Retirement News Highlights

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Public Pensions' New Inflation Dilemma

Caught between the Federal Reserve's new strategy for managing inflation and historically low bond yields, the plans now need to take a fresh look at their actuarial assumptions and inflation protection.

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To signal its intent to let the economy run a wee bit "hot" after the recession's end, seeking to restore full employment, the Federal Reserve has announced that it will fiddle with its inflation targets. It now calculates its trigger points over long periods, so it won't hit the brakes prematurely at the first sign of inflation. Meanwhile, the Fed has also crammed interest rates down by sopping up trillions of recent years' new deficit-funding U.S. Treasury bonds, which monetary mavens expect to later cause future inflation, perhaps toward the end of this decade.

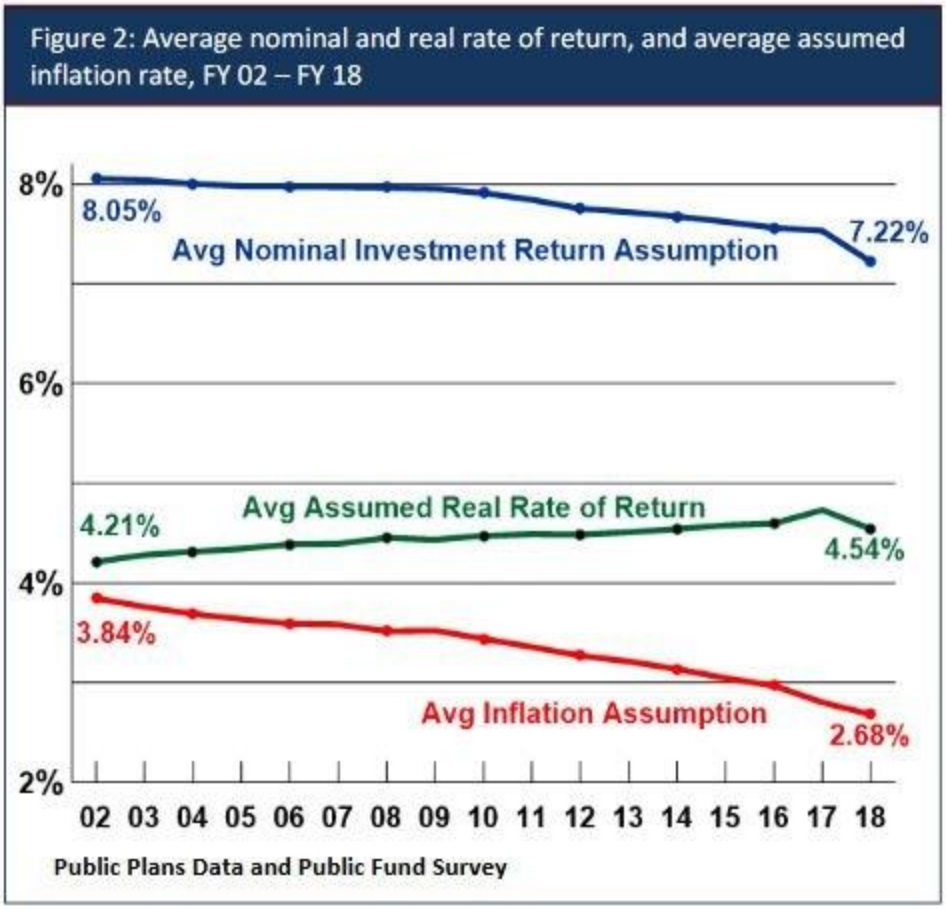
As a result, there's a new problem on the horizon for public pensions, one that will call for some thoughtful reassessments of the always fraught assumptions that underlie their funding structures.

The problem begins with bonds. One important consequence of these Fed actions is that the "real" yields (net of inflation) on Treasury Inflation-Protected Securities are now negative, ranging from minus 0.3 percent to minus 1.3 percent depending on when they mature. This has profound importance for pension funds. It means that today there is no way to secure inflation protection from risk-free government bonds without giving up principal. As a result, riskier assets like stocks and real estate may no longer provide a "free lunch" to protect retirees from future inflation while also reliably providing sufficient investment returns to fund the pensions.

When I began my career in public finance decades ago, a rough rule of thumb was that historical inflation rates over 50 years were 3 percent, while stocks yielded 10 percent and bonds returned 5 percent. So a diversified 60/40 portfolio of stocks and bonds was thus expected to return 8 percent before inflation and 5 percent net of inflation.

Let's fast-forward to today. Inflation expectations are now much lower than 3 percent, and the Fed has restated its 2 percent target. But high-quality bonds — not just the risk-free ones — no longer yield enough income to amply exceed even that level of inflation. So have public pension systems' portfolio investment-return expectations adjusted appropriately? And what are the actuarial implications for the retired-and-retiring baby-boom generation vs. the younger workers who joined these plans more recently?

Amid the rampant inflation of the 1970s, many public pension plans committed themselves to providing cost-of-living allowances to retirees. But the ground has shifted beneath us, and in today's market environment long-held plan-design assumptions no longer apply. Public employers and prudent public plan fiduciaries should schedule a "21st Century Inflation Chat" with their actuaries and consultants. It would help to educate employees, retirees and other stakeholders about the new drought parching their communal COLA money tree.



A good place to start is with the pension plans' investment and inflation assumptions. The most authoritative, highly respected source of data on this topic is the National Association of State Retirement Administrators. NASRA's annual Public Fund Survey is diligently compiled by the forthright Keith Brainard. The most relevant data from the latest NASRA survey is contained in Figure 2 from its accompanying issue brief. The data, displayed here, tracks the averages for public pensions' investment and inflation assumptions from 2002 to 2018:

• Between 2002 and 2018, pension funds reduced their composite annual investment-return expectations by 83 basis points (0.83 percent) , from 8.05 to 7.22 percent. This is widely hailed as a movement to realism, although it mostly reflects the steep decline in bond yields.

• Inflation expectations built into the pension plans' actuarial calculations have declined even more sharply, by 116 basis points, from 3.84 to 2.68 percent per annum. (Note that, actuarially, lower actual inflation would beneficially reduce the plans' future baby-boomer COLA liabilities.)

• The plans' average assumed annual real rate of return (net of inflation) has thus increased over the past decade, by 33 basis points, from 4.21 to 4.54 percent. That uptrend seems dubious.

Stocks and popular "hard assets" like gold now trade at premium prices. Bond yields are the lowest in our lifetimes, pushing their market prices to record levels that will suffer badly if inflation returns. So the central question that pension decision-makers must ask themselves is whether it is now realistic to expect that the real rates of return on pension portfolios will remain persistently higher for decades to come, and particularly if monetary inflation erupts.

The second question, and perhaps the most directly relevant to their inflation enigma, is whether public pension plans can continue to rely on the backstop that financial markets had historically given them to cover the COLAs baked into the benefits payable to retirees.

I fully realize that this stirs up a hornet's nest that most folks in the pension world would much prefer to sidestep. My point here is not to deprive current retirees of benefits they were promised or to take away benefits already earned by

current employees. But it's time for honest, independent assessments of the long-held assumptions that investment returns can be sufficient to fund COLAs indefinitely while also paying off today's combined trillion-dollar unfunded liabilities.

This affects different generations differently. One could argue that baby boomers' pension and COLA benefits are now actually running at a lower rate of increase than the actuaries had once assumed. (The problem with boomers is not their COLAs; it's their heretofore-underfunded benefits.) Conversely, the cost of COLAs for younger workers could break the bank in future decades if monetary inflation resurfaces. Worse, the 2030s and '40s markets could mirror the 1970s, crushing pension fund portfolios.

In the private sector, purchasers of retirement annuities have a choice: They can buy standard policies that pay a non-escalating benefit, or they can pay more to secure future inflation adjustments. Many public pensions, on the other hand, have installed caps on their COLAs to avoid runaway costs, but these caps have a perverse way of being lifted when elderly and disabled retirees swarm televised public hearings. One worthwhile reform would be to give non-vested younger employees and new hires a plan option to secure supplemental pension inflation protection at their own expense through a higher corresponding employee-contribution rate. This better aligns costs with benefits, and also inhibits unfunded increases.

A few states link COLA caps to the plans' funding progress. This squarely addresses the issue of future investment shortfalls: They are shared by all parties, not just employers. It's a logical concept but very difficult to implement, given the entrenched interests in pension politics.

This is an uncomfortable discussion, and probably an unwelcome topic in many circles. But the problem is real. Like the coronavirus, it will not fade away just because folks choose to deny, dismiss or ignore it.