Casey Mullooly: Welcome back to the Mullooly Asset podcast. This is your host, Casey Mullooly, and this is episode 370. In this week's episode, we talk about why pension funds have been lowering their expected returns for 10 years in a row now and what that means for folks on the receiving end of the pension funds, meaning the ones who live off of those pension checks that they spent years funding. Thanks, as always, for listening. We hope you enjoy.

Casey Mullooly: Another interesting chart that we saw floating around in the financial media, it shows how pension funds have lowered their expectations for 10 straight years. So in 2009, the expected return for, these are S&P 500 pension funds, was in between seven and 8% and now we're down to in between five and 6%, which lines up more with what we're using here. I know it's different between building financial plans for individuals and investing for pension funds, but what's your guys' take away from this?

Brendan Mullooly: I'd say the first thing that comes to mind is just that pension funds have mandates in terms of how much they can invest in certain areas. They have investment policy statements and so if they have an IPS that tells them that they have to have 30% of their money in investment grade bonds, I mean, you can look at the interest rates on those and you know that you have to drop your return expectations correspondingly over that window of time just because of the interest rates you're going to get on investment grade bonds at this point in time. So there's a factor of that in there.

Tom Mullooly: I think that's a big part of it. I also know that it's easy to spot... I shouldn't say it that way, but when you see pension plans that have a expected annual return target of something around 7%, or God forbid higher than 7%-

Brendan Mullooly: Underfunded.

Tom Mullooly: They're underfunded and they are going to need to take a lot of risk, which is going to put you at risk if you're a participant in the plan. That's very, very worrisome. So over the years, and this chart only shows the last 10 years, but it goes back even further, into the '90s, where they were talking pension administrators off the ledge from eight and a half percent down to eight, and then into the sevens and into the sixes. I happen to sit on a committee that oversees a pretty large pension fund and I'm trying to get them down into the fives because I think that's a little more realistic.

Brendan Mullooly: The reluctance to do that sort of thing comes from the difficulty of alternatives though, which means sending more money, like fund it better. Because you can solve any problem in terms of a projected funding need by saying, "Oh, well, we can continue funding at the same rate. However, we're going to expect 9% instead of seven and a half and then there's no problem." However, what happens when the nine doesn't roll in?

Casey Mullooly: Right. So when a pension fund is underfunded, that means that they have to increase their returns from the investments and that is what leads to more risk?

Tom Mullooly: Well, there's two ways to solve that problem when they're underfunded. They can take more risk and hope for the best or-

Brendan Mullooly: Ideally the second one.

Tom Mullooly: The second one is where all the participants have to cough up more dough. They have to put more money into the plan. The company is also putting money in alongside, but you're seeing more contributions, more dollars flowing in to help alleviate the underfunded situation. What most pension funds want to get to is a situation where they are 100% funded, then they can talk to their participants about not needing to increase future contributions.

Tom Mullooly: Hopefully what we're starting to see now, because of a couple of years of healthy market returns, has been pension plans that are now 105% funded, 110% funded. What a pension fund can do when you get to 110% funding is you can go to your participants and say, "Hey, we're going to freeze our plan," or, "we're going to terminate our plan and we're going to give you 100% present value of what you would expect. You can take it as a lump sum or you can annuitize it now, but really what we would like to do is get out of the business entirely. Get out of the pension business and just offload this entire plan to an insurance company who will then issue annuities, guaranteed income for life for you and then that gets us out of the pension business. You can do that if you are 100% better, if you're 105% or 110%." Businesses didn't intend to get into taking care of their employees for life. I mean, that was very noble a hundred years ago, but that's really complicated now.

Casey Mullooly: I was going to say that seems like this is just a over-promise from the companies and-

Tom Mullooly: "We'll take care of you for life."

Casey Mullooly: Governments alike that are in these situations and it sounds like kind of a avoidance to go back on their word and telling the participants that they do have to cough up more money. It's easier to just be like, "Oh, we can invest in some speculative area of the market and make up the difference" instead of having the difficult conversation and be like, "Hey, this is a problem we need your guys' help with this."

Tom Mullooly: The California pension called CalPERS became the biggest venture capital firm in the world about 25 or 30 years ago because they were able to change their charter and go in and say, "Hey, instead of just owning stock and bond portfolios, we want to invest." So they actually got into a little bit of greenmail and a little bit of the corporate takeover business in the mid '80s and then they started branching out into some venture capital things. And some of the investments, like a lot of venture capital funds, were really huge home runs. I mean, CalPERS were early investors in a lot of technology stocks, in a lot of biotech companies that were just getting started and they provided the seed money for a lot of these companies to get off the ground. But alongside of that, for every hit that you have, you have 49 others that go to zero and so it's a super risky business to be investing Mr. Joe Smith's monthly pension check that he's going to live on for the rest of his life. Holy moly, what a... I don't know how they would sleep at night doing stuff like that.

Brendan Mullooly: They do it. They put it into like timber futures. They do all sorts of insane crap. Yeah, I think you hear about the successful people like Swensen at Yale and CalPERS, but for all of the other pension funds out there that try to emulate them and do hedge funds and private equity and commodities and change the sleeves of their portfolio, so to speak, because things like bonds are offering lower yields or stocks are at higher valuation. So they still need to hit their return target and the way they're doing that is by putting an investment into there that maybe doesn't even have an expected return so they can slap whatever they want on it and say, "This thing's going to make 20% a year and we've got 10% of the portfolio in that, so problem solved. It doesn't matter that bonds are only yielding 1% now", and that's not okay in my opinion.

Brendan Mullooly: I think that's a bad game to play. We've seen it. It doesn't work out for them. They always go into these things at the wrong time. All of them pivoted into hedge funds after '08. It's like "Great. So now you've got a decade of bad returns from hedge funds because hedge funds most of the time are hedged, meaning they're not going to do well in a market environment when the market is in general going up. So you just bought the insurance after the fact, but it looks good to all the people-"

Tom Mullooly: After the barn burned down.

Brendan Mullooly: You have to talk to all the people on your board and you put out your annual report. It sounds great when you do that, that you've put money into these things that have been doing well, but buying funds out the rear-view is a pretty good way to not do well going forward.

Casey Mullooly: Don't they know that past performance is not indicative of future results?

Tom Mullooly: Well, it's funny that you bring that up because just in my reading and experience and getting to know a little more about this part of the market, the gateway drug for a lot of these pension plans is junk bonds. That's how they get started because it's like, "Hey, in a 60-40 portfolio, we can have 40% allocated to bonds. How much of that can we actually put in non-investment grade bonds? Can we change our charter so that we can put more? Because that will help goose the returns by putting money into junk bonds." The problem is when the economy slows down or heaven forbid, goes into a recession, who takes it on the chin? All of these poorly financed and poorly structured companies. So all these junk bonds, I shouldn't say all of them, many of them drop substantially in value, creating losses, or they go to zero, and now you're standing in line with all of the other companies as a creditor. It's certainly not what you thought you were getting involved in.

Brendan Mullooly: Right, you start to go into stuff like market neutral where you go into more and more opaque strategies where you're levering up the bond side, lever junk bonds because on the books it looks cool, but you're actually levered 200% long the junk bond side of your portfolio, which is just asking for trouble when what you just described unfolds. So it becomes even worse than it could have been on the surface just from owning them outright and not doing smart guy stuff.

Casey Mullooly: Didn't we do a video recently about an ETF with some ridiculous-

Tom Mullooly: 7% income. And they call it income, which is really unfair. I'll use the street term. It's not fair because what they're doing is they're returning 7% of your own money back to you. And the thing that really just made my ears burn was when I heard them say that will actually reduce your current income per year. I'm like, "Of course it will. It's my own money coming back to me."

Tom Mullooly: This was the thing I could never wrap my arms around when master limited partnerships were created in the late '80s, one of the very first ones that we did was Green Acres shopping mall. That's a shopping mall in Valley Stream. Green Acres shopping mall, they had a distribution rate of 10%. We could not say that it was a 10% yield. We could not say that it was a 10% dividend. It was a 10% distribution because 95% of that money, that distribution each year, was your own money coming back to you. People were like, "Hey, I got my 1099 and I got like $2,000 of income, but I only have like 50 bucks that I have to report." And we're like, "Yeah, that's a return of capital." So what a lot of people missed was that return to capital lowers your cost basis in this. So when you do go to sell it, "Oh, I have a pretty large capital gain I got to pay now. Wish I knew that."

Brendan Mullooly: Right, you're just paying the tax later in a different shape and form than you otherwise could have. You can transform these things, but you can't destroy them. That's what Corey Hoffstein says about risk in the markets, and I think it's probably true for tax too. You can transform your tax bill, but you're not going to destroy it. Somebody's foot in it at some point, whether it's you or somebody else.

Casey Mullooly: Do you think it's mostly due to the interest rate environment that we're seeing now, why these expected returns are coming down?

Tom Mullooly: That's only part of it. I guess the best analogy I can use to explain this was when social security was created in 1933, the average life expectancy was 66 years old and so your social security would kick in at age 65. They kind of knew that they were going to win this bet. So the problem now with pensions is that, first of all, fewer and fewer work roles come with pensions, so I think you're pretty lucky if you do retire with a pension these days in 2020 or 2021, but people are living longer. So the obligation of someone who retires at 59 and a half or 61 or 63 or 65, they could be living for another 30, 35 years. That is a ton of money that these businesses, these pension plans are on the hook for. They never would have gotten into this business had they known that.

Brendan Mullooly: I think they're lowering return expectations. I would hope because they're understanding that-

Casey Mullooly: [inaudible 00:13:54].

Brendan Mullooly: Yeah. Right. They're understanding that part of it and choosing to do the responsible thing, which is have realistic return expectations and figure out how they're going to make their obligations work otherwise. It's just reality.

Casey Mullooly: I was wondering if they were just lowering return expectations so they would look better to their-

Tom Mullooly: Yeah, it's certainly going to take the heat off because let's face it, if your goal is 6% per year and you have one year where you make 24% you've basically just captured four years of return, so you can take a bad year after that or the year after that and you're still going to come out okay. So yes, it does lower the stress that you have to put on your investments to, "Hey, I got to hit that 6% or that 5.75% return every year."

Brendan Mullooly: I don't think they're doing it just to coast. I think they're doing it because they're being realistic about the current market environment, whether that's interest rates or market valuations or prospects for their other sorts of investments they're packing into their pension fund and just saying like, "We're not going to be able to meet this higher return expectation and the ramifications of that are unpalatable, so we got to do something about this, because the ramifications are like... It's not funded and people are relying on this, and we can't stomach that. It's bad PR and it just feels bad because that's horrible."

Tom Mullooly: It's going to become a future obligation of the company. If their pension plan falls short, someone's got to make up the difference. They can't just offload this on that government agency, PBGC, the Pension Benefit Guarantee Corp. I mean, everyone in the plan pays a couple of pennies in every year. It's literally pennies compared to the assets in these plans to basically buy insurance. But when you get a big company like an Eastman Kodak that goes into bankruptcy and all of their pensions get thrown into this thing. I mean, just the next time we go into a recession watch how many companies just offload their pension obligation to PBGC. I don't know how they can continue to exist.

Casey Mullooly: But then Powell is going to swoop in and backstop all these pension funds, so it's going to be okay.

Brendan Mullooly: Yeah, I don't-

Casey Mullooly: I'm kidding. That was a joke.

Brendan Mullooly: I don't think that the government is going to allow them to not be paid so I don't think that that is actually a joke. They'll find the money from someplace. It's not like they're going to stop paying the checks because I wouldn't use that as a way to scare somebody out of collecting a pension either.

Tom Mullooly: Along the same lines, we've heard people tell us that they want to file now for social security at age 62 because they don't know how long social security is going to be around. Congress and the Fed, last year, created $7 trillion out of thin air. I don't think social security is really going to be at risk.

Brendan Mullooly: Either that or just change the way that it's being collected. That's what we're looking at now with these pensions, we're looking at in terms of how can they make the investments meet the obligations and then they're considering how they're going to fund that to make it happen in conjunction with the investments. And then the very final option would be, "We can't do this. It's going to PBGC," and I don't think that that's not getting paid.

Tom Mullooly: It raises another point that I think is worth mentioning is the fact that we've had some real twists and turns, especially in the last 18 months, in the economy, and there's a lot of people that went to college and got their undergrad degree and got their master's degree and got their doctorate in economics so they've studied all the books and they've studied all the history, and they say, "When this event takes place this is what happens next." And it just seems to me when that happens, the Fed or Congress or somebody moves the goalposts, or they change the rules. So a lot of these people, they understand economics by textbook and not real life, they are just confounded and so they write editorials for the New York Times or some other place and they just say, "This makes no sense. This is all going to blow up." Zero hedge, they said this can't last, this can't continue, but it does. But it does.

Brendan Mullooly: Yeah. The signal for me is if you're on Twitter and you see somebody typing about the Fed and they capitalize it as if it's an acronym, that's when you know they're going to have a hot take about Powell and everybody else. It's not an acronym, man. It's the Federal Reserve.

Tom Mullooly: I heard somebody this morning on Bloomberg say-

Casey Mullooly: FED ticker symbol.

Tom Mullooly: Yeah.

Brendan Mullooly: Right.

Tom Mullooly: Dollar sign FED. I heard somebody on Bloomberg just this morning say the Fed has a balance sheet now of eight and a half trillion dollars, and that may not be big enough. The Fed may actually be this size and larger into the future and it's just a vehicle that we've never really considered-

Brendan Mullooly: People just like using the Federal Reserve as the boogeyman for why they didn't make money. It's like the end of a Scooby-Doo episode and they take the hood off of the guy who didn't make any money and he tells you how he would've gotten away with it if not for the meddling Federal Reserve. You can either choose to make money or you can rail against the Fed on zero hedge. I mean, I know which one I would choose there.

Tom Mullooly: I blame Shaggy.

Brendan Mullooly: Yes.

Casey Mullooly: That's going to do it for episode 370 of the Mullooly Asset podcast. Thanks as always for listening. We really appreciate it and we'll see you for 371.