



## Pew Research: Gap Between Promises and Assets Widens for State Pensions

After reviewing the investment results for 230 public pension plans for the last two years, Pew [reported last Thursday](#) that, despite strong recent stock market performance, the gap between liabilities (promises) and assets for those plans widened by 17 percent, to \$1.4 trillion. Put another way, those plans should have nearly \$4 trillion in assets to enable them to keep their promises. The latest data shows them with just over \$2.5 trillion instead.



Said Greg Mennis, director of the project, “Many states face significant challenges in meeting pension promises to workers. The continued volatility [in stock market performance] and low investment returns are a reminder that policymakers cannot count on investment returns to close the pension funding gap.”

The numbers are daunting. Only one state — South Dakota — has fully funded its pension liabilities. The next four — Wisconsin, New York, North Carolina, and Tennessee — are close, averaging 97 percent funded. The really bad news is for the bottom five: Pennsylvania (55.8 percent), Connecticut (49.4 percent), Illinois (40.2 percent), Kentucky (37.8 percent) and, in last place, New Jersey, at 37.5 percent. It gets worse: Each of those bottom five has seen their liability shortfalls increase by between two and five percent over the last two years.

Until 2001, pension plan liabilities and assets were closely matched to each other. But following 9/11, the growth in assets failed to keep up with the increasing liabilities. By 2007, the gap was \$300 billion. Two years later the gap had widened to nearly \$800 billion. Once behind, it’s nearly impossible to catch up.

It’s easy to project into the future, especially if the stock market performance returns to normal. That funding gap will continue to get larger unless something miraculous, or realistic, happens.

There are numerous options — none of them attractive. One is to change the plan design so that the investment risk falls on the beneficiaries and not on the states or cities (and their taxpayers) offering the plans. Another is to put in place more realistic investment returns. Most plans estimate their assets will earn between 6.5 and 8 percent every year. For the last two years they have earned only 3.6 percent.

Still another option is to increase employer and worker contributions to close the gap. Some states have already implemented this option (e.g., Wisconsin), but they haven’t closed the gap. According to Pew, only 14 states are contributing enough to start closing the gap, known as net amortization.

Another more painful option would be to reduce further the interest assumptions in those 230 plans, in anticipation of additional future disappointments in stock market returns. For instance, the compound annual growth rate (annualized return) for stocks, adjusted for inflation, from January 2009 (just before



Written by [Bob Adelman](#) on April 24, 2017

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the Great Recession) through 2016, was 13 percent. This is far above the average CAGR going back to 1900: 8.4 percent. If stocks just revert to the mean, most of those state and local pension plans will not be able to make up for lost ground. And the problem with that “reversion to the mean” assumption is that when stocks do return to normal, they usually greatly underperform for years, putting those plans ever farther behind.

The risk is increased by plan administrators who might want to increase their stock exposure in light of the Trump rally which has pushed the market up by double digits just since November. Most plans have between a quarter and a third of their assets invested in stocks, and the temptation would be to increase that exposure.

This would be the very worst possible time to do that, according to the Warren Buffet “indicator.” That indicator compares the total market capitalization for all publicly traded companies to the country’s gross domestic product (GDP). If the indicator is at 100, it shows that stocks are reasonably priced. Today Buffet’s “indicator” is at 127.1. It’s been higher only two times since 1950. In 1999, just prior to the bursting of the dot.com bubble, it was at 153.6. In late 2015, it ticked up to 129.7 before relaxing somewhat.

There’s another indicator that shows where stocks are priced now: the Case-Shiller cyclically adjusted price-to-earnings (CAPE) ratio. By that measure the S&P 500 Index is overpriced by 75 percent.

Finally there’s the Wilshire 5000 Index compared to the market capitalization of all stocks in the Index (around 3,700, not 5,000). That ratio is trading at nearly 140, an all-time high.

That’s the problem facing asset managers trying to make up lost ground, thanks to overgenerous interest assumptions and decades-long underfunding. The final resolution will take years to play out, but the results will be the same: Pensioners won’t get what they’ve been promised; new employees will take on investment risk on their retirement funds; and taxpayers will be forced to ante-up more in taxes to fund higher contributions to the plans by their sponsors.

It’s the inevitability of the collision now occurring between simple mathematics and the “eighth wonder of the world”: compound interest. For the foreseeable future, the math is going to win.

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