THE “OTHER” INTEREST RATE PROBLEM

You sure don’t need us to remind you that attempting to find any semblance of rate of return in what are considered “safe” assets such as bank CDs, short term US Treasuries, etc. has been difficult at best across the period from 2009 to present, and at worst, near impossible. For risk averse investors, this has been quite the difficult period, forcing many to take investment risks they never would have considered in prior market cycles. This issue has been especially pressing for retirees. In stark reality, the Fed has removed very meaningful income generation for the typical risk averse investor. It’s no wonder why personal consumption is struggling and retailers like Macy’s are closing 100 stores nationwide. Quite the mystery.

The members of the Fed certainly are not ignorant of the consequences of their actions. They have chosen to support equity and real estate markets, as well as financial institutions at what in hindsight has become the expense of savers. Please remember, the Fed is not a government institution. Its primary mandate at creation is to provide the US with a safe, flexible, monetary and financial system. In English? Its primary mandate is to ensure the solvency of the US banking system, the very banking system close to the brink of collapse in 2009. Historically low interest rates have allowed US banks to heal over the last 7 years.

Although not widely covered, the effect Fed actions have had in terms of eliminating safe rate of return from the financial markets far from stops at the household saver. In fact, it is now becoming an “effect” that may cost US taxpayers dearly in the decades ahead.

Relatively quietly, and in some geographic locations not so quietly, pension underfunding issues that have been brewing for years, if not decades, are slowly finding their way from the back page of the newspaper to the front. The Illinois State Teachers fund (the largest pension fund in the State), for example, can be characterized as being in current crisis with very few options for resolution except much higher taxes in the State of Illinois. Even that may not make the numbers work for this fund longer term. Illinois is not alone, they’re just one of the very first to arrive at the pension funding crisis party, a party that in good part has been instigated by the inability of pension funds to achieve needed financial asset rate of return to meet their obligations. In past financial market cycles, pension funds have been able to rely on adequate rate of return in the bond portion of their investment mix as well as the equity and alternative investment side to achieve their funding goals. That is no longer true in the world of bonds.

The fact is that the Fed holding interest rates near zero for seven years now has negatively impacted investment returns for pension funds at the exact time their payout requirements have accelerated due to baby boomer retirements. Despite the second longest stock bull market in the history of the market, pension funds in the US, and most specifically public pension funds, remain meaningfully underfunded. Just what happens when the market cycle ultimately turns down and the value of investments falls?

Let’s define a bit of what is going on with pension fund accounting and look at a direct example that is the second largest pension fund in the US, and one close to home – CALPERS. One of the most important numbers for a pension fund is its assumed “actuarial rate of return.” In English, this is the rate of return a fund must earn in order to pay out its long-term projected benefits to all beneficiaries. For CALPERS, that number is 7.5% annually. If a fund does not earn its actuarial rate of return, it can become “underfunded,” meaning the only way it can be made whole again is either via increased future contributions from employers/employees, or hoped for future investment returns above the actuarial rate. For public pension funds, only higher taxes in the geographic region will help fund employer side contributions as taxes are the source of funds for public/government entities – exactly as we are seeing in Illinois right now. Relative to its 7.5% long-term return assumption, CALPERS earned 2.4% in its fiscal year ended June 30, 2015 and 0.6% (no, this is not a typo) for the year ended June 2016. Over these two consecutive years, CALPERS missed its return mandate by close to 12%. A number quite meaningful for a $300 billion fund, implying a roughly $35 billion miss in needed investment returns over just the last 2 years. Again, it’s not just household savers starving for rate of return in the current environment, they have a kindred spirit in US public pension funds.

Of course the Fed is not directly responsible for the investment outcomes at CALPERS, but they have helped create a financial market environment of difficulty by systematically removing rate of return for fixed income (bonds) investors. Think about it, if CALPERS bought a ten year US Treasury bond today and held it to maturity, it would earn roughly 1.6% annually. It would need another investment earning approximately 13.4% for ten straight years to achieve a blended 7.5% return on its total investment. Just where can that be found? This is the exact dilemma faced by investors today, as the Fed continues to believe crisis period interest rate levels remain appropriate. Trust us, the Fed is fully aware of the financial condition of the US public pension funds and what its policies of the last seven years have done to in part to help create the pension funding issues of the present.

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Just how important are investment returns to a pension fund like CALPERS? The most recent numbers tell us that for every dollar paid out by CALPERS to beneficiaries, the source of funds was 15% employee contributions, 21% employer contributions and 64% investment returns. To suggest investment returns are crucial for public pension plans in meeting their longer term financial goals is an understatement. Just who makes up for a potential shortfall in assumed investment returns? Employees and/or their employers. Of course by "employers," we mean taxpayers, being the funding source for public governmental entities.

One last issue quite important to public pension funds, and ultimately to jurisdiction specific taxpayers. The "underfunding" problem for pension funds is not something that has sprung up out of nowhere over the last seven years. It has been an issue for a very long time now, only exacerbated in the current environment with low rate of return on investments. Moreover, US public pension funds calculate their unfunded liabilities in a different manner than do public pension funds worldwide and corporate pension funds in the US. Their assumptions are much more liberal than we see on the corporate side and across global public pension funds. Here is an example. In the year 2011, CALPERS calculated its unfunded obligations at $85.5 billion. Alternatively, in that same year the Stanford Institute for Economic Policy Research calculated the CALPERS unfunded obligation at $170 billion. Which number is correct? Of course, the right answer is only time will tell.

What does all of this mean as we look forward? The public pension funding crisis is real. We suggest it will be a front page item in the next financial market downturn. The Pension Task Force of the Actuarial Standards Board in the US calculates unfunded pension liabilities for all state and local government pensions in the US at $5 trillion as of a few months ago, and this is after the second longest stock bull market in history and the largest bull market in bonds now lasting over 35 years. Will these lucky streaks in financial asset returns be replicated in the years ahead? If not, taxpayers will be asked to fund shortfalls? Again, this is exactly what is occurring in Illinois right now. Keep your eyes on this posterchild for other state pension outcomes in the future.

What we are also seeing is that at the margin, public pension funds are now increasing their allocations to higher risk assets, given the void of rate of return in safe assets engineered by the Fed. We've spoken of Warren Buffet's favorite stock market valuation indicator that is the value of all stocks relative to GDP many a time. This number shows us the second highest valuation in history at present, only eclipsed by what was seen in the year 2000. Is now the time public pension funds should be increasing their allocation to higher risk assets? The fact is that given the artificial interest rate environment of the moment, they have no choice if they even hope to achieve needed rates of return. They have been backed into a corner by broad financial market conditions.

Remember, pension funds have very long term obligations. Their payouts will happen over multiple decades, not tomorrow. This has been the mantra of public officials for years now, but the reality is that the public pension fund retiree rolls are growing faster than ever given the demographics of the baby boom generation and this will only accelerate ahead. In other words, the "piper" has officially shown up. In a world where investment returns may remain muted for time, the resolution of public pension underfunding will be resolved with either benefit reductions or higher public taxes to fund these obligation shortfalls. So far, and in many cases, the US Government has ruled pension benefit reductions will not occur, and that leaves higher taxes as the only viable solution of the moment. This is exactly what is now occurring in Illinois.

We see this as the "other" interest rate problem that simply does not receive the attention it deserves. As risk managers, we need to anticipate tomorrow's meaningful issues that could impact the US economy and financial markets well before they become reality. If we can correctly anticipate tomorrow's meaningful issues, we can hopefully avoid colliding with investment icebergs on moonless nights.