

Dow Jones Reprints: This copy is for your personal, non-commercial use only. To order presentation-ready copies for distribution to your colleagues, clients or customers, use the Order Reprints tool at the bottom of any article or visit www.djreprints.com

See a sample reprint in PDF format.

Order a reprint of this article now

THE WALL STREET JOURNAL.

WSJ.com

OPINION | Updated April 9, 2013, 7:21 p.m. ET

Andy Kessler: The Pension Rate-of-Return Fantasy

Counting on 7.5% when Treasury bonds are paying 1.74%? That's going to cost taxpayers billions.

By ANDY KESSLER

It has been said that an actuary is someone who really wanted to be an accountant but didn't have the personality for it. See who's laughing now. Things are starting to get very interesting, actuarially-speaking.

Federal bankruptcy judge Christopher Klein ruled on April 1 that Stockton, Calif., can file for bankruptcy via Chapter 9 (Chapter 11's ugly cousin). The ruling may start the actuarial dominoes falling across the country, because Stockton's predicament stems from financial assumptions that are hardly restricted to one improvident California municipality.

Stockton may expose the little-known but biggest lie in global finance: pension funds' expected rate of return. It turns out that the California Public Employees' Retirement System, or Calpers, is Stockton's largest creditor and is owed some \$900 million. But in the likelihood that U.S. bankruptcy law trumps California pension law, Calpers might not ever be fully repaid.



Getty Images

So what? Calpers has \$255 billion in assets to cover present and future pension obligations for its 1.6 million members. Yes, but . . . in March, Calpers Chief Actuary Alan Milligan published a report suggesting that various state employee and school pension funds are only 62%-68% funded 10 years out and only 79%-86% funded 30 years out. Mr. Milligan then proposed—and Calpers approved—raising state employer contributions to the pension fund by 50% over the next six years to return to full funding. That is money these towns and school systems don't really

have. Even with the fee raise, the goal of being fully funded is wishful thinking.

Pension math is more art than science. Actuaries guess, er, compute how much money is needed today based on life expectancies of retirees as well as the expected investment return on the pension portfolio. Shortfalls, or "underfunded pension liabilities," need to be made up by employers or, in the case of California, taxpayers.

In June of 2012, Calpers lowered the expected rate of return on its portfolio to 7.5% from 7.75%. Mr. Milligan suggested 7.25%. Calpers had last dropped the rate in 2004, from 8.25%. But even the 7.5% return is fiction. Wall Street would laugh if the matter weren't so serious.

And the trouble is not just in California. Public-pension funds in Illinois use an average of 8.18% expected returns. According to the actuarial firm Millman, the 100 top U.S. public companies with defined benefit pension assets of \$1.3 trillion have an average expected rate of return of 7.5%. Three of them are over 9%. (Since 2000, these assets have returned 5.6%.)

Who wouldn't want 7.5%-8% returns these days? Ten-year U.S. Treasury bonds are paying 1.74%. There is almost zero probability that Calpers will earn 7.5% on its \$255 billion anytime soon.

The right number is probably 3%. Fixed income has negative real rates right now and will be a drag on returns. The math is not this easy, but in general, the expected return for equities is the inflation rate plus productivity improvements plus the expansion of the price/earnings multiple. For the past 30 years, an 8.5% expected return was reasonable, given +3%-4% inflation, +2% productivity, and +3% multiple expansion as interest rates plummeted. But in our new environment, inflation is +2%, productivity is +2% and given that interest rates are zero, multiple expansion should be, and I'm being generous, -1%.

So what to do? I recall a conversation from 20 years ago. I was hoping to get into the money-management business at [Morgan Stanley](#). I wanted to ramp up its venture-capital investing in Silicon Valley, but I was waved away. It was explained to me that investors wanted instead to put billions into private equity.

One of the firm's big clients, [General Motors](#), had a huge problem. Its pension shortfall rose from \$14 billion in 1992 to \$22.4 billion in 1993. The company had to put up assets. Instead, Morgan Stanley suggested that it only had an actuarial problem. Pension money invested for an 8% return, the going expected rate at the time, would grow 10 times over the next 30 years. But money invested in "alternative assets" like private equity (and venture capital) would see expected returns of 14%-16%. At 16%, capital would grow 85 times over 30 years. Woo-hoo: problem solved. With the stroke of a pen and no new money from corporate, the GM pension could be fully funded—actuarially anyway.

Things didn't go as planned. The fund put up \$170 million in equity and borrowed another \$505 million and invested in—I'm not kidding—a northern Missouri farm raising genetically engineered pigs. Meatier pork chops for all! Everything went wrong. In May 1996, the pigs defaulted on \$412 million in junk debt. In a perhaps related event, General Motors entered 2012 with its global pension plans underfunded by \$25.4 billion.

In other words, you can't wish this stuff away. Over time, returns are going to be subpar and the contributions demanded from cities across California and companies across America are going to go up and more dominoes are going to fall. San Bernardino and seven other California cities may also be headed to Chapter 9. The more Chapter 9 filings, the less money Calpers receives, and the more strain on the fictional expected rate of return until the boiler bursts.

In the long run, defined-contribution plans that most corporations have embraced will also be adopted by local and state governments. Meanwhile, though, all the knobs and levers that can be pulled to delay Armageddon have already been used. California, through Prop 30, has tapped the top 1% of taxpayers. State employers are facing 50% contribution increases. Private equity has

shuffled all the mattress and rental-car companies it can. Buying out Dell is the most exciting thing they can come up with. Expected rates of return on pension portfolios are going down, not up. Even [Facebook](#) millionaires won't make up the shortfall.

Sadly, the only thing left is to cut retiree payouts, something Judge Klein has left open. There are 12,338 retired California government workers receiving \$100,000 or more in pension payments from Calpers. Michael D. Johnson, a retiree from the County of Solano, pulls in \$30,920.24 *per month*. As more municipalities file Chapter 9, the more these kinds of retirement deals will be broken. When Wisconsin public employees protested the state government's move to rein in pensions in 2011, the demonstrations got ugly—but that was just a hint of the torches and pitchforks likely to come.

Meanwhile, it's business as usual. California Gov. Jerry Brown released a state budget suggesting a \$29 million surplus for the fiscal year ending June 2013 and \$1 billion in the next fiscal year. Actuarially anyway.

Or as Utah Rep. Jason Chaffetz told Vermont Gov. Peter Shumlin, upon learning at a 2011 House hearing about that state's unrealistic pension assumptions: "If someone told me they expected to get an 8% to 8.5% return, I'd say they were probably smoking those maple leaves."

Mr. Kessler, a former hedge-fund manager, is the author most recently of "Eat People" (Portfolio, 2011).

A version of this article appeared April 10, 2013, on page A13 in the U.S. edition of The Wall Street Journal, with the headline: The Pension Rate-of-Return Fantasy.

Copyright 2012 Dow Jones & Company, Inc. All Rights Reserved

This copy is for your personal, non-commercial use only. Distribution and use of this material are governed by our [Subscriber Agreement](#) and by copyright law. For non-personal use or to order multiple copies, please contact Dow Jones Reprints at 1-800-843-0008 or visit www.djreprints.com