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Pension Gaps Loom Larger

Funds Stick to 'Unrealistic' Return Assumptions, Threatening Bigger Shortfalls

By DAVID REILLY

Many of America's largest pension funds are sticking to expectations of fat returns on their investments even after a decade of paltry gains, which could leave U.S. retirement plans facing an even deeper funding hole and taxpayers on the hook for huge additional contributions.

The median expected investment return for more than 100 U.S. public pension plans surveyed by the National Association of State Retirement Administrators remains 8%, the same level as in 2001, the association says.

The country's 15 biggest public pension systems have an average expected return of 7.8%, and only a handful recently have changed or are reconsidering those return assumptions, according to a survey of those funds by The Wall Street Journal.

Corporate pension plans in many cases have been cutting expectations more quickly than public plans, but often they were starting from more-optimistic assumptions. Pension plans at companies in the Standard & Poor's 500 stock index have trimmed expected returns by one-half of a percentage point over the past five years, but their average return assumption is also 8%, according to the Analyst's Accounting Observer, a research firm.

The rosy expectations persist despite the fact that the Dow Jones Industrial Average is back near the 10,000 level it first breached in 1999. The 10-year Treasury note is yielding less than 3%, and inflation is running at only about 1%, making it tougher for plans to hit their return targets.

Return assumptions can affect the size of so-called funding gaps—the amounts by which future liabilities to retirees exceed current pension assets. That's because government plans use the return rates to calculate how much money they need to meet their future obligations to retirees. When there are funding gaps, plans have to get more contributions from either employers or employees.

The concern is that the reluctance to plan for smaller gains will understate the scale of the potential time bomb facing America's government and corporate pension plans.

"It's unrealistic," [John Bogle](#), founder of mutual fund giant Vanguard, says of the return assumptions in place at most pension plans.

Pension funds at companies in the S&P 500 faced a \$260 billion shortfall at the end of 2009, according to Standard & Poor's. Estimates of the fund deficits faced by state and local governments range from \$500 billion to \$1 trillion.

Some plans are beginning to trim their return forecasts.

Earlier this month, New York State Comptroller Thomas DiNapoli said he would reduce the expected rate of investment return for his state's pension system, the third-largest in the nation, to 7.5%, from 8%.

The country's two biggest plans—the California Public Employees Retirement System, or Calpers, and the California State Teachers' Retirement System, or CalSTRS—both are undergoing reviews of projected investment returns that could lead to reductions later this year.

Many plans have held onto an 8% return expectation though thick and thin. Such return assumptions partly reflect the heady years of the 1990s bull market. Public pension plans posted a median, annualized return of 9.3% over the past 25 years, but just 3.9% over the past 10, according to consulting firm Callan Associates.

The Oregon Public Employees Retirement System has had an 8% assumption since 1989. Its actual return averaged 10.7% annually from 1970 through 2009. The Teachers Retirement System of Texas has had a similar expectation since 1986, with an annual return of 9% return since then.

A spokeswoman for the Texas system said it doesn't change assumptions "in response to short-term situations," and currently "sees no reason to change our investment-return assumption." A spokesman for the Oregon system said there are no special plans to review its return expectation.

The challenge for many plans, given investment horizons that can stretch out 50 years, is gauging which time period to look at when charting a future course.

George Diehr, vice president of the Calpers board, said in May that the question is whether the credit crisis has "dramatically altered long-held assumptions about investing in the world's financial markets. Are investors in for a sustained period of meager or below-market growth? Or will the traditional business and economic cycles, the ones investors have grown accustomed to over the past couple of decades, return?"

The outcome of Calpers's ongoing review "hangs on how we answer that question," a spokesman says.

Depressed stock prices aren't the only thing putting pressure on potential returns. Plummeting bond yields mean that plans' fixed-income portfolios will likely earn less in the future. A lower inflation outlook means that funds will have to generate greater real returns to meet their return targets.

Funds use a so-called discount rate to estimate the size of future obligations to retirees, and thus the contributions needed to fund them. Corporate plans use a discount rate based on corporate bond yields. But government plans use their expected return rate on all investments as their discount rate.

The higher the discount rate, the smaller a fund's pension obligation. That gives public plans another big reason to hesitate before cutting their expected return rates.

The Colorado Public Employees Retirement Association showed in its 2009 financial report the impact of reducing the rate. Using a 8% expected return rate, the plan faced a \$23.4 billion deficit, based on market values, at the end of 2009. If the rate was cut to 6.5%, the shortfall would jump to \$34 billion.

Meredith Williams, the Colorado plan's chief executive, says cutting the rate "creates pain." Nevertheless, Colorado at year-end of 2009 cut its return assumption to 8%, from 8.5%. Mr. Williams says the rate may be lowered again later this year.

Others have been more hesitant. In 2009, Matt Smith, state actuary for Washington state, recommended that its retirement system cut its return expectation to 7.5%, from 8%. That advice was rejected by the state's pension-funding council.

Mr. Smith says he thinks Washington and other states eventually will lower expected returns, but that it will be a slow process because reduced assumptions "will increase the cost of pension benefits, and right now the budgetary environment is a big obstacle to that."

Pension plans say they take a decades-long view of potential returns. "We can't knee-jerk our way through this. Funding a retirement system is a long-term proposition," says David Stella, secretary of Wisconsin's department of employee trust funds. Last year Wisconsin's plan reviewed its expected return rate of 7.8% and remains comfortable with it, he says.

Companies have found out the hard way that their options are limited. From 2005 to 2009, S&P 500 companies with pension plans expected to generate about \$475 billion in returns. The actual returns were only about \$239 billion, a 50% undershoot, according to Jack Ciesielski of the Analyst's Accounting Observer.

In recent years, some funds have tried to boost returns by shifting funds out of stock and into alternative investments such as hedge funds or private equity.

Some find this approach too risky. This summer, the Virginia Retirement System cut its expected investment rate to 7%, from 7.5%, giving it the lowest assumption among the nation's 15 largest pension systems. The shift began in 2005, when the plan's board cut the rate to 7.5%, from 8%.

"There was a general thinking that equity markets were unlikely to repeat the period of the 1990s," explains director Robert Schultze.

The alternative was to take more risk, he says, but the board didn't want to "stretch or be swinging for the fences" to meet higher investment expectations.

Other plans, he predicts, will follow suit. "I just think people are going to be coming off that 8% view," he says.

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