Despite Stock Market Gains, Public Pension Plans Fall Further Behind

In its latest report on public pension plans, Moody's announced on Thursday that, despite recent historic gains in the stock market, those plans' liabilities are increasing even more quickly. Reporting on the 25 largest public defined benefit pension plans in the country, Moody's Global Credit Research estimates that those plans are now $2 trillion short of where they need to be to pay out all the benefits promised to their beneficiaries. This has occurred despite record gains in the stock market, which, over the last five and half years, has seen the Standard & Poor's 500 Index triple in value. Instead of closing the gap, those pension plan liabilities have actually expanded from a $650-billion dollar deficit in 2004 to $2 trillion today.

Blame can be placed on governmental insistence that most emphasis be on investment returns instead of on themselves or the pension plan participants. Moody's put it more gently:

> Despite the robust investment returns since 2004, annual growth in unfunded pension liabilities has outstripped these returns. This growth is due to inadequate pension contributions, stemming from a variety of actuarial and funding practices, as well as the sheer growth of pension liabilities….

Al Medioli, a Moody's vice president, pointed out the problem: "It is inherently difficult to recover an overall asset position after the double-digit losses seen during the [Great R]ecession." He added that recovery is complicated by emphasizing rate of return on investment assets in order to reduce the pressure on employees and employers contributing to the plans: "Accounting [rules] emphasize investment returns over annual contributions; *the resulting funding disincentive is at the core of the public sector pension asset liability gap*." (Emphasis added.)

Translation: Political pressure has demanded more from investment returns so that less may be required of governments and their employees to make sufficiently large contributions to keep those promises. The pension plan managers were counting on "pixie dust" to make the math work out.

Just three months ago, the Center for Retirement Research at Boston College released its study showing that the shortfall was only $1.1 trillion, whereas, according to Wilshire Consulting, the funding gap had risen to $1.4 trillion in September, all while the stock market was making new all-time highs.

Despite the fact that the stock market, as measured by the S&P 500 Index has gone from 676 in March 2009 to 1,966 on September 25, 2014 — nearly a triple in 5½ years — pension plan liabilities increased even more quickly. According to Wilshire, state and local governments have managed to increase their contributions since 2009 — from $23 billion to $95 billion — but even that increase has failed to close the gap.

Part of the problem is demographics: More and more workers are retiring sooner than anticipated, many of them taking early retirement through buyouts. Part of the problem is not understanding how difficult it is for a pension plan to come back from the huge losses it sustained during the Great Recession. For example, a pension plan that had $10 million in assets in it prior to the Great Recession might have seen those assets decline to $5 million. Simple math says that the remaining $5 million in assets must earn 100 percent just to get back to even. All the while, the liabilities continue to increase, making a comeback less and less likely, not to mention getting ahead of the curve to meet the increasing demographic demand from retiring employees.

Although Moody's doesn't say so, these pension plans are in a "death spiral" which can only end badly.

The solution is what it has always been: cutting benefits, delaying benefits, and increasing contributions from both workers and their governments. The pressure to move from defined benefit plans which put the risk on the taxpayers, to defined contribution plans which put the risk onto the workers themselves, will continue to increase.

There's another risk is well. The stock market has moved up in nearly a straight line since March 2009, making a correction more and more likely with the passage of time. There's another rule in investing and that is the inevitable "reversion to the mean," which simply means that the 20 percent annual returns over the last five and half years simply cannot be sustained, and that a correction is in the offing which will bring those returns down to the historical average of 10 percent per year. When that correction occurs it will almost certainly overshoot to the downside. This is just simply a restatement of the other investment rule that pension managers have been hoping to ignore: "nothing ever grows to the sky."

Governments, workers, and taxpayers are shortly going to rediscover the validity of these rules and principles, to their detriment. The reemergence of reality will be painful.

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