Time to stop high-risk gamble

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It's time for U.S. public employee pension plans to lower the risk profiles of their investment portfolios.

U.S. public funds have become the biggest risk-takers among pension funds internationally, according to a study by Aleksandar Andonov of Erasmus University Rotterdam, Rob Bauer of the University of Toronto and Martijn Cremers of the University of Notre Dame.

Their research shows that as U.S. Treasury rates declined, U.S. private pension plans and Canadian and European plans reduced their discount rates, but U.S. public plans did not, and those public funds increased their funds' risk profiles. That is, U.S. public employee pension plans are taking more risk in their funds than their U.S. private and international peers.

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their performance."

That is, despite the greater risk assumed, U.S. public plans underperform the U.S. private and non-U.S. funds studied by about 50 basis points a year, and their underperformance is substantially worse if the fund is more mature.

"A 10% increase in the maturity of U.S. public pension funds is associated with 38 to 58 basis points lower returns," they reported in the study. That is U.S. public pension funds with a higher percentage of retired members invest more in risky assets, maintain higher liability discount rates, and obtain lower returns.

Andrew Biggs, resident scholar at The American Enterprise Institute for Public Policy Research, told a Harvard seminar on state pension underfunding in October that pension plans in the Netherlands, "which are widely considered among the best-funded in the world, use a discount rate of just 3.5%. The U.K. and Canada valued liabilities using interest rates of between 4% and 6%." Public funds in the U.S. use an average discount rate of 7.6%.

"Using a common discount rate, U.S. state and local plans would be shown to have set aside only about half as much funding per unit of promised future benefits as do Dutch pensions," Mr. Biggs told the seminar, sponsored by the Mossavar-Rahmani Center for Business and Government. "Given that the benefits promised by these plans are qualitatively similar, it stands to reason that someone must be wrong: Either Dutch pensions are systematically overfunding their future benefits or U.S. pensions are underfunding them."

That is, U.S. public employee plans are still underfunding their obligations, with higher-risk portfolios being used to justify high discount rates that disguise the true level of underfunding, which according to some scholars, is as much as $3.85 trillion.

With most economists predicting long-term returns from stocks will be about 5% per year, not 7.6%, it's time for public fund executives to end their high-risk, high-return gamble. It is more likely to end badly, and taxpayers will pay the price in higher taxes or poorer services.

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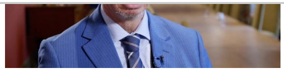

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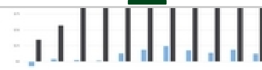

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