Written by **Bob Adelmann** on September 7, 2015

Public Pension Plans Cut Rate of Return Targets; Still Not Enough

Twenty million pension plan beneficiaries have just been warned: You won't be getting what you have been promised when you retire. Part of the reason is that pension managers have been far too optimistic in estimating what they are able to earn on your money. And part of the reason is that they continue to remain so.

In its analysis of 126 public pension plans, the National Association of State Retirement Administrators (NASRA) noted that more than two-thirds of them have reduced their estimates, however slightly, since 2008, while 39 of them are still stuck with eight percent assumptions, higher than many of them have been able to achieve recently, and far higher than they are likely to accomplish going forward.

On Friday the New York State Common Retirement Fund, the nation's third-largest public pension plan when measured by assets under management, said it plans to drop its internal investment assumption to seven percent from 7.5 percent, which it has been using as a target for the last five years. A day earlier the San Diego County Employees Retirement Association announced its drop from 7.75 percent — ready? — all the way down to 7.5 percent.

And heavy duty discussions are taking place among the managers at CalPERS (the California Public Employees' Retirement System, the nation's largest) about whether it should drop its target below its current 7.5 percent. Others are jumping on board as well: Both the Oregon Public Employees Retirement System and the Texas Municipal Retirement System announced in July that they were dropping their targets by a breathtaking one quarter of one percent.

There was a time, back in the 1960s, when pension managers were realistic about what was possible. Using a combination of short- and long-term bonds, pension returns were between 3 and 3.5 percent. But then over time, mathematics, politics, and the increasing desire to offer more benefits without being troubled about how to pay for them took over. The math is simple: For every one percent increase in estimated returns, the need to fund the plans dropped by 12 percent. So, using these paper estimates, pension fund liabilities appeared to drop, allowing managers and their political overseers to spend pension money elsewhere.

It was magic. As managers expanded their portfolios to include stocks, real estate, commodities, and even investments in high-risk hedge funds, the estimated returns moved ever higher until the standard nearly across the board and the country became the magic number: 8.0 percent returns for as far as the eye could see.

But those eyes didn't see far enough. If one goes back to January 1, 1964 and tracks the performance of the Standard & Poor's 500 Index — made up of the prices of the stocks of 500 large companies having their stocks listed on either the New York Stock Exchange (NYSE) or the NASDAQ — its compound annual growth rate (CAGR) was 10.05 percent. If one uses January 1, 1994 as a starting point, that CAGR was 9.43 percent.

But if he starts from January 1, 2000, the CAGR is only 4.2 percent. Even if he starts from January 1, 2007, the CAGR of the S&P 500 is 7.04 percent.

And that would apply only to pension plans investing all their funds in stocks. They have only a percentage invested in stocks, with the rest "allocated" according to some fancy formula among other classes of investments.

Once behind the curve, however, it's nearly impossible to catch up. The Pew Charitable Trusts reported in July that state and local pension plans are not only underfunded by $1 trillion, but those liabilities actually increased last year by $54 billion, even in the face of enormous (but now apparently temporary) gains in stock valuations during that time.

Many of those states failed to meet even their minimum ARCs (annual required contributions) to their plans. The total for 2013 was supposed to be $92 billion, and yet states contributed only $74 billion. And among all 50 states, just 24 were able to contribute 95 percent of their ARCs.

Part of the problem is that, long before the start of the Great Recession, many of those plans were already desperately underfunded, thanks to politicians being only too willing to make promises they couldn't keep, and pension managers playing with the numbers to make the politicians' budgets balance. As Pew noted: "The recession exacerbated the challenges — but many states entered the recent downturn with fundamental weaknesses in their retirement systems that stemmed from early mistakes and decisions."

Part of the problem facing those anticipating retiring with promised benefits based on false or flagrantly optimistic assumptions is that future returns from stocks aren't like to be anywhere near what they recently have been. As Jason Zweig wrote in the *Wall Street Journal* just months before the current correction:

> After more than six years of a bull market [in stocks], investors should stare a cold, hard truth straight in the face: future returns on stocks are likely to be far slimmer than the fat gains of the past few years.

Just how much slimmer? Based on the historical fact that stock returns tend to equal the sum of two numbers: dividend yield (total dividends paid over the past year divided by the current share price) plus the inflation-adjusted rate of growth of those dividends, the future returns on stocks can be estimated with some precision. Today the dividend yield on the S&P 500 is about 2 percent. And the growth rate of dividends, for more than a century, has averaged about 1.5 percent, after inflation. 2.0 + 1.5 = 3.5 percent, or less than half the new downwardly revised estimates being touted by pension managers as being "more realistic." According to the NASRA, the "average target of 7.68 percent is the lowest since at least 1989." But that is still twice what Zweig and his formula are projecting on stocks for the future.

In a microcosm this is the same cold, hard reality faced by the U.S. government and those counting on it to fulfill its promises. In testimony before the U.S. Senate recently, Boston University Professor Laurence Kolthoff asserted:

> Almost all the liabilities of the government are being kept off the books by bogus accounting….
>
> The government is 58 percent underfinanced…. Social Security is 33 percent underfinanced … so the entire government enterprise is in worse fiscal shape than Social Security is, but they are both in terrible shape.

Just how bad? Explained Kotlikoff:

> If you take all the expenditures that the government is expected to make, as projected by the Congressional Budget Office (CBO), all the spending on defense, repairing the roads, paying for the Supreme Court Justices' salaries, Social Security, Medicare, Medicaid, welfare, everything and take all those expenditures into the future … and compare that to all the taxes that are projected to come in … the difference is $210 trillion. That's the fiscal gap. That's our true debt.

If one thinks of the present welfare state in America as one gigantic underfunded pension plan, one can see that the impact will not be limited just to those 20 million beneficiaries counting on receiving their promised benefits, but will be extended to every living soul with his dipper in the federal government trough.

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