Pension Returns Slump, Squeezing States and Cities

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Demonstrators from Erie, Pa., rallying at the Pennsylvania Capitol in Harrisburg last month to press for more state aid for district schools. ENLARGE

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Long-term returns for U.S. public pensions are expected to drop to the lowest levels ever recorded, portending deeper pain for states and cities as a $1 trillion funding gap widens.

Twenty-year annualized returns for public pensions in the U.S. are poised to decline to 7.47% once fiscal 2016 results are released in coming weeks, according to an estimate from Wilshire Trust Universe Comparison Service, which tracks pension investment returns.

That would be the lowest-ever annual mark recorded by Wilshire, which began tracking the statistic 16 years ago. In 2001, near the height of the dot-com boom, pensions' 20-year median return was 12.3%, according to Wilshire.

The dip is intensifying a national debate over whether states and cities can continue to afford pension obligations, as the soaring costs are squeezing budgets across the U.S.

"Many states and local governments may be facing difficult choices if investment returns remain low," said Keith Brainard, research director at the National Association of State Retirement Administrators. "The money has to come from somewhere."

Connecticut now allocates 10% of its budget to pay down unfunded pension liabilities that more than doubled in size over the past decade. Chicago's $20 billion pension-funding hole prompted its credit rating to tumble to junk, a rare low mark for an economically diverse city.

A reminder of how long-term fortunes have turned came last week as two pension bellwethers reported their worst results since the 2008-09 financial crisis.

Weak annual gains for the California Public Employees’ Retirement System and California State Teachers’ Retirement System dropped their 20-year returns below 7.5% investment targets, to 7.03% and 7.1%, respectively. The two funds, known as Calpers and Calstrs, are the largest public pensions in the U.S. by assets and oversee a combined $484 billion for 2.6 million public workers and retirees.

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The drop in 20-year annualized returns is significant because officials who oversee retirements for police officers, firefighters, teachers and government workers have long said one bad year or two isn’t as important as the long-term average, and they would earn enough money over decades to pay for retiree obligations.

Those long-term returns have dropped below expectations due in large part to two recessions over the past 15 years and a sustained period of low interest rates. Pension funds invest heavily in fixed-income securities, so the loss of a few percentage points of bond yield hinders their ability to post steady returns.

Funding shortcomings often mean taxpayers or workers are asked to chip in more to account for rising liabilities. Every one-percentage-point drop in investment returns represents an increase of 12% in liabilities, according to the Center for Retirement Research at Boston College.

In Erie, Pa., schools are struggling to afford the basics because pension costs have nearly tripled in the past five years, said city schools Superintendent Jay Badams.

Students in Erie receive stapled copies of “Everyday Mathematics” rather than the hardcover textbook. Two winters ago, 21 buckets were needed to catch all the leaks from the ceiling of a second-grade classroom following a snowstorm. Since 2011, one-fifth of the workforce has been eliminated and three schools have closed.

“Our pension costs have been a major expense that force us to spend less on students and more on employee benefits,” Mr. Badams said.

The increased payments reflect a push to make the required contributions into the state's retirement systems, following years of failing to do so, according to a spokeswoman for the Pennsylvania Public School Employees' Retirement System. Pennsylvania is making the full required contribution for the first time in 15 years for the fiscal year that started July 1, the spokeswoman said.

Pennsylvania state leaders are debating whether to pass pension changes that would cycle certain workers into cheaper 401(k)-style plans. Poor returns will trigger a "greater sense of urgency" and "escalates the conversation" around stepping away from the traditional pension, said Pat Browne, a Republican state senator who is involved with proposed changes to the state pension system.

Many states and cities tried to narrow funding gaps following the last financial crisis by passing a series of changes to benefits. But even as those moves were made, a sustained period of low interest rates pulled down returns just as a wave of new retirees started to collect pension checks.

If funding continues to slide, pension critics have more ammunition to argue for more aggressive benefit cuts, said Daniel DiSalvo, a senior fellow at the Manhattan Institute, a conservative think tank that supports 401(k)-style options for public pensions.

"The basic question the public will have is: 'Didn't we already reform these systems and shore them up in the wake of the recession?' " Mr. DiSalvo said. "But here we are back at square one."

In California, the incoming head of the largest U.S. public pension isn't ruling out changes. Marcie Frost, who starts as Calpers' chief executive in October, said on a July 14 call with reporters that she is an advocate for traditional pension benefits but couldn't say "whether the full [defined-benefit] plan is…the right plan" for California.

"We always have to think about what options might be out there," Ms. Frost said. A spokesman for Calpers said Ms. Frost has yet to have meaningful discussions with the retirement system's board or senior leaders about priorities and initiatives.

Ms. Frost's comments came days before Calpers said that its fiscal 2016 return was 0.6%, the slimmest gain since the 2008-2009 crisis. Calpers has a funding gap of roughly $112 billion, according to the most recent available data. As recently as last year, Calpers Chief Investment Officer Ted

Eliopoulos said in an annual letter that the plan was “reassured by our 20-year investment return of 7.76%,” which exceeded the internal target of 7.5%.

Now, “it is a struggle to have a positive return,” Mr. Eliopoulos said in a media call last week.

The decline in 20-year returns wasn’t surprising after two recessions in the last decade, said Christopher Ailman, Calstrs’ chief investment officer. They were like “Pearl Harbor and the great recession happening in a seven-year time period,” he said.

“It’s a marathon, so the first 10 years our pace was good and strong,” Mr. Ailman said. “The last 10 was more uphill and the pace was slower.”

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