

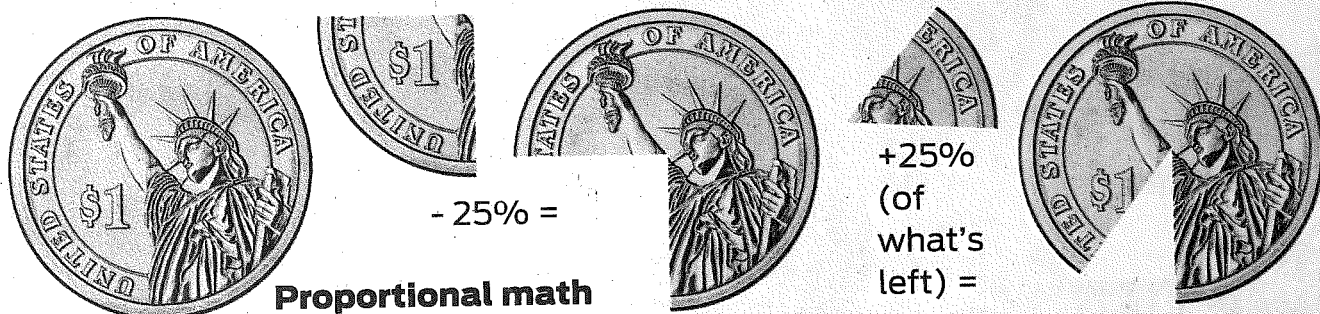
**OPINION**

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OPEN FORUM *On Pension Reform*

# Catching up is hard to do



Chronicle illustration

Dollar coins are useful for diagramming economic theories, but they have other uses as well (see next page).

By **David Crane**

Imagine you are saving for your child's college costs, expected to amount to \$100,000, and that you are 80 percent of the way there with \$80,000 in your account.

The next year, the value of your investment account drops 25 percent, to \$60,000.

The year after that, it bounces back 25 percent. Are you back to where you started?

No, because now you have \$75,000 in your account.

Next, assume college costs are rising 8 percent per year. Now how close to paying for college are you?

The answer: 64 percent, because you have \$75,000 toward \$117,000 of costs. Even though your investments rose the same percentage as they fell, you're further from your goal than before.

That is the situation faced by pension funds. Even after good returns this past fiscal year, they still have a huge hill to climb. This is because:  
 ► Their recent gain is measured from a smaller base than was their decline, as illustrated above.

► Pension funds are allowed to report pension liabilities on a discounted present value basis and to use a discount rate for that purpose that is equal to the rate of return they expect to earn on their assets. Thus pension liabilities automatically grow by that rate, which is typically 7.5 percent to 8 percent. That, in turn, means pension funds must earn at least that rate of return just to stand still. After more than a decade (including the recent good year) in which pension funds earned just a fraction of their discount

rates, a yawning gap has developed.

This is why Jack Ehnes, CEO of CalSTRS, the California teacher retirement fund, rightly points out that even after the recent good result, pension contributions must increase. And the sooner those contributions are made, the better, because the longer we wait to increase pension contributions, the greater the cost down the road. That's because un-contributed amounts accrue interest at the discount rate.

This is why pension funding is a moral issue, not unlike climate change. By not making sacrifices today to reduce greenhouse gas emissions, our generation is imposing a larger burden on future generations. Likewise, by not contributing more money to pension funds today, we are forcing people tomorrow to use their money to cover our costs plus interest. In turn, they will have less money with which to compensate their own public employees, fund their colleges, build their infrastructure, finance their environmental protection, maintain their parks and more.

Similarly, it's immoral to contribute insufficient amounts today in the false hope that pension funds will make up deficiencies through outside investment returns. Bonds and cash, which usually make up about 28 percent of most pension funds, can be expected to yield no more than 5 percent. That means, to earn the 7.5 percent to 8 percent return needed to meet their promises, pension funds are depending on the remaining 72 percent of assets invested in stocks to earn 10 percent before fees and expenses. That's nearly 40 percent more than equities earned in the 20th century.

It is an unrealistic assumption made by many corporate and public pension funds. Investor Warren Buffett writes:

"During the 20th century, the Dow advanced from 66 to 11,497. This gain, though it appears huge, shrinks to 5.3 percent when compounded annually. For investors to merely match that 5.3 percent market-value gain, the Dow ... would need to close at about 2,000,000 on Dec. 31, 2099. People who expect to earn 10 percent annually from equities during this century ... are implicitly forecasting a level of about 24,000,000 on the Dow by 2100. Many (such believers) are apparently direct descendants of the queen in 'Alice in Wonderland,' who said: 'Why, sometimes I've believed as many as six impossible things before breakfast.'"

We've already seen a glimpse of the consequences of past under-contributions based on such Alice-in-Wonderland assumptions. So far this century, equity markets have provided less than 0.005 percent of the 23,988,000 points needed to meet pension fund expectations. To fund just a portion of the resulting pension deficiency, governments have laid off employees, raised college tuition and taxes, and diverted money from welfare and other services. The rest of the deficiency is being deferred to our kids. Because those deferrals accrue interest, it will be exponentially worse for them.

Our generation simply must dig deep and fund the promises we've made.

*David Crane was an economic adviser to former Gov. Arnold Schwarzenegger and a former California State Teachers' Retirement System board member.*