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Doing the Basics Brilliantly as Fixed-Rate NQDC Plans Return

Yields Approach 6-12 Percent – Some with No Cost to Shareholders

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There are times when doing the basics brilliantly delivers an equally polished payback. Such is the case with top executives who are clearly benefiting from no nonsense deferred compensation plans with fixed rates of return. Many companies today offer these plans precisely because they yield predictable rates of return, and they are simple to understand and manage.

Take a moment to review the 2010 proxy statements of leading companies (Chart I), and you'll soon discover that top executives at some companies are earning returns on deferred compensation accounts as high as 12 percent.

Chart I
Adding Competitive Investment Options, Including High Fixed Rate Investment

Companies with Fixed Rate Plans	
Comcast	12.0%
McKesson	8.0%
Limited Brands	7.6%
Wal-Mart	6.6%
Bank of New York Mellon	6.6%
Edison International	6.4%
Honeywell	6.3%
Illinois Tool Works	6.3% - 8.4%

Source: Public proxy filings.

Nonqualified plans (NQDCs) are quite prevalent among the Fortune 1000, with 85 percent providing such a plan according to the 2009 Clark Consulting Executive Benefits—A Survey of Current Trends (Chart II). This same study further calculates 11 percent of companies offer a fixed rate of return.

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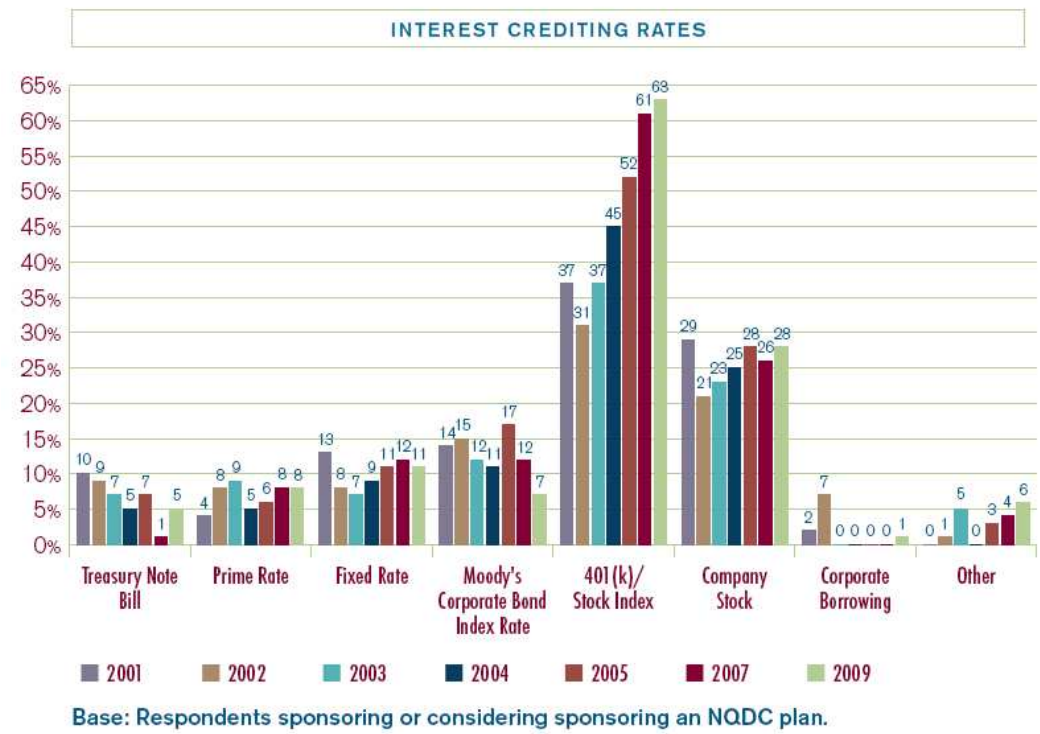
Chart II



Source: Clark Consulting's 2009 Executive Benefits - A Survey of Current Trends

A Common Purpose

NQDC arrangements make it possible for highly paid employees to save for retirement without the burden of government limitations. The Internal Revenue Service (IRS) limits the amount employees can contribute to a 401(k) plan ($16,500 in 2010). Companies that truly place a premium on executive talent set up these supplemental plans to strengthen their ability to recruit, reward and retain highly compensated employees. Top performers will naturally seek competitive benefits packages that accelerate their ability to set aside more money for retirement. These plans are designed purposely as "nonqualified" compared to "qualified" employer-sponsored 401(k) plans. Nonqualified simply means that the plan is not subject to the requirements of qualified plans, which are regulated by the Employee Retirement Income Security Act, known as ERISA. This freedom from regulation confers significant benefits on the NQDC plan participant.

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Deferred compensation arrangements, as in NQDC plans, generally provide investment elections that mimic mutual funds available in the employee 401(k) plan. However, investments in NQDC plans are not protected by ERISA, like 401(k) plans. As a result, participant account balances are subject to the claims of the company's creditors.

With historic volatility in the stock market this last decade, the S&P 500 rate of return has produced a paltry equivalent to 1 percent. Little wonder, then, why many organizations have decided to return to fixed crediting rates to supplement or replace the notional mutual fund type of return.

A Look Back

Back in the 1970s and 80s, many organizations adopted fix rates of returns for deferred compensation arrangements, offering participants a rate tied to either the 10-Year Treasury Rate or the Moody's Corporate Bond rate. Then, the interest rate climate was superheated; it was not uncommon to come across plans that offered Moody's plus 5-8 percent rates which produced a fixed return equal to 20-22 percent.

Those attractive numbers were possible prior to the Tax Reform Act of 1986, and due to unique life insurance funding strategies that produced these returns. What's more, the numbers were achieved with no cost to the shareholders. Of course, that concept has since been legislated out. For a fortunate few, some plans were grandfathered and still exist. In fact, we still hear from many smiling executives who continue to enjoy fixed rates of return north of 10 percent.

Cost Neutrality

Even so, given the number of funding alternatives today, you can still support a fixed rate of return around 6 to 7 percent. The key is how the company funds or hedges the liability for the high-fixed return. Let's start with some basic math: If a full taxpaying company can deduct the benefits it pays to nonqualified participants, then a 6 percent return would cost a 40 percent bracket corporate tax payer 3.6 percent after tax (Chart III). To hedge that liability, the sponsoring company must earn 3.6 percent after tax or be tax free. Many organizations, as mention earlier, do earn a 6 to 7 percent return by wrapping fixed rate of return assets in a corporate-owned life insurance (COLI) policy, which is owned by the company. Major insurance companies offer current fixed rates in COLI policies with a guarantee of 3 percent. Other insurers allow you to purchase bond portfolios and stable value funds with more attractive returns.

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Chart III

Gross Crediting Rate	Tax Savings*	Net Crediting Rate
6.00%	2.40%	3.60%

** Based on a 40% corporate tax rate*

Capture the Gain

RCG has developed a strategy whereby a company can leverage its fixed-rate investment, and borrow internally from the policy to leverage the return. As an example, if the participant deferred $100,000, and the company deposits those funds into a COLI policy with an investment fund earning 5 percent, the company can borrow at LIBOR plus 1 percent (as of March 2010, 1.75%) and capture the additional gain.

Of course, there are various methods to support a cost neutral rate of return, and a sponsoring organization is advised to conduct due diligence by carefully examining all alternatives.

Net Takeaway

In the world of investments, we always look for the highest clarity diamonds in the rough. Only today, we must view opportunities through the optics of a jeweler's loop. Stock market volatility, aggravated by flat equity growth in stock options and restricted stock plans, impels restless companies to get back to basics. The more cost-effective alternative investments await the patient. Thus, we urge you to consider a leverage strategy to capture the most brilliant aspects of fixed-rate investments.

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