



TEXAS ASSOCIATION
OF COLLEGE TEACHERS



TEXAS COMMUNITY COLLEGE
TEACHERS ASSOCIATION

2004 Analysis of Possibilities for ORP/TDA

The Texas Optional Retirement Program (ORP) is designed for full time faculty at state supported institutions of higher education. Created by the Texas Legislature in 1967, it is offered as an alternative to participation in the Teacher Retirement System of Texas (TRS). Upon employment at an institution, an employee is given 90 days to choose whether to invest his or her retirement fund in ORP or TRS. This choice is irrevocable. A new law passed in 2003 also requires a 90-day waiting period before state funds are used. If a decision is not made by a new employee, he or she will be enrolled in TRS by default.

More often than not, new faculty members participate in ORP. First, there is a contribution of up to 15.15 percent of salary placed into a retirement plan. This is the sum of the employee's contribution (6.65 percent of gross salary) and the state's contribution (from 6.0 to 8.5 percent of salary). Second, the retirement savings plan is self-directed, and the vesting period is one year and one day. If an employee does not vest, the state's monies are returned. The retirement benefit or monthly income is based on contributions and earnings on those contributions.

Another new law passed in 2003 by the Texas Legislature allows institutions participating in the Optional Retirement Program to supplement the state employer contribution for all participants up to 8.5 percent of salary. This legislation overturns the previous prohibition of such supplements for participants hired since 1995.

The Teacher Retirement System is for all persons who opt not to be in ORP or are not eligible for ORP. TRS is a defined benefit program, in which the employee's retirement benefit is 2.3 percent of average salary in the highest three years, multiplied by the number of years of participation in the program. The current vesting period for TRS is five years.

Whether the choice is ORP or TRS, most employees are eligible to place additional pre-tax contributions into a Tax Deferred Account (TDA). A TDA

is a supplemental investment that may be made in addition to the mandatory program. TDAs receive no state contribution.

The most recent federal overhaul of retirement rules is included in the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA). This law raises the limits of pre-tax contributions to deferred compensation plans, and also provides for additional "catch up contributions" for participants over 50 who have not contributed enough for their retirement.

A particular benefit for faculty in the Act is the repeal of the Maximum Exclusion Allowance, a complex formula that limited the tax-advantaged treatment of combined contributions to ORP and other deferred compensation programs. Higher education employees should seek the advice of a financial advisor to learn how changes due to EGTRRA may affect individual retirement planning.

Most companies have incorporated TDA loan provisions into their policies or custodial agreements under the Tax Equity and Fiscal Responsibility Act of 1982. The IRS and each firm will have certain guidelines and criteria that must be followed. If the IRS rules are not followed, the loan could be considered a withdrawal

or premature distribution and subject to tax and ten percent penalties. For specific information, the investor should contact representatives of the company.

All performance figures quoted in this study are net of all administrative or management fees for the specific years mentioned. Net performance is a good starting place for comparison. Neither low nor high expenses and charges assure the best investment. Is an investment that has a gain of ten percent and charges only one percent per year (nine percent net) better than an investment that has a gain of 30 percent and charges three percent per year (27 percent net)? Historical investment performance does not and cannot guarantee future results. However, many individuals will use past performance to assist in the decision process. Flexibility

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detailed product
descriptions, and
comparative tables
showing company
rankings, fees,
and performance
histories for 17
fund categories are
available online at
www.tccta.org.*

Editor's Note: For the thirtieth consecutive year, this analysis has been made available to members of the Texas Association of College Teachers and the Texas Community College Teachers Association to assist in retirement planning. The staff of the two associations remain grateful for the efforts of Frank L. Wright, who managed the project for most of its history, and to the professionals of the ORP/TDA companies who cooperated in making this service possible.

No investment decision should be based solely on data reported in this analysis. Past performance does not guarantee future success.

Formulating the Decision

1
What will be my financial needs at retirement, and should I supplement my ORP with other investments such as a tax deferred account?

2
What is the likelihood of a good return throughout the term of my investment?
Is it diversified enough to ensure stability?

3
What are the outside rating firms' evaluations of the carrier? Does the company have soundness and experience to fulfill its contract and provide good management?

and portability should also be considered.

As an investor, it is important to analyze front end charges (which reduce the amount of money that goes to work immediately), and contingent deferral charges (which tend to limit flexibility and the portability of the investments). In order to maximize potential gains in the future through new products or innovations, flexibility and the allowance of change are important factors.

Fixed Accounts

Fixed accounts are traditionally investments in the "general accounts" of an insurance company. These accounts function similar to a bank's Certificate of Deposit. The dollars on deposit are "lent" to the insurance company. The insurance company agrees to repay both principal and a contractually-guaranteed minimum interest rate. Most companies pay the current interest rate, which is normally higher than the contractual minimum. This rate may change daily, monthly, quarterly, or annually. The current rate of interest is derived from the company's earnings, and is set by the board of directors. The actual formula for the current interest rate varies from firm to firm. It is often an unknown and discretionary formula, subject to change.

Other types of fixed accounts offer more specific information regarding their yields. They may offer a rate based upon a pool of specific underlying assets such as government bonds, treasuries, or other securities. These are sometimes called Market Value Adjusted accounts. Only when a firm will disclose and contractually guarantee the formula can investors be assured of the interest crediting method for their contract. While most insurance companies work on an old banking principle, paying policyholders two percent less than the company earns on its investments, the choice of formulas is still at the discretion of the company's board.

Insurance companies credit or pay interest in many different methods. A widely used method is to "band" interest rates. As money is received by the company the current interest rate is applied. The current interest rate can be guaranteed for any period of time. However, as the rate changes, monies received from that point forward would be considered a new band and credited at the new rate. The old money, or band, may continue to earn the former rate of interest for the specified period of time. Once that time has elapsed, a new rate may be applied to that band. Over time, the contract may have many bands of different rates. Some firms band for a year and then the dollars drop into a pool or portfolio. The current rate paid on the pool or portfolio may be higher than the initial band. If the rates are quoted on a portfolio basis, the dollars earn the stated interest rate when deposited.

To attract new participants, many companies will increase or enhance third quarter current rate declarations, when companies receive the lowest contributions of the year. Not all companies engage in this practice; however, one should be aware that this strategy is used to entice participation in certain programs.

Another tool to entice participation is the "two-tier" crediting process. This process enhances the rate for dollars that are annuitized at retirement, and credits less interest to those wishing a cash option. Annuity contracts have two phases, accumulation and distribution. Annuitization is a distribution phase. By utilizing this distribution process, a participant can buy an

For a comprehensive printable overview of current rules governing TRS and ORP, provided by the Texas Higher Education Coordinating Board, visit www.tccta.org.

"income stream." The insurance company will guarantee, according to the contract choice made, to provide an income the annuitant cannot outlive. Other options can include: receiving money for a set period of time, or even an income stream for the spouse upon the annuitant's death (known as joint and last survivor option)

or any other mutually-agreed combination. The loss of flexibility and liquidity for the dollars annuitized is assured, since the purchase of an income for life guarantees the accumulation in the account to be with the insurance company for a very long time.

When comparing interest rates, be careful of the manipulations that companies may use to "enhance" their contracts. The highest interest rate is not necessarily the best bargain. Since interest rates have declined, a number of companies will pay a first-year bonus thereby enticing a move to that company. However, the enhanced first-year rate can be at the expense of the renewal rate.

Not all enhancements to contracts are negative. Some bonus contracts truly provide a positive enhancement to earning potential. Annuitization is necessary to some people's financial planning, but is typically not recommended for all accumulations. Keep in mind, the firms currently available for ORP and TDA are focused upon creating competitive products for accumulations. At retirement, shopping for the best annuitization rate is a very prudent decision. In addition to checking with one's current firms, there are several companies that specialize in the distribution phase (annuitization). At retirement, all accumulations in both ORP and TDA accounts become 403(b)s. 403(b) is the section of the Internal Revenue Code that allows for these retirement programs. Therefore, all dollars could be comingled. By placing a larger sum on deposit, one could purchase a higher income stream, but do not forget to shop because it is a lifelong decision.

Most fixed contracts, like CDs, will have a penalty for early withdrawal. The term for this is surrender or withdrawal penalty. This charge is usually assessed on payments made to the contract that have not been "on-deposit" for a specified period of time.

Finally, it is important to consider ratings of firms if the dollars are invested in the fixed side of any contract. Since the money is guaranteed by the insurance company, solvency of the firm should be a factor for consideration. When placing assets in a fixed account, utilizing two or even three different rating services is considered prudent. (See Table 1.)

Each rating service (such as A.M. Best, Standard and Poor's, Duff and Phelps, and Moody's) has a different area of expertise and specific evaluation criteria. Some of those areas include solvency and claims-paying ability. However, be advised that even these rating services are not infallible. In the past, several companies have been placed into "receivership" despite having high ratings by these services. Texas does have a guarantee program. This program

offers protection of up to \$100,000 of account value with each company.

Mutual Funds

Mutual funds are available for ORP and TDA deposits. An investment company or a mutual fund is either a corporation or a trust in which investors pool their funds and invest them in a wide variety of securities. An investment company or mutual fund is engaged in the business of investing in securities, managing funds for people more effectively than individuals ordinarily could for themselves. A fund operates as a single large account that is owned by many shareholders. Today, there are more mutual fund choices available than companies listed on the New York Stock Exchange. As the world economy continues to grow, opportunities for investing beyond our shores become increasingly viable options. Additionally, most funds are now grouped in “families” that offer a broad array of funds within one package or company.

Here is a brief description of the kinds of investments available.

1. Money Market Funds invest in securities that mature in less than one year. These funds can be composed of one or more of the following: Treasury bills, certificates of deposit, commercial paper, Eurodollar CDs, and notes. The objective is to maintain a constant share value while producing a return slightly above bank money market funds.

2. Bond Funds can come in many varieties, including a government bond fund, a corporate bond fund, high yield bond fund, or others. Typically, the investment criterion requires that any holding purchased be a bond.

3. Stock Funds can be classified in three categories. Equity-Income Funds focus on income, with capital appreciation as a secondary concern. Growth and Income Funds attempt to produce both capital appreciation and current income. Growth Funds seek capital appreciation first while current income is a distant secondary concern.

4. Balanced Funds are also called “total return” funds. The objective is to provide total returns through growth and income. The fund typically purchases stocks, bonds, and convertible securities. Weighting of each asset class will depend upon the manager’s perception of the market, interest rates, and risk levels.

5. International (Global) Equity Funds consist of two types. International or Foreign Funds may only invest in stocks of foreign companies. Global Funds can invest in both foreign and U.S. stocks. The objective of either category is growth of capital.

6. Aggressive Growth (Small Company) Funds are mutual funds that focus strictly on appreciation, with no concern about generating income.

7. Special Funds are grouped in two categories: Metal Funds and Non-Diversified Funds. A metal fund purchases metals in one or more ways: bullion, gold stocks, and mining stocks. Non-Diversified Funds are defined by the Securities and Exchange Commission as holding more than five percent of the funds’ total holdings in the security of one company. These funds can also be industry specific.

The above definitions have been modified from those found in the Certified Fund Specialists guide.

Each mutual fund comes with a prospectus, which

must be provided to the investor before purchase. This prospectus will provide information such as the name and credentials of the fund manager, the goals and objectives of the specific fund, and information regarding fees and other expenses. It will also describe the limitations placed on the manager. All funds instruct the investor to “read the prospectus carefully before investing or sending any money.” Unfortunately, the prospectus is written in such technical terminology, most people would have difficulty interpreting its contents.

All mutual funds have fees, including so-called “no-load” funds. The investor ultimately pays these expenses, which include marketing, research, administrative support, reports, fund managers, and other costs. Accepting the fact that there is “no free lunch,” what charges should one review before investing?

The investment advisor or advisors, making the daily decisions—to buy, sell, or hold the investments of the fund—must be paid. The research and overhead costs for administering the fund must also be paid. These are usually described as “investment advisory expenses” or “management fees.” It is always best to find out what the management fees are, since the fee amount can affect the performance of the fund. While one does not want to make this an overriding concern, an investor needs to be comfortable and understand the fees assessed. Generally, net performance, not internal cost, is the most important factor to consider when investing.

There are three pricing strategies for mutual funds. A-share mutual funds are front-loaded funds. The cost to invest will usually range from zero percent for Money Market Funds to more than five percent for International Funds. The load immediately reduces the amount going to work. These funds will typically be presented by a salesperson who receives a commission to represent that company.

B-share mutual funds are sometimes known as no-load with a contingent deferred sales charge. These shares have an early withdrawal penalty if the amount does not remain on deposit for a specified period of time. These funds typically have higher management fees than the A-shares and are often clones of an A-share fund.

C- and D-share mutual funds are no load in, and if held for a period of time (up to one year), no load out. These are deemed no-service or self-service funds. This class of funds can be brought to the investor in two ways. The old line of funds has no sales force; transaction are made using a toll-free phone number. The new line of funds uses salespersons that may or may not receive an up front commission. The management fees will probably be higher than B-shares, therefore one should check the prospectus. More families will begin offering C- and D-shares.

Another fee that may be assessed is a 12-b-1 fee, named after a federal government rule. This fee pays for distribution costs, including advertising and dealer compensation. The 12-b-1 fee may provide a venue for use, compensating a professional to work with an investor in the design of an investment plan. The professional will be paid based upon the amount invested and the performance of the account. If applicable, this fee will be found in the prospectus.

It has long been the subject of much discussion whether paying an up front charge is best or if it is

4
What are the expenses involved with the program? Do transfer fees, surrender charges, and other costs permit flexibility as my investment needs change?

5
Is my contract surrenderable for cash value, in whole or in part, after leaving covered employment for ORP, and after I turn 59½ for TDA? Does it allow lump sum withdrawals in lieu of annuitization at retirement?

6
Do I have sufficient choices between fixed and variable types of investments and can I shift between them easily and without cost?

preferable to have a contingent charge. One position holds that if the investment is for the long term (ten years) it will be better to pay up front charges, since this will make the annual management or investment charge significantly lower. However, this argument does not take into consideration personal, economic, or product changes. The original investment chosen today may not be the best investment for an individual in the future.

Variable Annuities

Variable annuities can be described as a combination of fixed annuities and mutual funds with a twist. Variable annuity contracts are life insurance contracts that have as few as one or as many as 30 variable investment options. These options are referred to as sub-accounts. The sub-accounts are, by law, separate accounts. The variable choices offered differ from the fixed account in that the investor, not the insurance company, absorbs the investment risk. There are no guarantees. The money is never commingled in the insurance company's general account. All earnings or losses are tied to investment performance of the underlying account.

Many variable annuity contracts have fixed accounts. Research shows that almost 60 percent of assets in variable annuity contracts are in fixed accounts. While this may be prudent for a particular investor, the discussion provided in the fixed annuity section applies here. In some cases, the fixed portions of these contracts are not as competitive as a fixed only contract. Variable annuities are by design variable investments.

The variable annuity is a product that is constantly evolving. The horizontal integration of these contracts is an innovation that seems to be growing. Previously, all programs were vertically integrated. Management, marketing, administration, and sales were all performed by the same company. In the late 1980s, several firms began adding external fund managers to the proprietary funds offered in the contract. Today, an investor can even cross fund families in one contract.

Remembering that the variable annuity contract is offered by an insurance company may assist an investor with the following discussion regarding fees. The expense risk and mortality charge are fees assessed in most variable annuities. The expense charge guarantees from the date a contract is signed that the charges for management and annual contractual charges will not increase for the life of that contract. The mortality charge is unique to variable annuities. Mortality charges are guarantees by the insurance company that in the event of death, heirs will receive either the contributions (deposits) or the face value of the contract, whichever is greater.

Today, several contracts have expanded the mortality feature. This is called a "stepped-up death benefit." If available, the contract will increase the amount invested at a certain rate (e.g., five percent per year) or at a contract anniversary date (e.g., the fifth contract year). This value is the new "floor" that the heirs will receive. This can be a very attractive feature for older faculty investing in stock accounts late in their careers. Another fee assessed by the variable annuity is the investment advisory fee and, if applicable, a 12-b-1 fee.

The surrender or withdrawal structure of the variable annuity is very similar to B-share Mutual Funds

(no-load with a contingent deferred sales charge). Most contracts will not have front end charges, but will have surrender charges. These charges may be level (say, three percent for three years, then dropping to zero), reducing (say, six percent the first year, then reducing one percent per year), or level for a certain period of time then declining (say, six percent the first two years, then declining each year to zero). This penalty may be assessed upon each contribution. This type of surrender charge is called a "rolling surrender charge." The penalty can also be based upon contract years. This type of surrender charge is called a "non-rolling surrender charge." If dollars are moved to another firm before the time period for surrender charges has elapsed, the contributions can be penalized for early withdrawal. Unlike mutual funds, most companies allow a ten percent free withdrawal, allowing a transfer to another firm. This ten percent free withdrawal is usually not a cumulative privilege.

Another feature offered by variable annuities is dollar cost averaging. This allows an investor to place a systematic transfer of a specific amount each month from one sub-account to another. Theoretically, if the investor purchases shares over a period of time when prices are high and low, the cost per share will be less expensive in the long term using dollar cost averaging. The availability of this option could be an additional feature to consider.

Additional Options

A recent innovation in ORP and TDA investment products is the trust. This option allows the investor to design a very personal investment. Unlike investing in one family with limited options, through the trust arrangement the investor can mix different funds and cross family lines. The ability to select the top performers, or specific asset classes from several mutual fund families, is a powerful investment tool. Currently, this option is available for fund use only (not multiple variable annuities) through several different trust programs.

Another innovation is on the money management side. Texas law, under the section of law that created ORP, allows the use of independent professional investment advisors. The fee for this service can vary, but may not exceed two percent annually. The recognition by the investment community that this service can be provided to faculty has added a new dimension to ORP and TDA accounts.

Money management has many schools of thought. There are extremes. At one extreme are the institutional investors who typically use asset class selection with systematic rebalancing. At the other extreme are the market timers. This theory purports the ability to take advantage of upswings while limiting the downside. Of course, most theories and services fall between these extremes.

Summary

As with all cash accumulation plans, investment performance may vary. There are no guarantees. This study should not be the sole basis for investment decisions. The final decision regarding retirement investments should remain between the investor and the investment professional, when utilized. A properly designed program can be developed to enhance performance and maximize gains given the investor's risk tolerance level. ☆

7
Are my company's reporting and servicing policies sufficient for my needs?

8
Have I checked my company's Web site for the most current information?