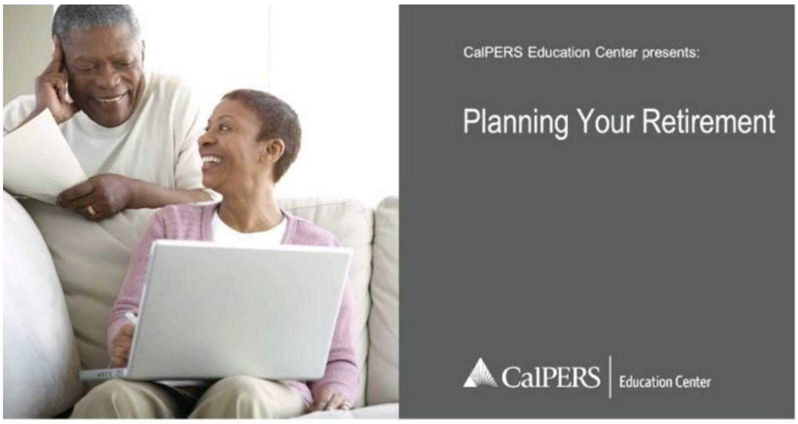
Large Pension Plans Adjusting Their Targets Downward



Heading into negotiations this past weekend between the California governor's office, teachers' unions, and pension plan trustees managing the California Public Employees' Retirement System (CalPERS), Governor Jerry Brown spoke the truth: "There's no doubt CalPERS needs to start aligning its rate of return expectations with reality."

Coming out of the meeting, the gap between the plan's target rate of return and reality remained immense.

The last time CalPERS faced reality and flinched was in 2012 when it dropped its target rate of return (the investment rate needed to guarantee that the plan would have the money to pay out to its beneficiaries when they retired) by one-quarter of a percent: from 7.75 percent to 7.5 percent. The trouble is, during the 12-month period ending June 30, 2016, the plan returned less than one percent: 0.61 percent to be exact.

This brought the plan's assets from $295 billion to $302 billion, still way short of the $450 billion the plan needs currently to be fully funded. What spurred the emergency meeting was that the plan this year paid out $18 billion in benefits but received only $13 billion in contributions. That's a negative of $5 billion and sufficient cause for the emergency gathering.

After a weekend of negotiations, CalPERS agreed to flinch once again, with the plan trustees agreeing to drop the target rate from 7.5 percent all the way down to — ready? — 7.35 percent next year. The following year? 7.25 percent. The year after that? 7 percent.

The CalPERS trustees and its various interested parties aren't alone in trying to come to grips with reality. The Illinois Teachers Retirement System dropped its target rate from 7.5 percent to 7 percent, matching the New York State and Local Retirement System's decision to cut its assumption to the same rate.

Earlier this month Connecticut's state employee retirement fund went from 8 percent, one of the highest in the country, to 6.9 percent, while the Hawaii Employee's Retirement System cut its target rate assumption from 7.55 percent to 7 percent.

The denial of reality can be seen by looking at the average target rate of 127 pension plans monitored by the National Association of State Retirement Administrators: it's currently 7.56 percent. And that's the lowest average since at least 1989.

Further downward adjustments will be forced upon these plans by the new investment reality. Since December 2014 the S&P 500 Index, which measures the price performance of the stocks of 500 companies, had gained nothing as of the day before the election. It was 2090 in December 2014 and it was 2090 on Monday, November 7. As this is being written, it is at 2268. That gain of 178 points, or 8.5 percent, has all come in the days since Trump was elected. And if a pension plan held all 500 stocks in that index, it would have earned 4.25 percent a year, way below the present dreaming by actuaries and plan trustees.

Robert Shiller's Cyclically Adjusted Price Earnings (CAPE) index jumped from 26.89 last month to 28.26 currently, a gain of 5 percent. The bad news is that the normal for Schiller's CAPE index is in the high teens. Just a reversion to the mean would knock hundreds of points off the popular stock market averages.

Most pension plans invest part of their funds in bonds, for safety first and yield second. The longer bonds yield the most, but their values are most susceptible to increases in interest rates. With the Fed raising rates last month and announcing further rate increases next year, those plans invested in long-maturity bonds are going to suffer substantial losses in their holdings.

Taking all that into account, Wilshire Associations told CalPERS in November that the fund's 10-year return would barely hit 6 percent.

One can only conclude that reality has yet to set in among those managing billions across the land. That new reality is going to wind up costing states, cities and townships (and their taxpayers) massive sums in order to meet the needs of, and keep the promises to, the plans' beneficiaries. It's possible that many of those plans won't be able to keep their promises, with beneficiaries bearing the brunt of the new reality that plan actuaries are still hiding from.

An Ivy League graduate and former investment advisor, Bob is a regular contributor to The New American *magazine and blogs frequently at LightFromTheRight.com, primarily on economics and politics. He can be reached at badelmann@thenewamerican.com.*