What Can't Be Sustained Will Not Be Sustained

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Oversaturation of Information.

Making sense of financial news and figuring out investment options has been getting more difficult as of late. It seems that on every news channel someone knows exactly and precisely why and when the future will occur. I too share my thoughts regarding my view of financial news and available investment options 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 which investment options will do well in the environment we are in or the environment where I <u>think</u> 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". State pensions, the subject of this newsletter, is a perfect example of something that cannot go on forever in its current form. Unfortunately states are just not prepared to meet all of their obligations. Considering that pensions are virtual guarantees to employees by the state and that pensions make up a large amount of a state's total future obligations, it will be impossible to meet these obligations when taxes collected by states are being lowered and state revenues continue to decline. With that premise, let's move right into our discussion of state pensions.

Government State Pensions.

One of the more alarming issues brought on by years of great economic growth followed by the worst economic failure since the Great Depression is that of 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 for the State. It has not helped that while pension liabilities have surged for the state, we have also experienced 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. In your state it is called something different. And just for clarity and objectivity, I have many clients and family members that have very lucrative government careers and retirement expectations tied to the FRS. Over the years as salaries in the public sector have grown, the liabilities of states have steadily increased. Much of the increase in liabilities has been a function of generous changes to pension rules favoring retirees and great economic performance throughout the US. Additionally we have experienced huge increases in medical costs, which have been incorporated into pension liabilities through post retirement subsidized healthcare benefits. Specific methods used by states to calculate pension benefits have created asset liability mismatches for the pension funds. What is called asset liability mismatch refers to the ability of an asset that we own to diffuse a liability that we owe. So in short, when we have an asset liability mismatch, our assets cannot pay for the debt we owe. When asset liability mismatches grow too large, it is diifcult to meet all obligations or liabilities. The following statement was taken from the FRS website in Florida. It clearly states that benefits will be promised regardless of performance of assets that generate retirement benefits.

"Any investment gains or losses are borne by the trust fund, and they do **not** affect your <u>accrued retirement benefit</u>. Your benefit under the Pension Plan is fixed by a formula that considers your age, FRS membership class, service and salary - and **not** investment performance." [emphasis theirs]
http://www.myfrs.com/portal/server.pt/community/comparing_the_plans/235/investment_risk

Using deduction, it is not a far stretch to imagine that if investment performance is poor and should asset liability mismatches grow too large in the states, taxpayers will have to fill the gap should problems arise.

It is true that taxpayers benefit in many ways from the labor of State government employees. Everything from trash collection (in some areas this may be contracted), fire services, police, administration, civic boards and more are staffed by State employees. Without government or state employees we would not have many of the basic services and life enjoyment that we experience every day. So it is with some pain that I write a criticism of the retirement system designed to help the very people that help all of us each day. However, without facing the facts soon, we will find ourselves with mandatory cuts in services or mandatory layoffs for state workers in the near future. I think that there may be many constructive ways to redesign the state pension system to provide a more sustainable promise to our state employees. One example may be to shift the burden of funding retirement guarantees from taxpayers to state employees. One of the immediate changes that can be made so that state employees can continue to look for benefits at retirement is to implement a 401K like plan where employees can make their own contributions and decisions regarding their retirement pension. The revised retirement plan can even be a hybrid of state contribution and employee contribution. Whatever design is chosen, the shift in burden from a 100% dependence on taxpayers and state revenues to something more equitable should be considered soon.

The purposes of pension retirement plans are simply to provide a well-deserved living benefit to the retiree after a long career. The pension provides for two basic types of payouts in retirement. The first is a maximized monthly income benefit that is based on the remaining lifetime of the retiree. The second is a reduced benefit payment that covers the lifetime of the retiree and that of his or her spouse called the joint life with survivorship benefit payment. The survivorship benefit payment assures the retiree that if he or she dies prematurely or shortly after retirement, his or her family would receive a level benefit payment in order to maintain the standard of living that the family enjoyed before the demise of the retiree. However, in recent years many state pension plans have 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 states have promised retirees extreme promises, in the form of benefits, which the states cannot keep.

For example, the typical retirement is paid out over monthly or bi-weekly installments. These monthly or bi-weekly installments allow for states 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 fund itself and the more likely the pension will satisfy its obligations to all retirees in the pension plan. However, with 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. The lump sum payout increases the amount of money leaving the pension plan at any given point in time. With less assets and a growing asset liability mismatch, there is less opportunity for remaining assets to earn enough return to fill the liability gap. You guessed it! The gap has to be filled. After all didn’t the state say, more or less, that the benefit is guaranteed. Who do you think will fill the gap? That’s right…the state taxpayer. 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 in the future when returns on pension assets fall short of the accumulated retiree liabilities o be paid (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 distributions to retirees, it only takes one or two years of poor returns on pension assets to throw surpluses into deficits, especially when retiree benefits are tied to cost of living increases, increasing insurance costs and increasing salaries.

The Great Salary Divide.
Adding to the great pension debate coming to a state near you is the salary divide between government (public) and private sector employees. Before we go any further I must insert a disclosure: I am not advocating taking away any human beings standard of living. My wife is also a state pensioner and the difficult choices that will be made in our home state will most likely affect her retirement when the time comes. 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 (BLS). 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 in both public and private employment where we can observe the trend we see in the chart. The chart suggests large diffrences 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 pension liabilities to increase at a greater amount than the amount of return generated on current pension assets and tax dollars harvested 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 from a private and public pension perspective. 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. I think the value of the GM pension fund actually exceeded the total value of General Motors as a company! 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 and money began to pile up, fiscal responsibility began to weaken against the pressure of certain interest who saw a better way to account for extra money in the kitty (surpluses). 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 if something went wrong. In good times assets can have values far exceeding liabilities. However, in bad times, depending on the asset type, liabilities can quickly overtake assets. 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 salaries 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 of psychologist (emotions). If this should happen we should ensure that our portfolios are constructed to weather the change. Change is inevitable and some things do come to an end. Regardless of when, how or why, just be ready!

Warm Regards from your friend and hoping his wife’s pension won’t get cut too badly advisor,

Kareem Brantley

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