Questions from Representative Ron Kind

Question 1: Could you please provide information on the historical investment returns of public pension plans over the long term (for example, 30 or 25 years) and the returns of such plans over the short-term (for example the last 10 and 5 years and the last year)?

Answer 1: Over the 25 years ending 12/31/2010, the average annual investment return has been 8.8 percent. Over the past 10 years, it has been 5% and over the past 5 years it has been 4.5%. The last year, 2010, it was 13.1 percent.

Although there were substantial losses during the last two recessions, which pulled down the growth rate for the past 10 years and the past 5 years, strong growth in recent years has allowed pension funds already to recoup about two-thirds of the $900 billion in asset losses they experienced during this most recent recession.

Question 2: A recent CBO issues brief on public pension plan funding was introduced into the record at the hearing and one of the concerns noted in the brief regarding the use of a riskless rate to discount plan liabilities is the volatility of the plan liabilities from year to year. You make the same observation in your written testimony — for example, what sort of fluctuations would have occurred in the past if the riskless rate had been used?

Answer 2: Between 1980 and 1985, the yield on 30-year Treasury Bonds — a proxy for the riskless rate — exceeded 10%, peaking at 13.45% in 1981. The yield then hovered between 7% and 9% for the next 7 years, and between 5% and 7% through 2002. Between 1977 and 2002, the yield averaged 8.4%, as compared with a yield close to 4% today.

There was some substantial year-to-year volatility: a 2 percentage point increase from 1979 to 1980, and a 3 percentage point drop from 1985 to 1986, for example. The latter could have required a sudden increase in contributions. Rates have changed less dramatically recently, but the 1990s were characterized by year-to-year drops and increases in the one-half to one percentage point range. Yields were 4.91% in 2006, but less than 4% today. And each percentage point difference in the discount rate may have a substantial effect on required contributions, averaging something like one percent of state and local budgets.

It is worth noting that the period with the high yields was also the period in which state and local governments were transitioning from pay-as-you-go to pre-funded pension plans, a transition that began in the 1970s. If plans had at that time estimated their liabilities using Treasury bonds as the benchmark for their discount rate, they would have been required to deposit only small amounts into their pension funds, and funding arguably would not have grown to reach full funding in 2000.

Testimony by another witness at the hearing, Jeremy Gold, illustrates the lack of connection between the Treasury rate and the funding needs of a pension plan.

Gold wrote: "Based on recent data reported by various sources (and analyzed by Novy-Marx and Rauh among others), revealing massive unfunded liabilities…, it is very likely that future taxpayers are going to be severely burdened by pension obligations incurred in conjunction with public services that have already been rendered. This has not always been the case. A similar analysis, had it been performed any time during the 1980's would have revealed significant pension plan surpluses… attributable to the high rates of interest available in the U.S. Treasury markets compared to relatively low rates used to value public pension plans at that time."

In other words, if the same amount of assets and promises as exists in today's pension had been analyzed using 1980s interest rates, the results would show overfunding rather than today's unfunded liabilities.