TEXAS ASSOCIATION OF COLLEGE TEACHERS

TEXAS COMMUNITY COLLEGE TEACHERS ASSOCIATION

2019 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. Therefore, new employees are urged to make this decision carefully.

The TRS is for all persons who choose 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% of average salary in the highest three years (five years for newer employees), multiplied by the number of years of participation. The vesting period for TRS is five years. (If an employee does not vest and withdraws, the state’s monies must be returned.) A “Rule of 80” (when the combination of age plus years of service entitles TRS members to retire early without penalty) applies for those currently vested. However, a law passed in 2013 places financial penalties for some individuals on early retirement before age 62. New and recent hires are urged to consult the TRS website for details, at *trs.texas.gov*

Both the employee and the state make monthly contributions to TRS and ORP based on percentages of the employee’s salary. The percentages are established by the Texas Legislature and may fluctuate over time. Employee contribution rates are 6.65% for ORP participants. TRS employee contribution rates are increasing under the 2013 law mentioned above. The rate increased from 6.7% in fiscal year 2015 to 7.2% in fiscal year 2016, and to 7.7% in fiscal year 2017. As of September 1, 2017, if the state contribution rate is reduced below 6.8%, the contribution rate for active employees will be reduced by an equivalent percentage.

The state contribution rate for TRS is 6.8%, and 6.6% for ORP. TRS members should consult the schedule from the TRS website link provided earlier. For ORP, the employer share is 6.6%.

Convenient links to the most popular ORP carriers in Texas higher education are now available at www.tact.org/orp

For ORP, a “defined contribution” program, the total contribution is the sum of the employee’s contribution, local supplements (of up to 1.9%) and the state’s contribution. The retirement savings plan is self-directed, and the vesting period is one year and one day. The retirement benefit is based on contributions and earnings on those contributions.

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.

An important federal overhaul of retirement rules was included in the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA). This law raised the limits of pre-tax contributions to deferred compensation plans, and also provided for “catch up contributions” for participants over 50. The law also repealed the Maximum Exclusion Allowance, a complex formula that limited the tax-advantaged treatment of combined contributions to deferred compensation programs. Higher education employees should seek the advice of a financial advisor to learn how any changes may affect 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 have guidelines that must be followed or the loan could be considered a withdrawal or premature distribution and subject to tax and 10% penalties. For specific information, the investor should contact representatives of the 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

Editor’s Note: For the forty fifth 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?*

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

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 5% 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.

For a comprehensive overview of the rules and rate histories of TRS and ORP, provided annually by the Texas Higher Education Coordinating Board, visit tact.org.

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 0% for Money Market Funds to more than 5% 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 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% 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., 5% 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, 3% for three years, then dropping to zero), reducing (say, 6% the first year, then reducing 1% per year), or level for a certain period of time then declining (say, 6% 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 10% free withdrawal, allowing a transfer to another firm. This 10% 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

An option available 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 option 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 2% 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. ☆

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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?

7

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

8

Have I checked my company's website for the most current information?