Public Employee Deferred Compensation

ILLINOIS PUBLIC PENSION FUND ASSOCIATION
PUBLIC SAFETY FINANCIAL AND INVESTMENT TRAINING
(*IPPFA PS-FIT*)

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Chapter 1:
Deferred Compensation—Introduction and Participation

WHAT IS DEFERRED COMPENSATION?

When a person receives wages (*i.e.,* compensation), income taxes are withheld and the total earned is reported to the IRS at the end of the year.

However, sections of the Internal Revenue Code and Illinois law allow an employee to *defer* receipt of some wages until after he or she retires. At the time these deferred wages are earned, they are neither received in the paycheck, subjected to tax withholding, nor reported as taxable to the IRS. They are instead deposited into an account and invested as directed by the employee. When the accumulated money is ultimately received after retirement, the withdrawal payments are then reported to the IRS as taxable distributions. This deferral of wages and taxes until after retirement is commonly referred to as deferred compensation or "deferred comp."

For most public employees, deferred compensation under IRC code Section 457 is the strongest part of the "personal savings" leg of the three-legged retirement income stool (pension, Social Security, and personal savings). Your personal savings can of course include the value of your home, brokerage

accounts, individual retirement accounts, investment real estate, and bank savings. But the ability to save through the paycheck on a tax-advantaged basis has made deferred compensation a large personal asset for most public employees.

SECTION OUTLINE

In this section we'll first take a look at some background information on Section 457 plans. Then, we'll "follow the money." We cover how money is put into the plan, how it is invested along the way, and how it is withdrawn to meet your goal of a secure retirement. In the middle part I stop short of making that chapter an investment guide. There is really nothing unique about 457 investing when compared to other supplemental plans where the employee self-directs the account. But we'll still go over the basics. Then the section ends with hopefully good tips for you on how to proceed, along with some final enthusiasm for these excellent plans.

LEGAL STANDING

Deferred compensation systems have evolved under legislation and IRS rulings specifically in relation to the employer of each worker. Each plan is designated by the section of the Internal Revenue Code that authorizes and governs the deferral. Section 401(k) plans, the most prominent type of deferred compensation, grew out of profit sharing plans and have been primarily used by private sector employees in for-profit companies. Section 403(b) has been the primary plan for employees of education, scientific, and charitable organizations. These plans are found in many not-for-profit hospitals, and both public and private schools. Finally, **Section 457(b)** plans are available to employees of state and local government and, in a modified form, to some management and professional employees of not-for-profit agencies. We'll concentrate on the government form.

HISTORY OF 457 PLANS

Prior to 1978, various organizations, including the International City Management Association (ICMA), obtained "private letter rulings" from the IRS allowing employees to defer compensation. An actual code section authorizing deferrals was subsequently included in the *Revenue Act of 1978* as a new Section 457(b) of the code. There have been some revisions since then, the notable being the improvements in the 1996, 2000, and 2002 reform laws. Most importantly, the **1996 reform law** established that funds held in a 457 plan are trust funds and are not available to the municipalities' general creditors. This change, long overdue, followed the bankruptcy of Orange County (California) after an investment scandal. Observe that when judges' money was at risk, things happened quickly!

Changes in 2000 and 2002 went a long way in making the 457 plan look just like its private sector cohorts under 401(k) and 403(b). The allowable contribution amounts were made to be very similar between the plans. The withdrawal rules and the opportunity for rollover from one plan to the other or to an Individual Retirement Account (IRA) were made similar. Prior to these reforms, it was very important for public sector employees to be given special instruction on 457 plan deferred compensation

(the withdrawal rules were particularly complicated). That need has lessened now—public employees can obtain general information from the financial industry or media on deferred compensation and then check with their plan administrator for specific 457 plan rules.

WHO ARE THE PLAN ADMINISTRATORS?

The plan administrators frequently used by municipalities in Illinois are IPPFA Benefits, Nationwide Retirement Systems (NRS—formerly PEBSCO), the ICMA-RC (generally called simply ICMA, although it is a separate retirement corporation). Many other investment firms provide Section 457 plans, such as T. Rowe Price, Prudential, VALIC, and others.

The Illinois Public Pension Fund Association (IPPFA) has established a Section 457 plan through the IPPFA Benefits division and Transamerica. Their approach concentrates on low fees and employee education.

HOW DOES TAX DEFERRAL IMPROVE RETIREMENT SAVINGS?

All deferred compensation plans work essentially the same way in terms of the taxation effect. First, an employee elects to defer compensation at a set amount or a percent of pay. When he or she is paid each payday, the deferred compensation amount is deducted from the paycheck and deposited into a special account. Taxes withheld from the paycheck are calculated on the basis that the amount deferred was taken from the paycheck "before taxes." So the paycheck does not go down as much as the total amount put into the deferred compensation account. Then, at the end of the year, the amount deferred is not reported to the IRS or state as a taxable wage. An example follows.

A Tale of Two Savers

To see how deferring compensation compares to savings through taxable channels, let's look at two savers, Tim and Suzanne. They both earn $4,000 monthly and can afford to put away $300 per month for retirement savings. Tim opens a brokerage account for his investments and has his employer sends the $300 to his account via the ACH automated banking system. Suzanne joins her public employer's deferred compensation plan. Here's how their monthly gross and take-home pay are affected (excluding Social Security or pension contributions which are unchanged by either approach).

	Tim	Suzanne
Salary	$4,000	$4,000
Deferred Compensation	0	(428)
Taxable Wages	$4,000	$3,572
Federal Fax	540	427
State Tax	200	185
Brokerage-Account Deposit	300	0
Net Pay	$2,960	$2,960

Tim and Suzanne both have the same monthly net pay but Suzanne saves $428 monthly while Tim puts away only $300. This happens because Suzanne's tax deferral advantage on the $428 deposit reduces her net pay by only the $300 that she can afford. Of course, Tim is free and clear on the taxes for the principle amount he has saved; Suzanne eventually does pay the tax on her $428. But let's see how that works out.

Suppose Tim earns 7.5% annually on his savings and pays 23.1% in tax on his earnings each year. If he keeps up his savings/investment/tax program for 30 years, he'll have $281,200 in his account at retirement. If Suzanne earns the same 7.5% return over 30 years, her balance will accumulate to $551,000. She still owes tax on that amount, but she has almost twice the amount that Tim has. Tax rates are simply not high enough to take away the advantages she has already gained.

Also, there are other factors in her favor. First, if she lives in a state that doesn't tax 457 withdrawals, such as Illinois, she will avoid the state tax completely. Moreover, if she draws her money out gradually (while still experiencing investment earnings), she will continue to enjoy the benefit of tax deferral while drawing money out at levels that do not trigger excessive taxes. And in retirement her tax rate may well be lower than the rate when she made her deposits.

Personal financial experts are virtually unanimous in their advice that deferred compensation is an excellent way to save. Even changes in the tax code, which reduced taxes for people who own stocks and mutual funds outside of deferred compensation, have not diminished the attractiveness of these plans.

WARNING: If an employee routinely pays a large amount of money to the IRS at year-end, enrolling in or increasing deferrals in a Section 457 plan may not eliminate a large tax payment on April 15th, although it will reduce it somewhat. The employee may still need to adjust his tax withholding by completing a revised declaration of exemptions (W-4), which is available from the payroll office.

WHAT ABOUT THE ROTH APPROACH?

There is a senator from Delaware named Roth who in 1997 gets Congress to establish the Roth IRA. In time, that morphs over into a Roth 401(k) and eventually a Roth 457 option. Your employer may or may not offer a Roth 457 plan or option.

The overwhelming majority of public employees save for retirement using a traditional tax-deferred 457 plan as opposed to a Roth. Because of that, I've concentrated this section of the book on the method that most of us have used (including me). Also, the pros and cons of the Roth approach are the same for you as for your IRA or 401(k) saving friends and relatives. So you can get good information from most sources that provide such advice. In keeping with the approach of this book, I don't spend a lot of time on issues that affect you the same as every other saver or pensioner.

But, in case this Roth thing is new to you, I'll provide just a short explanation. In a Roth 457 plan, there is no tax savings or other advantage at the time the employee makes his or her payroll deduction

deposit. So if Suzanne in my example put $428 monthly into a Roth 457 plan, her pay would go down $428, not the $300 shown in the table. However, the money earned by Roth deposits is not taxed at the time of withdrawal. The earnings in a Roth account are not simply tax-deferred, they are *tax-exempt*—a much better tax treatment.

To summarize, the Roth has no tax break at the time of the deposit but all of the earnings are tax-exempt. The traditional 457 approach gives the saver a tax break going in, essentially creating more money to be saved, but those tax-deferred deposits and all earning are eventually taxed.

RULES FOR DEFERRING INCOME

Back to the traditional 457 plan, a maximum of $18,500 may be deferred in 2018, which will be indexed to inflation in the future. There is no statutory minimum amount of deferral. Some administrators or employers may set a minimum, say $10 or 1% of pay. Your employer's payroll system may support either a flat deferral or a percentage of wages or both. An advantage to deferring based on a percentage is that if you work overtime or get a pay raise or promotion, some of that increased salary is deferred automatically without any action on your part.

There is a provision of Section 457 that allows an employee to exceed the annual maximum, up to double the amount of the annual maximum, in the last three years prior to being eligible to receive a pension from the employer-sponsored retirement plan. The additional amount deferred is limited to amounts that the employee could have legally deferred in the past but did not. For example, if the employee could have deferred $7,500 in each year of his first ten years of employment ($75,000) but only deferred $45,000 during those years, he or she has $30,000 left that can be deferred in the last three years prior to eligibility for receipt of pension (in addition to the regular maximum).

This extra allowance is nicknamed **"the Catch-up Provision,"** since the employee is catching-up on deferrals that could have been made earlier in his career.

The 2000 reform law added an additional savings opportunity, the so-called "Age 50 Catch-up Provision." This provision allowed a person over age 50 to contribute an additional $1,000 in 2002, incrementally increasing to $6,000 in 2017/18. This additional amount cannot be contributed in a year when the standard catch-up provision is being used. But, this Age 50 allowance is not dependent upon the existence of "unused deferrals" in prior years. It is simply additional authority to defer salary.

THE RULE OF 72

Catch-up provisions are okay, but I am not a big fan. It's much better to put a little more money into deferred compensation during your career than a lot of money at the end. Let's explore that idea further and learn an important investment concept along the way.

The variables that affect how much you accumulate in deferred compensation are the amount you put in, your investment return, and how long the money stays on deposit. My favorite, and obviously that of author Tobias, is the time factor. The longer the amount of time your money is on deposit, the more generally fantastic things happen to it.

There is a mathematical **Rule of 72.** An investor can take his or her expected rate of investment earnings and divide it into 72. The product of that division is the length of time in years that it will take the invested money to double. So at an easy-to-use estimate of 7.2% annual investment return, money doubles every ten years (72 divided by 7.2% = 10 years). If $3,000 is invested, it will become $6,000 in ten years, $12,000 in twenty years and $24,000 in thirty years. If the rate of earnings is higher, say at 8%, money will then double every nine years, not ten. At thirty years the same deposits will have grown to not $24,000 but $30,000.

Total earnings and control of investment costs is so very important. But the Rule of 72 also amplifies the importance of time. If I made that same $3,000 investment three years earlier and had it on deposit for thirty-three years, the same one-time deposit of $3,000 at 8% will grow to $38,000—26% more than the same dollars invested for thirty years.

Remember Suzanne's accumulated $551,000. Say she increases her savings in the last three years by a total of $30,000 by "catching up" $10,000 each year. If she does this, her end-of-thirty-year total grows to $584,000. If she instead found a way to put in the additional $30,000 by saving $1,000 more in each of the thirty years of her participation, the balance at the end is $658,000. I'm not kidding.

Time is your friend. Save as much as you reasonably can as early as you can.

BUT YOU MAY WANT TO CATCH-UP TO SAVE STATE TAXES

Although I don't like the Catch-up Provisions for long term gain there is a short-term advantage: money withdrawn from Section 457 plans in Illinois is not subject to state taxes. A participant can save 3.75% on his or her money going in to the plan (since it's not subject to state withholding or reporting) but state taxes are not assessed on the money when it is withdrawn. Thus state taxes are not really deferred, they are eliminated completely. This is true on all of your deferred compensation deposits and earnings.

Chapter 2:
Deferred Compensation— Investment Overview

THIS IS AN AREA IN which you are not different.

Any book, article or advice from an expert (or a brother-in-law!) that educates you about asset allocation for retirement savings works for Section 457 plans. Like the 401(k) plan, most Section 457 administrators offer a variety of investments in the form of either public mutual funds or commingled investment accounts managed by investment experts. A participant is able to select from fixed or guaranteed rate investment accounts, various stock accounts, government and/or corporate bond accounts, a money-market account, or blended or balanced accounts that offer a combination of stocks, bonds, and short-term investment instruments. Your investment is held in trust and can only be used for your benefit under the rules of the plan and the Internal Revenue Code.

Since you can get advice or information anywhere and your investment goals and selections are not any different than your neighbor with a 401(k) plan, this book is not an investment guide. But I'll go over the basics, plus you may well have a certain amount of financial acumen anyway. You can then decide how much more research or assistance you need, if any, on this aspect of your personal savings and retirement plan.

WHO BELONGS IN WHAT INVESTMENT?

Professional investors break down the types of investments into broad asset classes—stocks, bonds, real estate, commodities, *etc*. How those are mixed together in a portfolio is called **asset allocation**. How does one select an asset allocation that is right for his or her long-term goals? You need to spend some time on this, as the experts say that asset allocation decision is far more important than which individual investments or funds that you select.

The American economic system rewards ownership. It is more advantageous to own a company than to lend the company (or a government) money, although lending certainly has its place in the economy and as an investment. When you invest in a stock mutual fund or other type of stock account, you are taking partial ownership of the many companies in the account. So it is not a surprise that, by all historic measurements, stock market investments outperform other asset classes. Accordingly, the percent of your asset allocation that you have in the stock market will be a key consideration.

The reality of investment returns supports the philosophical view of the benefits of ownership. Here are the various domestic (US) market returns from January 1, 1926, (before the great depression) to December 31, 2014:

ASSET CLASS	ANNUAL RETURN
Small Company Stocks	12.2%
Large Company Stocks	10.1%
Long Corporate Bonds	6.1%
Long Government Bonds	5.7%
Medium Term Government Bonds	5.3%
30-Day US Treasury Bills	3.5%

Sources: *Janus via skloff.com for small company stocks, all others from JVL Associates via jvlassociates.com.*

Of course, such returns and those in the future come with great volatility. Just look at what we've experienced over the past two decades: fantastic highs, big drops, periods of steady returns, a huge drop, and then a big recovery. But if you are a long-term investor, the long-term returns in stocks beat the safer bets, as long as you take some effort to manage the volatility.

100% MINUS YOUR AGE

To help you decide how much of your retirement savings should be in the higher-yield but more volatile investments, some personal financial experts suggest a basic formula known as **100% minus your age**. If you follow this formula, the percentage of your retirement assets that you will have in equities (*i.e.,* the stock market) will be equal to 100% minus your age. For example, if a person is 45 years old and subtracts his age from 100%, the difference of 55 (*i.e.* 55%) represents a suggested level for him to invest in stocks. If he was deferring $100 per paycheck, $55 would go to stocks and the balance would go to the bond or fixed accounts.

Some other experts think that even this level is too conservative to protect against future inflation and possible longer lives. These professionals recommend a formula of "110% minus your age."

Using either formula, or a similar approach, a saver ends up investing more aggressively when he or she is younger. At age 22, "100% minus your age" puts 78% of money in stocks. Continuing, the formula reduces stock holdings as a person ages and ultimately approaches retirement. At age 60, only 40% of the money will be in stocks. This is what you most likely want to happen, because the amount of the portfolio that is in a volatile investment is reduced as retirement approaches. But you still maintain some opportunity for growth to beat inflation or a hopefully long life. Under his approach, even an octogenarian has 20% of her retirement account in the stock market.

WHY NOT 100% IN STOCKS?

If stocks always beat everything else, why not put 100% in stocks? You may want to. But, remember that we can go through prolonged periods of stock market downturns. We have seen that in the past years, so never be fooled by a long bull market like the 1980s–1990s, the steady rise after the dot-com crash of 2001–2002 or the rebound since the Great Recession.

Here is another math lesson. If I have a $1,000 stock investment that drops 25%, what do I have left? The answer is $750. This isn't too hard to figure out. But here is an important follow up question. What investment return do I then need to get my $750 back to $1,000 before I can grow my investment even by one penny? The answer is *33.3%*, not the 25% I originally lost. Volatility is not just your investment going up and down—*volatility can hurt your returns*. That's why a 100% allocation to stock is risky.

Also, when the market is down for a prolonged period, your fixed income investments will help you keep your balances up *and* reinforce your confidence in deferred compensation. Further, placing a small portion of a portfolio in another asset class, even one that does not perform as well as your core investments, can result in less volatility and higher earnings if the account is rebalanced from time to time (more on that to follow).

Both of these factors are where the phase **diversification** comes in; I'm sure you've heard that before. A variety of asset classes in your diversified portfolio keeps you almost whole when one asset class underperforms. You also have the opportunity to rebalance between the asset classes to your long-term benefit. Keep reading.

REBALANCING

Very importantly, an allocation to both stocks and fixed income which you regularly rebalance will give you the opportunity to actually "buy low, sell high" for a long term overall gain.

Let's say firefighter Casey is an avid deferred compensation investor and currently deposits her money each payday along a 60/40 stock/fixed mix, with some of the stock piece in small companies and foreign stocks, and some of the fixed income piece to the plan's stable value fund. Over time, thanks to the pretty good performance in all aspects of her stock allocation, her account balance looks like this:

Small Company Stocks	$16,000	13%
Foreign Stocks	$8,000	6%
S&P 500 Index Fund	$59,000	46%
Bond Fund	$34,000	26%
Stable Value Fund	$11,000	9%
	$128,000	100%

Casey's stock allocation is now 65% of her portfolio even though her deposits went in at 60%. Good for her! She has been rewarded for her allocation to stocks. But she truly likes that 60/40 mix as part of her long-term goals and volatility management, so she rebalances the portfolio to look like this:

Small Company Stocks	$12,800	10%
Foreign Stocks	$6,400	5%
S&P 500 Index Fund	$57,600	45%
Bond Fund	$38,400	30%
Stable Value Fund	$12,800	10%
	$128,000	100%

She has been disciplined at rebalancing, and transferred 5% of her money out of stocks and into bonds or fixed income investments, bringing her balance to the target 60/40 mix (as well as to her specific desired allocations within all stock and fixed income asset classes). Now, if the stock market or a specific portion of it drops, she has already captured some gains by transferring money out of stocks to bonds when stock values were higher.

Likewise, if the stock market has a bad year, she will rebalance bond money over to the stock side of her portfolio at the time that stocks are "cheap." Then when stocks recover, she will have more invested in stocks at the beginning of the rally.

A study published in *Forbes* in 2011 examined two hypothetical investors who each put $10,000 into a 60/40 mix of stocks and bonds in 1985. One never rebalanced the portfolio, the other rebalanced annually. For the entire 25-year period from 1985 to 2010, the portfolio of the guy who rebalanced grew to $97,000, beating the other investor at $89,000. Of course there were times when the rebalancing didn't work, such as a prolonged bull market in stocks. But the theory and the practice over the decades supported the concept of rebalancing a portfolio.

There are "balanced" funds in some 457 plans that automatically rebalance to their targets. And some plans have a feature where you can mark your account to rebalance itself at some interval. Or

you can keep your eyes on your account and rebalance on a set schedule or just make a judgment call when you get a little or a lot off target. This last approach is what I do (which doesn't mean it's a good idea for you).

I'll close this sub-section with an anecdote from the Skokie Police Pension Fund. In February of 2009 we rebalanced our portfolio back to our then 45% target in stocks after taking a beating in the market but holding firm on our investment philosophy and policy. We rebalanced just in time to catch the great stock market rebound that began in March 2009.

ASSET ALLOCATION AND REBALANCING MADE EASY

A generation ago an investment adviser could conduct a two-day seminar on the whys and hows of proper asset allocation, diversification, and rebalancing. Then the major mutual fund companies came along with a new product that executes these strategies automatically—the "target date" fund (or something with a similar name—DIA calls theirs *Strategic Allocation Funds*). In such an investment, the investor picks an approximate date for retirement, say 2040, then invests in a fund with that 2040 retirement goal in mind. That investment fund in 2015 is fairly aggressive in terms of its allocation to equities (stocks), including higher risk small companies and foreign stocks. But as 2040 approaches, the manager switches gradually to a more conservative portfolio. And, along the way, the account is regularly rebalanced.

As long as the fees charged are reasonable (always watch fees), this is a great way to save. When my daughter started her first career job and 401(k) plan, she went right to the Vanguard Target Retirement 2045 Fund.

A WORD ABOUT PASSIVE INVESTING

If you don't choose a target date fund but prefer to select your own investments, a well-regarded piece of advice is to invest some or a good portion of your savings in an index fund. Let's examine the concept of an "index" and then explore the concept and advantages of an index fund.

An **index** is a hypothetical portfolio of investments that a knowledgeable group of people believe properly reflects the performance of an entire asset class. We hear about indexes all the time. When the TV news reports that the stock market went up 40 points, what does that mean? It means that a stock index, usually 30 companies monitored by the Dow Jones Company, went up 40 points. A broader index from Standard & Poor's tracks 500 large-company stocks; it is called the S&P 500 Index. When the stock market is measured over the years and decades, most observers are talking about the S&P 500. And there is an index for almost every asset class.

In 1976, the first "index fund" was launched, in which investor money was simply placed in each of the 500 S&P stocks. The fund did not have stock analysts researching whether any one stock, say IBM, was good deal. IBM was in the index so it was in the investment fund. Continuing, the index fund manager didn't consult economists to predict the ups and downs of the energy crisis. If 17% of the S&P 500 index companies were energy-related, then 17% of the index fund was in energy.

This is sometimes called passive investing. That phrase is used to differentiate the investment approach from an "active" manager who studies interest rates, company credit ratings, economic growth, and a zillion other factors before making an investment. The "passive" manager just sits back passively and selects securities that are in the underlying index.

That was in 1976. Today, there are over $2.5 trillion in assets in index funds of all types: S&P 500, Wilshire 3000 small company index, Barclay's aggregate bond index, and many, many others.

Why do this? For two reasons: First, it's cheap. The fees charged against your investment balance in an index fund are the lowest available (your returns in public employee deferred compensation are always "net" of the fees paid to the investment manager). Since the index manager doesn't have to hire analysts and economists for the fund, those savings are passed on to the investor. Secondly, these index funds, over time, produce returns comparable to or exceeding the more expensive "active" management approach.

But you may do better using active managers. Just keep the index concept in mind and do your own research into index or passive investing if the matter interests you.

HOW SAFE IS SECTION 457 INVESTING?

Risk of loss of principle is always present unless you are directly buying US government bonds or making FDIC insured bank deposits. Everything else includes some risk, such as a company going out of business or a foreign government defaulting on its debt. Only you can do both the research and the self-analysis to decide how much risk you are willing to take. The good news is that the various types of investment risk—credit, market, interest rates, foreign currency, whatever—are unchanged inside the Section 457 umbrella. Investing in the Fidelity Equity-Income Fund directly or through your 457 plan is no different, risk or otherwise.

How about out and out theft? Remember Bernie Madoff. He took investors' money, did not buy the securities or options that he promised, and then created phony statements to indicate that he had made proper investments. Meanwhile he was living the good life on his investors' cash. Could that happen in a major 457 administrator's operation or in the underlying mutual funds or accounts? Never say never, but I just don't see it. All of these operations have the proper trust account and custodian players in place (a custodian is a bank that holds the investments—the investment manager does not have access to the actual securities). If you have any doubts, talk to your plan representative.

Could a 457 plan choose an insurance company for a guaranteed investment contract (GIC) and have that company go bankrupt? Yes, it could, but there is a higher chance that this would happen if you did it yourself. And those GIC monies are usually protected by state guarantee funds.

I have a lot of confidence that the assets are safe. I know of no money that has been lost in modern day 457 savings other than from routine and expected investment volatility. Way back when there were some insurance company contracts that did not pay every penny on a dollar, but that was before the large specialized administrators came into the game.

Before I rolled it over to an IRA (more on that later), my 457 money was my biggest asset, even bigger than the value of my home. And I never had any trouble sleeping with that much money in a 457 plan.

CLOSING THOUGHTS ON INVESTING

Deferred compensation plans give a public employee the opportunity to build a diversified portfolio with an amazingly small starting investment. For example, a new participant in a deferred compensation might have his or her first $20 deposit put one-fourth each into an S&P 500 index fund, a small company stock fund, an international stock fund, and a government bond fund. Is this really possible with just $20: a $5 investment into foreign stocks and the rest into a diversified stock and bond portfolio? Yes it is possible—in employer-sponsored deferred compensation.

Allocation of retirement investment among asset classes is your most important decision after the decision to save, and before the decision of which specific mutual funds to pick. If you are unsure of how to invest your money, do some research or seek investment advice from a professional. Investing in a 457 plan is similar to investing in a 401(k) plan, so investment advisers, good ones, should be able to help you.

A personal recommendation is either of two excellent books by William Bernstein: *The Intelligent Asset Allocator* and *The Four Pillars of Investing: Lessons for Building a Winning Portfolio*. Dr. Bernstein is a neurologist who at some point began to fancy himself to be an investment expert. Turned out he was right. You can use the excellent information in either of these books to assist you in your deferred compensation investment plan.

One way that a 401(k) plan and a 457 plan are dissimilar is that the 401(k) private sector employee may receive an employer match. The unfortunate trade-off usually is that the private sector worker probably does not have a defined benefit pension like you do. But since you do have a DB plan, here's something to consider: your fixed pension acts in many ways like a bond investment. If I consider that when I decide on an asset allocation in deferred compensation, I'll put considerably more in the domestic and foreign stock markets. The fact that my defined benefit pension plan pays out a guaranteed fixed amount each month allows me to be more aggressive in the stock market with personal savings. There is some merit to this thinking, but I'll leave that call to you.

Timing the market doesn't work. If you think you can *consistently* move out of stocks at the top and go back in at the bottom of the market, get out of public safety and make yourself a billionaire.

Chapter 3:
Turning 457 Money into Retirement Income

SECTION 457 MONEY IS DEFERRED for retirement purposes. You do not have access to the funds until you either separate from employment (quit or retire) or have an unforeseeable financial emergency. The rules regarding withdrawal for an unforeseeable emergency are very strict. The emergency must be

something for which a reasonable person would not budget and cannot be dealt with using savings outside of the Section 457 plan. Imminent foreclosure, eviction, uninsured medical or funeral expenses or an uninsured casualty loss are examples. *This is a high barrier to access*. Don't plan on being able to get the money until you leave the job. Deferred compensation is a supplemental retirement plan; consider it as such.

BEFORE YOU NEED THE MONEY, STAY WHERE YOU ARE OR USE THE IRA ROLLOVER OPTION

At the time you retire, you may not need any of the proceeds of your Section 457 account. If you leave the money in place, your balance continues to grow on a tax-deferred basis. If you don't want to begin drawing the money at retirement, the only decision to be made is whether or not you want to leave your balance with your employer's deferred compensation plan or roll it over into an existing or new Individual Retirement Account (IRA).

There is a case for leaving the money where it is if you are satisfied with the employer-sponsored plan: the investment options that are offered, low fees, the customer service provided by the administrator, the continued oversight by your employer and union, and the opportunity to discuss the plan with your active and retired coworkers.

There is a case for rolling the money into an IRA if you are not totally satisfied with your employer's plan, you wish to invest in a wide array of options through an IRA (individual stocks or bonds, other mutual funds, FDIC insured bank deposits, etc.) and/or you'd like to consolidate your investments with another company or advisor. There is an additional case for rolling the money over to an IRA if you wish to use a truly self-directed IRA for things like real estate investing. To do this you need a knowledgeable trustee who does this for others.

A word of caution is in order regarding the 10% penalty that is paid when money is withdrawn from an IRA before age 59 1/2. Your municipal or state 457 plan does not have a 10% penalty for withdrawal before age 59 1/2. **Whenever you take out Section 457 money you pay only the tax.** But IRAs and a new employer's 401(k) plan *do* have such a penalty. If you roll Section 457 money into a plan that has such a rule, your 457 money will be subject to a 10% penalty if withdrawn before age 59 1/2. For this reason, it might be better to leave your balance with the deferred compensation plan administrator until you are ready to begin distributions or at least until after age 59 1/2.

There is a lot of good information available from general sources to help you make the rollover/don't-rollover decision. When I left the Village of Skokie, I eventually did roll my money over to an IRA. I wanted both to consolidate some accounts and use the services of a particular investment manager (Invesco of Des Plaines) whose fees were lower than mutual fund fees. I executed the rollover at age 55. By then I knew I would not want any of the money before the potential penalty age of 59 1/2.

Rolling your money over into an IRA and then converting the IRA to a Roth IRA is a related strategy; again beyond the scope of this book. But there is considerable information and advice available on this subject. I didn't do a Roth conversion, but my decision is not definitive for others at all.

WHEN YOU NEED THE MONEY

Prior to age 70 1/2, most Section 457 plan administrators and IRA custodians allow considerable flexibility on withdrawal of the funds. As retirement approaches, you should be in contact with your administrator to go over your options. Taking all of your money out at once is certainly allowed. This is the so-called “lump sum option,” but you’ll possibly skyrocket into a high tax bracket if you do this. Not a good idea.

You may want to choose a series of systematic withdrawals paid on a set schedule (month, quarter, year). While the money is being paid out, your balance stays invested as you have directed. Your administrator might also offer the opportunity for you to start receiving one monthly amount but then receive an increasing amount each year in the future.

Or you may choose some other schedule. When that time comes, check out your options. Again, your balance always stays invested as you directed while you are drawing out the money.

REQUIRED MINIMUM DISTRIBUTIONS

However, beginning approximately at age 70 1/2, if you are no longer working for the 457 sponsor, you must begin withdrawals that meet or exceed so-called Required Minimum Distributions (RMD). Essentially the RMD is an annual amount calculated with the intent that most of the account balance will be withdrawn during the remaining life of the participant. The plan administrator can advise you of how the RMD schedule will work and may have an on-line RMD Calculator to assist you in your planning. You can also look directly at the approved IRS schedule at irs.gov or simply Google “RMD table.”

But let me give you a quick example. At the date of publication of this book, an age 71 retiree with a $200,000 account balance must withdraw at least $7,600 that year. At age 81, an account balance of $200,000 would trigger a minimum withdrawal of $11,200.

If you do not live long enough to draw out a large part of your balance, there is no penalty associated with this. The IRS rules only apply to the minimum withdrawal payments after age 70 1/2. Any balance left when you die passes to your heirs and the tax liability is transferred to the next owner. Your beneficiary pays the tax when the money is withdrawn.

There is a lot written about how much a retiree can safely draw out of a defined contribution retirement plan and not run out of money during his or her life. Since public employee deferred compensation plans are supplemental to a pension (in the case of Illinois, an inflation-adjusted pension), the rate of withdrawal is not critical as it is for a person in a 401(k)-only retirement environment. Again, there is a lot written on this subject and it is easily available. If you absolutely never, *ever* want to run out of deferred compensation payments during your life, keep reading.

THE ANNUITY OPTION

I hope the discussion that follows is not too contradictory; we are going to spend a little time on a withdrawal option in which you probably have no interest. It is the annuity option. But spending some time on it has merit. It’s an option that exists, so you should know as much as you can. Also, you will

hear about annuities in everything from news articles to advertisements to investment pitches. Finally, learning a little about this subject will expand your understanding of the nature of taking retirement income from a personal account, even if you end up not being interested in annuities.

Before or after age 70 1/2, there is the opportunity to purchase an **annuity** to pay you (or you and your spouse) a monthly amount for life. Under this option, your balance does *not* stay invested as you direct. The annuity company takes all the money (*all the money!)* in exchange for the promise to pay the annuity each month as long as you live. If you live a short time, they win. If you live until 102*, you* win. There are also some variations where you can guarantee that a minimum number of payments will be made to your survivors even if you don't live a long time. Examples of specific types of payments follow later.

When you buy an annuity, you are really transferring investment risk and mortality risk (how long you are going to live) to an insurance company. Some people may want to do this. If a person was self-employed and sold a business in retirement for $3 million, he or she might reasonably consider using some of that money to buy an annuity. Since that retiree does not have a pension, the annuity that is purchased acts in many ways just like a pension.

But not many public safety retirees choose annuities to withdraw money from their deferred compensation plan. They already have a guaranteed income for life (the fire or police pension) with some level of inflation protection. They likely also have a Social Security benefit coming, even if they were not covered under that federal system while working at the police or fire department. So it's reasonably safe for a police or fire pensioner to accept the investment and mortality risk of their deferred compensation account as opposed to transferring that risk to an insurance company (and incurring the insurance contract's attendant fees and profits).

Your plan administrator can provide you with estimates of how much monthly income an annuity will pay to a retiree or a joint retiree/spouse payment. A quick public source is the website www.immediateannuities.com. At the date this section of the book was written, that website estimated that 60-year-old police captain John and his wife, 58-year-old Kate, would receive the following monthly payment annuity options for a $200,000 deferred compensation balance:

For John's life	$1,024/month
For John's life, 20 years guaranteed	$896
For John or Kate's life	$874
For John or Kate's life with 20 years guaranteed	$868

Just like any other product purchased from an insurance company, the more protection you want the more you pay in premium (or in this case, the more you give up in monthly income). John can get $1,024 per month for life. If he gets hit by a bus the next year, his entire balance is gone—he forfeited it when he elected an annuity. But if he lives to 102, he'll draw more than $500,000 from his account. If he selects the 20-year guarantee and draws $896 per month, then dies at age 68, the monthly payment of $896 continues to his beneficiary for another 12 years. If he selects the $874 option, he gets that each month and the payments continue to Kate after he dies for as long as she lives. But, if Kate dies before him, the "insurance" was wasted.

Even if you will not be interested in an annuity, the tools at www.immediateannuities.com might be helpful because it will give you a good idea as to how much money you can withdraw from your Section 457 balance during your lifetime, and your spouse's lifetime. For example, John and Kate above could decide to keep their money invested in the police department's Section 457 plan and take a monthly check of $874. This amount will surpass the minimum requirement when John reaches age 70 1/2 and is an amount that the experts (the annuity company) say should last during their joint life expectancies. But at the same time, they haven't given up any rights to an annuity company or incurred annuity costs. Should they both die younger than expected, there will be a balance in their account that can be left to their eight children.

I think that use of an annuity quote to help a person gauge his or her own withdrawals from deferred compensation is a great financial planning tool.

Chapter 4:
Deferred Compensation Summary

THOUGHTS THAT DIDN'T FIT ANYWHERE ELSE

Section 457 plans are very popular where they have been introduced. And, these plans were popular under the *old* rules, which restricted your withdrawal options and treated your account balance as the property of your employer. With the 1996 and 2000 reforms, interest in 457 plan participation grew. The tax break on contributions, access to the broad investment markets for a small deposit and the convenience of payroll deduction make these plans an excellent "third leg" of the retirement stool.

When I personally predict how much money I will have in my deferred compensation account at some time in the future, say age 70 1/2, I assume that my earnings would be in the 4% range. I use this low number to mitigate the effects of future inflation. Economists call this concept the "real" rate of return, *i.e.,* the rate of return over inflation. If you use this approach, along with a prediction of your pension based on future service at your current salary, you are using good solid numbers today that will hold in the future as they grow with inflation.

The dollars that go into deferred compensation will end up in competition with other expense and savings needs: buying a house, saving for kids' college, and other requirements of life. It's hard to max out every year and still feed your family. So, don't worry when your first child is born and your spouse cuts back at work. You will probably need to drop your contribution to deferred compensation. Keep everything in balance. But remember that magical time value of compounded earnings. Don't let deferred compensation sit too long on a back burner. The best approach: start deferring as soon as you are eligible.

If your employer does not sponsor a Section 457 deferred compensation plan, take action to bring this no-cost benefit to your workplace. Contact ippfabenefits.org for assistance.

What Else Can You Do to Improve Your Deferred Savings?

There are a range of further actions you can consider. Or not. Many of the readers already have a good grasp of their deferred compensation personal savings plan. Of course, if you are not saving in deferred compensation, strongly consider joining the plan. If your employer does not have a deferred compensation plan, contact your union. If you are not represented by a union, contact IPPFA or one of the other 457 administrators in Illinois to see about them approaching your employer.

If you are enrolled in deferred compensation and would like to improve this leg of your retirement income, you can do a little or a lot. Reread this section. Visit your plan administrator's website or review the written plan material. Consider the two recommended books from Dr. Bernstein or find something similar. Maybe a relative or a friend has a decent financial planning or retirement book. Rebalance your account if it hasn't been done since the 1990s. Be sure you understand your investments and statements. If you don't understand them, plan a meeting with the deferred compensation representative. Take ownership.

Section Summary

A public employee can place a considerable amount of personal savings into a deferred compensation account. This approach will beat savings outside the account over the long term. There are a broad range of diversified asset classes that can be chosen and mixed to create excellent long-term gains. Participants should understand these investments well enough to make appropriate allocation decisions. If you are not in that position, you can improve your own knowledge and/or work with the deferred compensation company or a personal advisor to assist you. Rebalancing your account regularly or even from time to time adds value. Deferred compensation accounts can also be put on a sort of "automatic pilot" as there are opportunities for preset, age-appropriate investing and rebalancing. There is a lot of flexibility in withdrawing the money, but moderately sized withdrawals must occur after age 70 1/2.

Section Endnotes

To arrive at the 23.1% tax rate imputed for "Tim's" savings outside of deferred compensation, we blended the capital gains/dividend rate for three-quarters of his investing with a typical top rate of 28% for the balance then added 5 percentage points for Illinois tax (the tax rate in effect at the time).

The historical returns by asset class were provided by BlackRock in response to an inquiry from the authors.

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