Retirement: Defined Contribution Plan

What Can I Do With My Defined Contribution Pension Plan?

By: Joe the Investor

Over the last 10 years, companies have been phasing out Defined Benefit Plans in favour of Defined Contribution Plans. Defined Benefit Plans tend to be found in the public sector, organizations with unions or in companies where pension plans have been operating for many years.

Defined Benefit and Defined Contribution Plans Defined

A defined benefit plan is a pension plan where the **future payout in retirement** is defined by a formula that is set out when you join the company. It is a calculation that usually includes your highest average salary, time working in the company, and how much money was contributed by you and the employer. The money is invested on your behalf and the firm is responsible for risk if something goes wrong. There is usually an implied rate of return that is guaranteed by your employer each year, which is the investment rate of return your money would earn if you could see your pension plan in a bank account.

A defined contribution plan is where the **money you pay into the plan** is defined: the amount contributed either by you or on your behalf by the company. It is a set dollar amount based on your salary in the year that you are working. You can think of it as the company (and sometimes you and the company) contributing to your pension account. This is similar to a Registered Retirement Savings Plan (RRSP) account, except that it is locked in. Locked in means that the money is in your name and you are entitled to the money, but cannot withdraw it unless there is a very exceptional circumstance (i.e. this is the only money I have and I need to pay my bills). Also like an RRSP Account, you get to choose the investments in the defined contribution scenario, and you are taking the risks. If you invest in a fund and it loses money, you must deal with the consequences. It is for this reason that it is good to have a plan. If you are in a situation where you have a defined contribution account, you will have to make the decisions.

Many companies offer some kind of education on what products you can invest in for your defined contribution account. The selection is usually pretty limited to one or two company offerings, because this is cheaper and easier for the administrator of the account to do their job. If all of the products are from one company, there is usually a saving on fees because you are dealing with one company and have all of the employee assets with them. The more money is concentrated in one company, the cheaper the rates tend to be – similar to the idea of buying in bulk.

Contributions

What do you need to know with respect to contributions? First of all, understand how the plan works. There is usually a vesting period, which states that you have to work at a company for a certain amount of time before you can keep the money. Sometimes, the contributions to your account start months after you begin employment and other times they start on the first day. When you negotiate your job offer, ask **what you will be getting and when** to make a more informed decision. This can be thought of as part of the benefits or bonus that an employer may offer you. Keep in mind that if you leave the company before the vesting date, you will lose the money.

What if I Leave the Company?

If you leave the company after the vesting date, you can leave the money with your former employer, or take it with you to another institution. If you leave it with your employer, you will be able to receive it when you reach retirement age – this is called a "deferred payment". It may also mean a series of payments over time – this is something I would ask the employer, especially if you will be retiring in the next 10 years. Since it is a pension plan, it will remain locked in until you are of retirement age. It would be kept separate from other non-locked in assets that you might have – like RRSPs, Tax Free Savings Accounts (TFSAs) or non-registered (cash) accounts. There are situations when you can combine locked in accounts from different employers into a single account. This should be discussed with your current employer.

You can also combine defined contribution and defined benefit plans together in certain situations - if your current employer has a way of calculating the value of the contributions between the two (or more) types of plans. This is also possible between defined benefit plans of different types. Please ask your employer for the rules of their pension plan upon arriving or leaving a job to make sure you have all of the options open. You can also manage pension money yourself once you leave the employer. The money would go into a Locked In Retirement Account (LIRA), which can be managed by the same financial institutions that manage RRSP accounts. You can also turn this money over to a financial planner or broker if you believe they can manage your money more effectively than you can. There are usually time restrictions on making these transfers, and rules of protocol to follow, so please ask your company when you leave the firm and get the proper procedure so you can implement this strategy if you want to. This also applies to redemption rules for the products inside the defined contribution account.

What About My Voluntary Contributions?

If you contributed your own funds as well as received company money inside a defined contribution plan, and you leave the company before the vesting date - your funds will be returned to you but employer contributions will be kept by the company. For information purposes, keep track of how much you and the company contribute from the beginning in the event of mistakes. As an aside, always keep your statements and print out hard copies of your records in case of issues with accessing your internet based accounts or loss of history. At the very least, have the records stored in your personal hard drive so they can be accessed without restriction. This is also a good idea for tax purposes. You want to be able to recreate your account situation from start to finish without relying on the internet, or any other parties to supply you with information. Keeping track of contributions will also help you distinguish between money earned on investments within the plan, and money contributed from your salary. This information is useful in indicating how well your investments have done.

Contribution Room

If you pass the vesting period, and then leave the company, you will get to keep your money and the company contributions. All contributions to this defined contribution account will be part of your RRSP contribution room. This is also the case with defined benefit plans. For tax purposes, you should view all of your retirement accounts as one entity in terms of how much you are allowed to contribute to them. If you increase deposits into one type of account, you would have less room to contribute to another type of account. The RRSP maximums given by the Canada Revenue Agency (CRA) are the ceiling for all the retirement accounts together – defined benefit, defined contribution, RRSP accounts, and any other account specified for retirement funds. If you feel you are getting a better return, better selection, or lower fees from your RRSP account versus a defined contribution plan, then put your voluntary contribution in your RRSP as it will benefit you more. If you find it easier to leave it to the company to do this for you – then maximize your contributions to your defined contribution plan. One advantage of using the RRSP instead of a defined contribution account for retirement savings is that money can be withdrawn from RRSP accounts when you need it. You will be taxed, but it is possible.

How to Invest and Compare Fees

If you have decided to keep the defined contribution account and you are given a list of products (usually mutual funds) to invest in, how do you go about it? Diversifying between different themes is always a good idea. If you don't know what is in a product, please inquire. Ask your boss, the pension account administrator – whoever will give you the most common sense answer to your question. I would also double check what they are saying in case of mistakes. It is your money, and it is better to do homework earlier than to have investment losses that could have been prevented. Choose some equity funds and bond funds as a minimum and have a Canadian equity fund and a global equity fund at a minimum. If there is an index fund on the list – I would choose it over any other fund of the same type because it is usually easier to understand and fees are generally cheaper. This option is not likely to be available, but I would look for it nonetheless. If you feel that you don't want to invest at the time of choosing your products, buy a cash equivalent fund to keep the money in something that is static. This can be a money market fund, a GIC fund a Treasury Bill fund, or a short term bond fund (the maturity on the bonds are one year or less). If you are allowed to keep cash in the account, this would be the best option.

Institutions Get Preferred Fees

A note about fees – even though defined contribution accounts typically have mutual funds in them, fees tend to be cheaper than if you were to buy them yourself. Why? The company sets up these plans with all their employees as a group, so they negotiate fees as an institution. The institutions get much lower fees than the individual investor by way of having more assets. I would ask when you choose the products how much the fees are that you would pay. If you are in a situation where the company is not passing the fee savings onto you, then you may want to consider putting voluntary contributions into your own RRSP and buy a product with cheaper fees. You will know this by comparing the fees they quote you on the defined contribution products and the fees on the equivalent retail product from another institution, such as your bank. There is usually a wide range of fees between all of the products offered, so find out the fees for all of the products on the company list and account for this when you make your choices. I would also ask if there is any cost to switch between funds, or any other restrictions. If you like to "actively manage" your money and get into and out of different markets, then this will be important. If you like to leave things as they are and not bother, then I wouldn't be too concerned about this.

Defined contribution accounts are a very useful retirement tool. Get the most out of these accounts by doing your homework and integrating them with all of your other retirement options.

Sources:

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