What Can't Be Sustained Will Not Be Sustained

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In this Newsletter Issue:

Oversaturation of Information.
Making sense of financial news and market-based investments has been getting more difficult as of late. It seems that on every channel and within every news outlet someone knows exactly and most precisely why and when the future will occur. I too share my thoughts regarding my view of financial news and market based investments with clients and others who read my newsletter. However, far from being a clairvoyant, I steer clear of trying to predict the future. At most I can certainly hope that my knowledge of finance can draw some simplistic conclusions of what type of investments will do well in the environment we are in or where I think we will be headed. And that in itself is a self-defeating proposition most of the time. However, some things are just plain common sense and we do not need to be fortunetellers to see what the end game will be. And so it is said … "if something cannot go on forever, it will stop".

Government State Pensions.
One of the most alarming issues that I have been speaking with people in the investment business, and clients in general, about is the problem that I see with our State's pension system and future spending obligations. It has been quite troubling to me for some time that employees, whether high risk (read police and firefighters) or not, have been given so much flexibility and ability in creating major pension liabilities and large public - private salary differentials in Florida. Just to keep order, lets deal with the pension issues first.
In Florida we have the FRS pension system, which stands for Florida Retirement System. And just for clarity and objectivity, I have many clients and family members that hail from very lucrative careers tied to the FRS. Over the years as salaries in the public sector have grown, the liabilities of the state have steadily increased. Much of this is a reflection of pension rules that enable a retiree to compute retirement benefits based on the average salary of the retirees last three years of employment along with increasing subsidized group healthcare benefits. Now its not a far stretch to imagine that a retiree, who has served in a public employment capacity for nearly thirty years, experiences a disproportionately higher salary towards the tail end of his or her career. So for example just imagine that a hypothetical retiree on average throughout their thirty-year career has made on average $68,000 per year. However, this same retiree has earned in excess of $80,000 in each of the last three years of employment before retirement, but only has an average salary over the thirty-year career of $68,000. This method of calculating benefits leaves the door open for strategic promotions to solely boost retirement income, poor assumptions of actuarial salary trends, strain on assets and the returns they generate to satisfy retiree pension liabilities and most of all a very large variable for taxpayers should problems arise.

One of my main disagreements with the current retirement system is the purpose. The initial purpose was simply to provide a well-deserved living benefit to the retiree after a long career. The pension provided for two basic types of payouts in retirement. The first was a maximized monthly benefit that is based on the lifetime of the retiree. The second was a reduced benefit payment called a survivorship benefit that covers the lifetime of the retiree and his or her spouse. The survivorship benefits assured the retiree that if he or she died prematurely or shortly after retirement, his or her family would receive the same benefit posthumously in order to maintain the standard of living that the family enjoyed before the demise of the retiree. However, in recent years FRS has decided that it would also be a great idea to offer all retirees the ability to select a third option called the investment plan or a lump sum pension distribution. I can clearly see that the state simply wants to reward its workers and offer as many flexible options for a well-deserved retirement. However, in an effort to be gracious and thankful for the contributions of State employees, the

State has gone off the cliff by promising retirees extreme benefits that actually reduce the integrity and funded status of the overall pension system. For example, the typical retirement is paid out over monthly or bi-weekly installments. These monthly or bi-weekly installments allow for the State to retain the bulk of the retirement promised to the retiree in an account that can continue to earn a positive return to meet the future monthly and bi-weekly liability of the State to the retiree. The less money the State has to pay out at any one point in time the better the financial condition of the pension itself and the more likely the pension will diffuse its obligations to all retirees in the pension plan. However, with the lump sum distributions the State loses the opportunity to “finance” the retiree payments over time and the retirement liability must be paid off immediately in lump sum to the retiree at retirement, increasing the amount of money leaving the pension plan at a given point in time. This is similar to an individual paying off their mortgage over time versus making the cash purchase outright in one lump sum down payment. By this example we can clearly see that there is more pain for the pension plan to satisfy the immediate lump sum payment versus the monthly or bi-weekly payment over the lifetime of the retiree. Further it’s not too far a stretch to see that by offering up lump sum payments to all retirees, the State will create severe asset liability mismatches when returns on pension assets fall short of the accumulated retiree liabilities (retiree benefits). With retirees being able to take their benefits in lump sum versus over time more pressure is placed on the pension assets to create greater returns to keep the pension plan funded for each and every remaining retiree, whether they opt for the lump sum or lifetime benefits. All of this is interesting when you think that a pension was really designed to be similar to social security by providing benefits solely for the lifetime of the employee and or spouse (survivorship rights). Somehow over the years pensions have become more than lifetime benefits. In some cases they have become legacy benefits to children of retirees, as is the case with lump sum distributions. States might consider rethinking the purpose of the pension and remember that just because pension surpluses might accumulate over time and plan advisors excite decision makers about these surpluses urging lump sum distribution, it only takes one or two years to throw surpluses into deficits, especially when retiree benefits are tied to cost of living increases and the highest earning years of retirees.

The Great Salary Divide.

Adding to the great pension debate coming to a state near you, let’s just have a look at the salary divide that we are hearing so much about on the news. Note that I am not advocating taking away any human beings standard of living. I am simply stating that the disparity in salaries should not be as great between public and private sector employees, especially when budgets are tight and states are bleeding. Below is a chart provided by the folks at USA Today, which analyzes data provided by the Bureau of Labor and Statistic. In it we see some startling differentials between private sector employment and public sector employment by job title. I am always a bit skeptical of a third party analysis of data, but regardless of the magnitude of the numbers, I think we all know family members or have friends where we can extrapolate the trend we see in the chart, which suggests an uneasy large growth in public sector salaries versus private sector salaries. Normally we would just say a hearty “good for you” or “at a boy” for anyone who is able to make large gains in life relative to the status quo. However, the trouble in this case is that most of the salary that would go towards paying federal or governmental workers comes at the expense of the taxpayer. The trend is unsustainable without being able to increase taxes and or cut services to fund large salary differentials and pension retirements. With such large salary growth over the past few years in the public sector it is not hard to see that the increases in salaries over such a short period of time forces retiree liabilities to increase at a greater amount than the amount of return generated on current pension assets combined with the available tax dollars harvested by the State from taxpayers. Something will have to give. Some things are giving. States have begun to lay off employees and give an economic tune up to their pension plans. Some have displaced current workers who are at higher than desired salary levels and replaced those workers with lower salaried, and in some cases, lower skilled workers. Although I understand organized labor, I just have never been a union fan. I do believe that workers should have their due. The question becomes just what that “due” actually is. The old General Motors story represent much of the issue that many pension funds will have to deal with. At one point General Motors was spending $4.5 Billion dollars on healthcare alone (that doesn’t include pension), which was something like $1,500 of the sticker price of each car. Well in the end GM went bankrupt and the US government bailed them out. Who will bail out the States?

Job	Federal	Private	Difference

Airline pilot, copilot, flight engineer	$93,690	$120,012	-$26,322
Broadcast technician	$90,310	$49,265	$41,045
Budget analyst	$73,140	$65,532	$7,608
Chemist	$98,060	$72,120	$25,940
Civil engineer	$85,970	$76,184	$9,786
Clergy	$70,460	$39,247	$31,213
Computer, information systems manager	$122,020	$115,705	$6,315
Computer support specialist	$45,830	$54,875	-$9,045
Cook	$38,400	$23,279	$15,121
Crane, tower operator	$54,900	$44,044	$10,856
Dental assistant	$36,170	$32,069	$4,101
Economist	$101,020	$91,065	$9,955
Editors	$42,210	$54,803	-$12,593
Electrical engineer	$86,400	$84,653	$1,747
Financial analysts	$87,400	$81,232	$6,168
Graphic designer	$70,820	$46,565	$24,255
Highway maintenance worker	$42,720	$31,376	$11,344
Janitor	$30,110	$24,188	$5,922
Landscape architects	$80,830	$58,380	$22,450
Laundry, dry-cleaning worker	$33,100	$19,945	$13,155
Lawyer	$123,660	$126,763	-$3,103
Librarian	$76,110	$63,284	$12,826
Locomotive engineer	$48,440	$63,125	-$14,685
Machinist	$51,530	$44,315	$7,215
Mechanical engineer	$88,690	$77,554	$11,136
Office clerk	$34,260	$29,863	$4,397
Optometrist	$61,530	$106,665	-$45,135
Paralegals	$60,340	$48,890	$11,450
Pest control worker	$48,670	$33,675	$14,995
Physicians, surgeons	$176,050	$177,102	-$1,052
Physician assistant	$77,770	$87,783	-$10,013
Procurement clerk	$40,640	$34,082	$6,558
Public relations manager	$132,410	$88,241	$44,169
Recreation worker	$43,630	$21,671	$21,959
Registered nurse	$74,460	$63,780	$10,680
Respiratory therapist	$46,740	$50,443	-$3,703
Secretary	$44,500	$33,829	$10,671
Sheet metal worker	$49,700	$43,725	$5,975
Statistician	$88,520	$78,065	$10,455
Surveyor	$78,710	$67,336	$11,374

Source: Bureau of Labor Statistics, USA TODAY analysis
http://www.johnmauldin.com/images/uploads/charts/012211-42.png

Unions and The Reasons Why.

Its no secret how we got here. Some may call it self-interest. Some will say governments laying down for unions or organized labor. But I really think it is much simpler. When times were good or great money began to pile up and fiscal responsibility began to weaken against the pressure of interest who saw a better way to account for surpluses. So loaded with self-motivation, pensioners and their representatives asked questions like “why should my earned benefits be limited to my lifetime? If I earned them then my family should be entitled to them.” And because tax revenues and surpluses were trending larger and larger every year no one could see why the party would stop or the harm that would come in one fell swoop to take it all away if something went wrong. It is simple human nature to want more and to irrationally advocate for our own self interests. However the principles of mathematics are unemotional and unfortunately do not vary under any circumstance. Thus we are left learning the hard lessons that we have known since grade school… 1+1=2

Taken separately the above issues regarding pensions and the States might be very small things. But in a world where the economy teeters on the ability of government to keep the economy stimulated while normal economic growth continues to recover, the small things added together may prove to be very big things when taken together. For your portfolio it may be a very big deal. The good news is that government stimulus will not end soon. When stimulus does end we will need great production from the economy to keep the party going. If the numbers don't look good after stimulus is removed later this year the market may actually reinforce its fundamental characteristic of being a mathematician versus its other less fundamental characteristic based on emotions. If this should happen we should ensure that our portfolios are constructed to weather the change.