the expected future benefits the company was obligated to pay. If the net present value number was greater that what was actually in the plan - they had a new number to disclose - the "unfunded liability."

Remember the idea was the come up with the projected benefit obligation and the net pension cost.

Now when financial statements began to come out with the new employee pension cost numbers the investing public panicked when these unfunded liability numbers came to light. Remember, up until that point, no one was focusing on this because it was

never required in the statements. Again, this was all off balance sheet stuff - other than a line item expense about the contribution of profits to the pension plan. Suddenly, large public companies - literally overnight, were showing multi-million dollar liabilities for the cost of these employee pension plans they had not yet funded.

In turn, stock prices began to fall because the numbers were so massive that no one believed the companies would ever be able to match the unfunded portion without contributing unheard of amounts of company profits going forward - profit that shareholders were looking to for dividends and stock price increases.

Now, I'm sure pressure was brought to bear on the companies to DO SOMETHING; and, I am sure, the investment committee members - particularly the ones who were also employees themselves - became fearful for their jobs. And so the smartest guys in the room realized - hay, we don't HAVE to offer these plans - we are not REQUIRED to offer this benefit - so at the end of the day, they simply decided to terminate the pension plan. They just stopped offering it to employees.

But now they had a recruitment problem because now they didn't have a retirement benefit to offer current and future employees. So, if they were looking to hire talent, and their competitors were offering some kind of retirement benefit and they were not, they were losing the chance to hire good employees. And, to a certain extent, they were also losing existing employees to the competition.

That's where the 401(k) came in. It was something - not nearly as good as the Pension Plan was for employees - but it was something.

Ok, so about 25 years ago the goal of the 401(k) was to make sure companies offering this new retirement plan would **never** again be LIABLE for the benefits to be paid to retirees.

So the first part was to change WHO would PAY for this benefit. No longer would it be just the company providing monies to employees out of profits.

The primary amount of money going into these plans was to come from employees - out of their pay. The incentive to get employees to buy into this idea was the money to come out of your paycheck would be before taxes were applied.

The other the other characteristic of the 401(k) plan was that employees themselves would be responsible for investing these monies for their own future benefit; so again the company would avoid any legal liability for future benefits.

And in order to make sure that that companies would not be liable, companies were forbidden to give investment advice to the employee. So if you ever gone to human resources and asked them to show you what you should invest in... Human resources would politely look at you and tell you that that they can't help you. And, in fact, HR has been instructed they are not to help you with investment choices or even to suggest what they personally think might be the best investment option in the plan - because at the end of the day, companies are trying to avoid even the perception they are giving advice, which, in turn, may make them liable for investment outcomes - which was the point of dumping Pension Plans to begin with.

so, we've basically gone from the smartest guys in the room with the assistance of professional experts not only to do the investment selection and the record-keeping but CPAs to watch

over the entire thing to make sure that everything was being kept straight; and, we've moved to the point where the least financially sophisticated individual, the employee, is responsible for all of it - on their own. To put this in perspective for you, to give you an idea how big this is; as of the 1st quarter of 2012, the total amount of money in US 401k plans was estimated at 3.4 TRILLION dollars.

Let's be honest here -If your education and experience is in engineering or sales or management or sigma 6 or human resources or customer service or social work or education or construction or marketing; what makes you an expert in investments? Remember this is YOUR retirement we're talking about here - and the line HAS been drawn in the sand - the only one responsible for it is YOU.

So what's the point? Why bother with this discussion? It's not to judge whether the 401k is right or wrong or good or bad or to blame anyone for where we are. The point is to let you know how we got here and the truth around ANY company's attitude around your retirement - regardless of what they may SAY and how sincere they are about your future welfare - their ACTIONS can only lead to one truth - you and you alone are responsible for your retirement.

It is what it is. And, being aware of the truth - you now have choices. I remember hearing long ago that the first step to escaping a prison is becoming aware that you ARE in prison.

What companies have NOT said and what Wall Street would rather you not know is - there is nothing to prevent you from getting whatever help you need from any source you choose, to guide you

to your retirement goals. That help may be education so you can DIY or it may be guidance or advice from an expert to do it for you or something in between. Again, you're responsible.

I'll leave you with this thought - what I have learned over the past 30 years - the investment arena has many ways to extract money from you if you are not very educated about the process. The market does not care if you win or lose - it does not care about genuine desires or good intentions - the investment markets, for as long as there have been investment markets, have changed and will continue to change - and if you are unable or unwilling to adapt and change - if you are thinking that investing for your retirement is an event - picking something from your 401k plan and forgetting about it for 20 or 30 years - the market will be very happy to take your money.

Hope this helps. In the next episode, we will talk about Asset Allocation Strategies and Modern Portfolio Theory assumptions in your 401k plan.

Check out the last episode (Special Episode # 1) if you want to know how to participate in this podcast - to literally have a voice using your iPhone - to ask real questions and get straight answers about your 401k to be aired on a future podcast. I'm really excited to hear your voice - and answer your 401k questions.

If it's easier, leave a comment on iTunes - or visit our Facebook Fan page to get transcripts of this show - Like us or leave a comment while you are there.

Until next time - this is your host, George Huss and this has been another episode of - The 401k Owner's Manual.