American Shareholders Association

Are Public Pensions Affordable?

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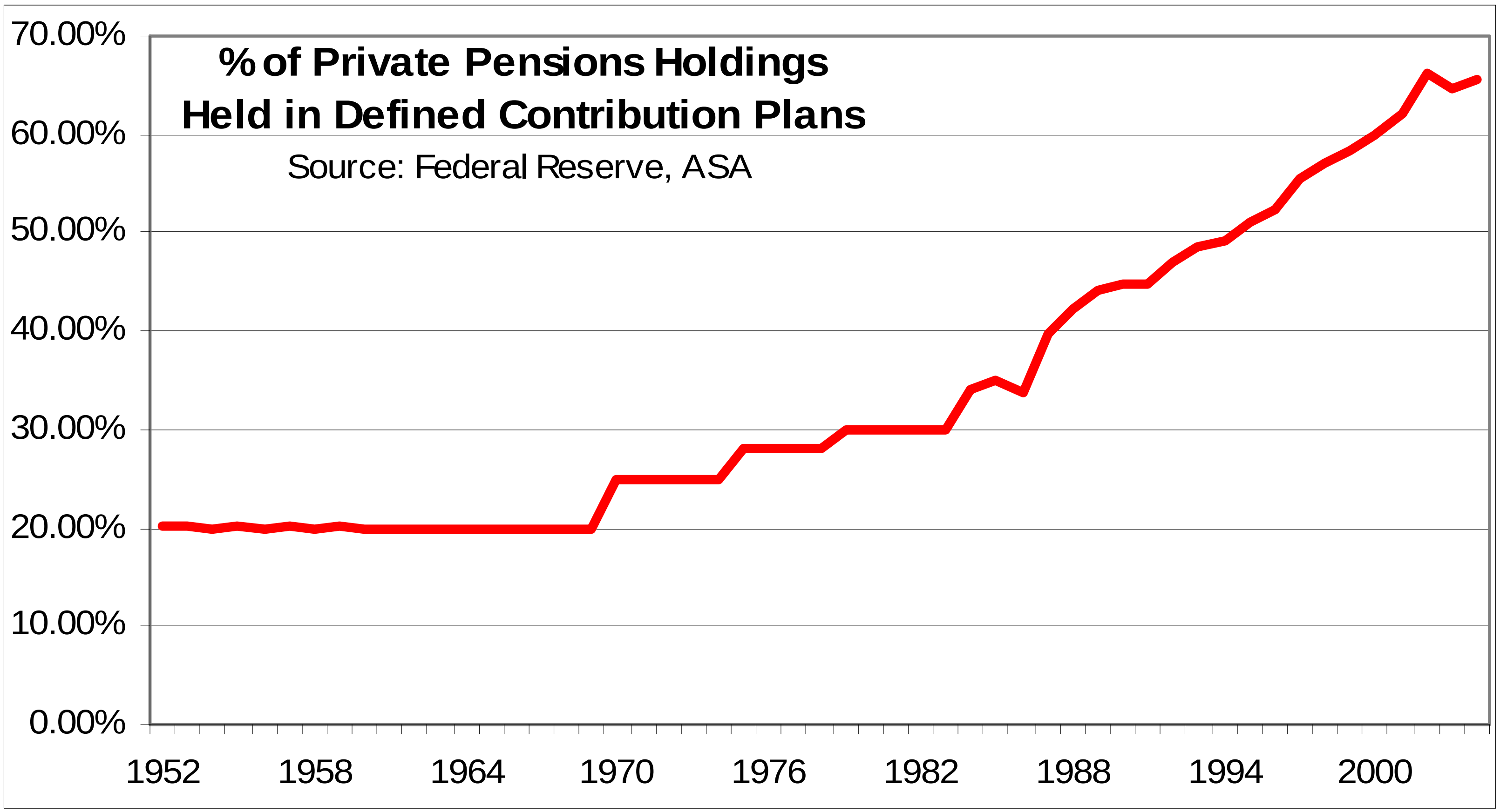
Portable Public Pensions

- 8 out of the last 10 major changes to state pension plans have been shifts from DB to more DC oriented plans.
- States are doing this in response to growing budget, demographic, and economic pressures.
- These costs will escalate in the future thus more states will be moving to DC plans.

DC Plans Represent 2/3 of Private Pension Holdings Already



Are Public Pensions Affordable?

- The problem is not now – it is the future costs that is leading to this shift.

1. Larger portion of state budgets
2. Greater uncertainty during last recession
3. Press accounts of spiking, etc..
4. Potential tax increases
5. Future demographic pressures
6. Increased labor mobility
7. State competition for businesses/residents

Are Public Pensions Affordable?

- Pensions are just one priority within competing demands.
- Late 1990’s benefit increases are costing more than expected and are automatic
- Policymakers are seeking a more flexible system.
- While some changes could be made to DB’s for cost purposes, the inherent nature of the system makes it nearly impossible to keep in the future.

Public Pensions

1. DB/DC and Political Ideology
2. Pressures Facing Defined Benefit Plans
3. Defined Contribution as Alternative
4. Correcting the Misinformation on Defined Contribution Plans

DC's a Right Wing Strategy?

NY Comptroller Alan Hevasi:

"I think it's a disgrace and I think we ought to fight tooth and nail to prevent this <u>right-wing cabal</u> from protecting the evil people who have so badly damaged the American economy."

Far From Right-Wing Ideology, Based on Practical Reality

"In these negotiations and your deliberations we must address broad changes to the retirement system, including the potential introduction of means-tested defined contribution plans."

NJ Governor Democrat Jon Corzine

July 28, 2006

Democrats Moving to Defined Contribution

"You've got to focus on managing your day-to-day costs, but you also have a responsibility to manage for the future."

Former Amtrak Chief Under President Clinton and Current NJ Transit Executive Director George Warrington.

Definition of Affordable

- *–adjective*

  That can be afforded; **believed to be within one's financial means**

Cost of Defined Benefit Plans

Public entities cannot maintain their financial position without major tax increases due to the economic uncertainties of defined benefit plans

Cost of Defined Benefit Plans

- Reform starts at the budget, not ideology
- States experiencing increase from 5% to as high as 20% for pension costs in 2010
- Taking away from other items such as education and transportation
- GASB healthcare rule only further exacerbates the pressure on policymakers.
- Benefits are constitutionally protected BUT not politically.

Cost of Defined Benefit Plans

Perverse Incentive – Unfunded Pension Increases

1. Pension fund used by politicians to raise benefits during good economic times

- Employers/Employees were not paying for these benefits during their workers lifetime
- Paid for from existing plan assets and therefore, increasing the unfunded liability.
- Not subject to ERISA requirements which makes it easier to enhance benefits w/o funding.

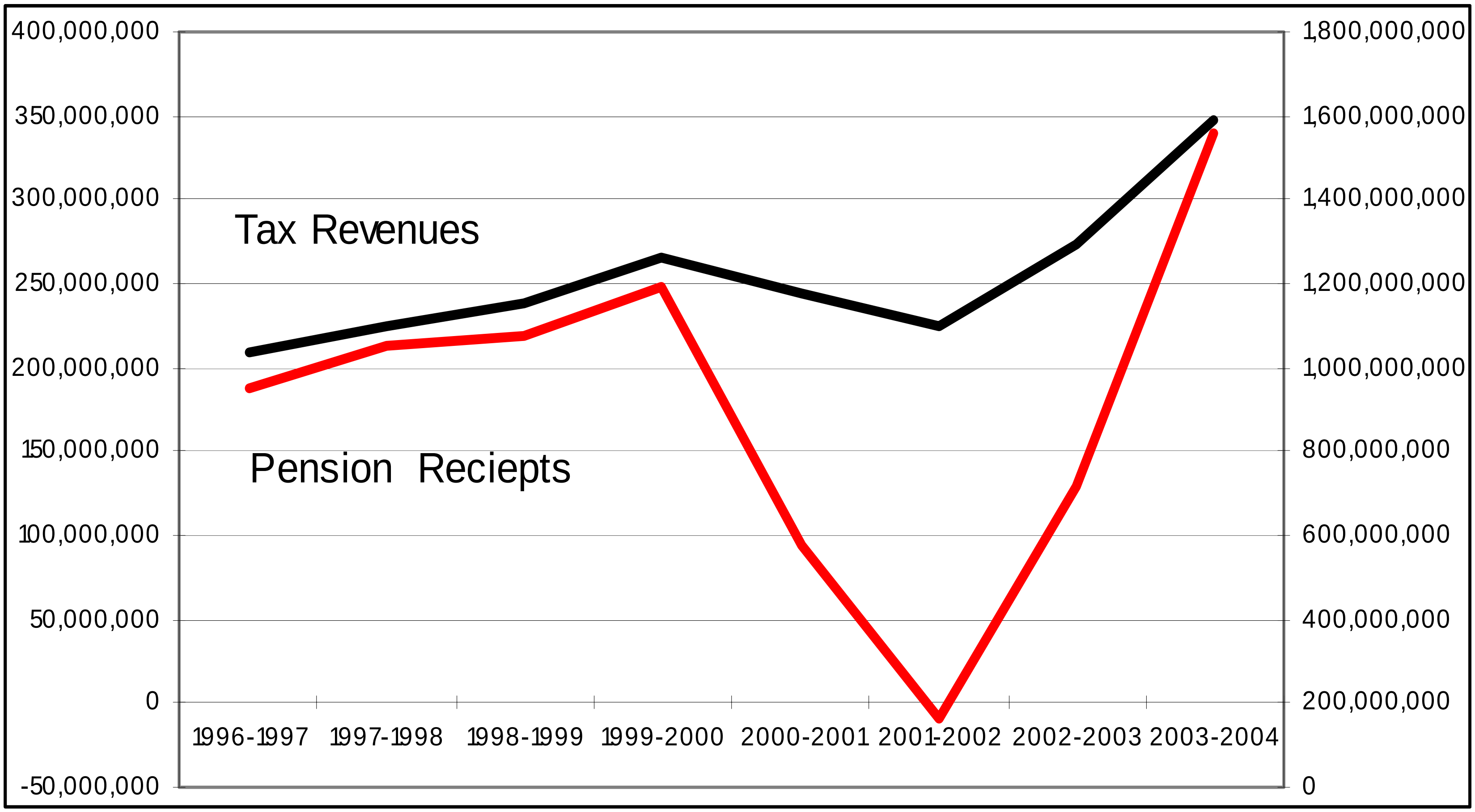
Cost of Defined Benefit Plans

Perverse Incentives – Timing of Payments

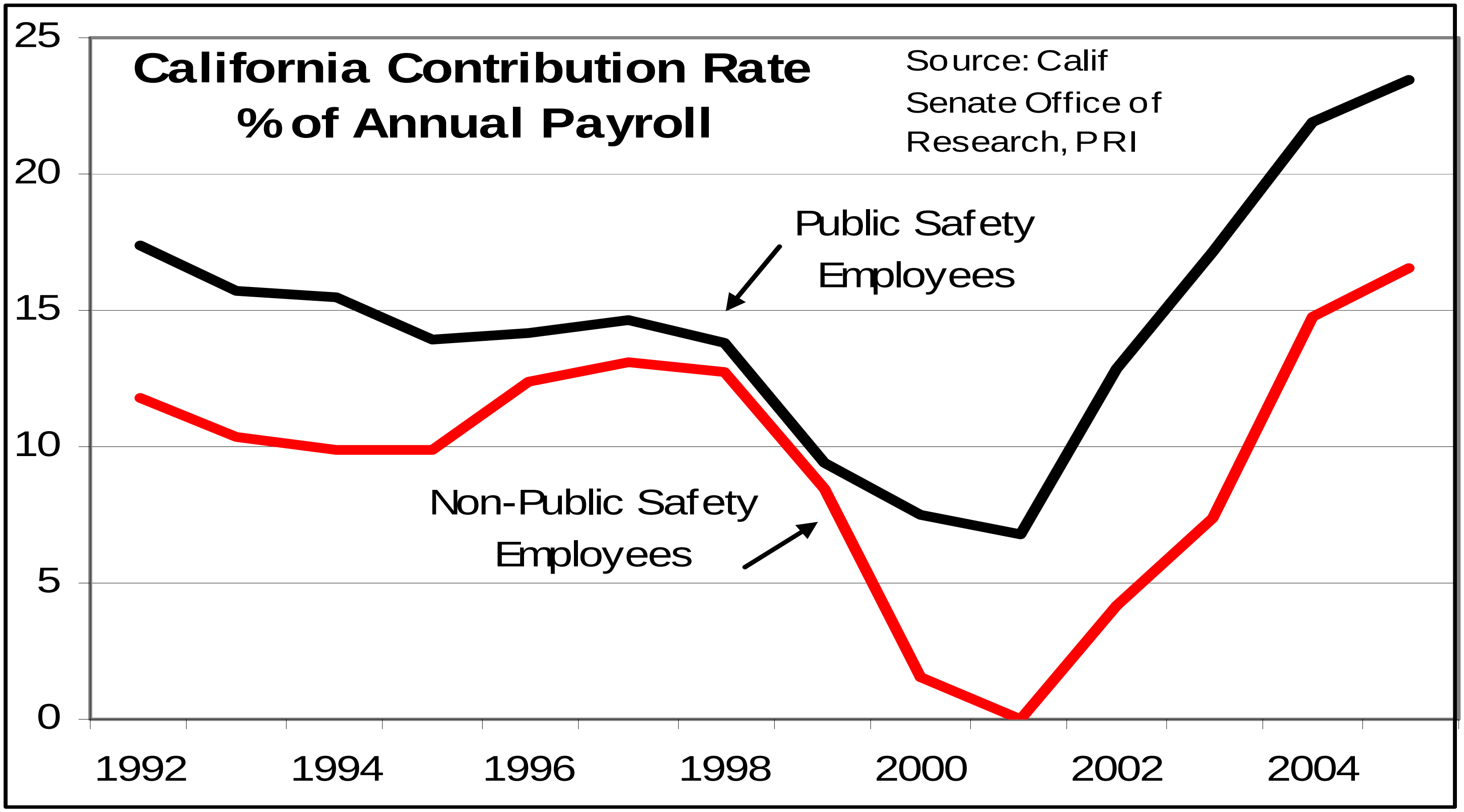
2. DB plans require greater contributions at exactly the worst time - when economy/markets are dropping

- Leads to increased taxes which are not politically popular or,
- Under funding of required contributions

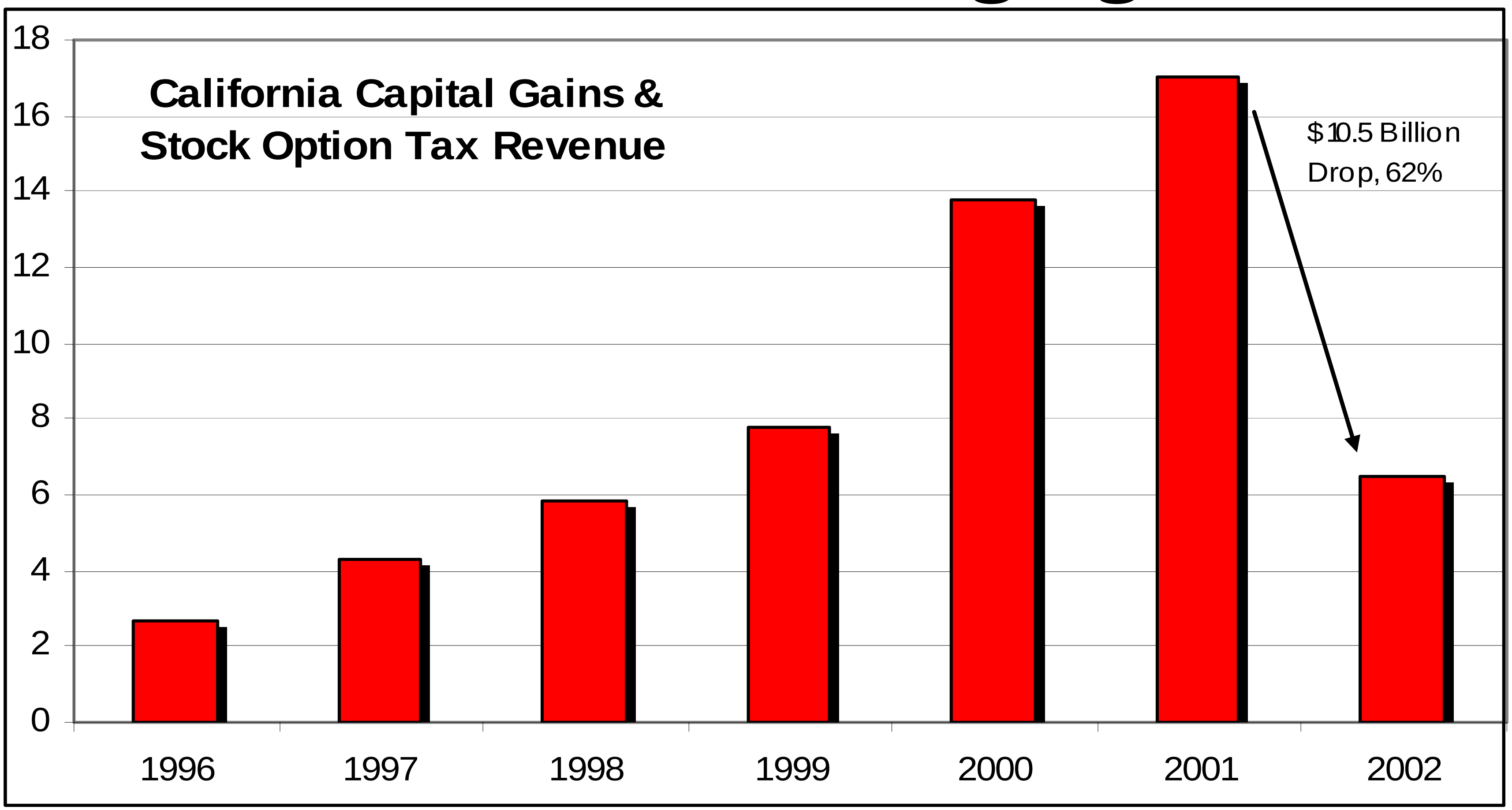
Defined Benefit: Perverse Incentives



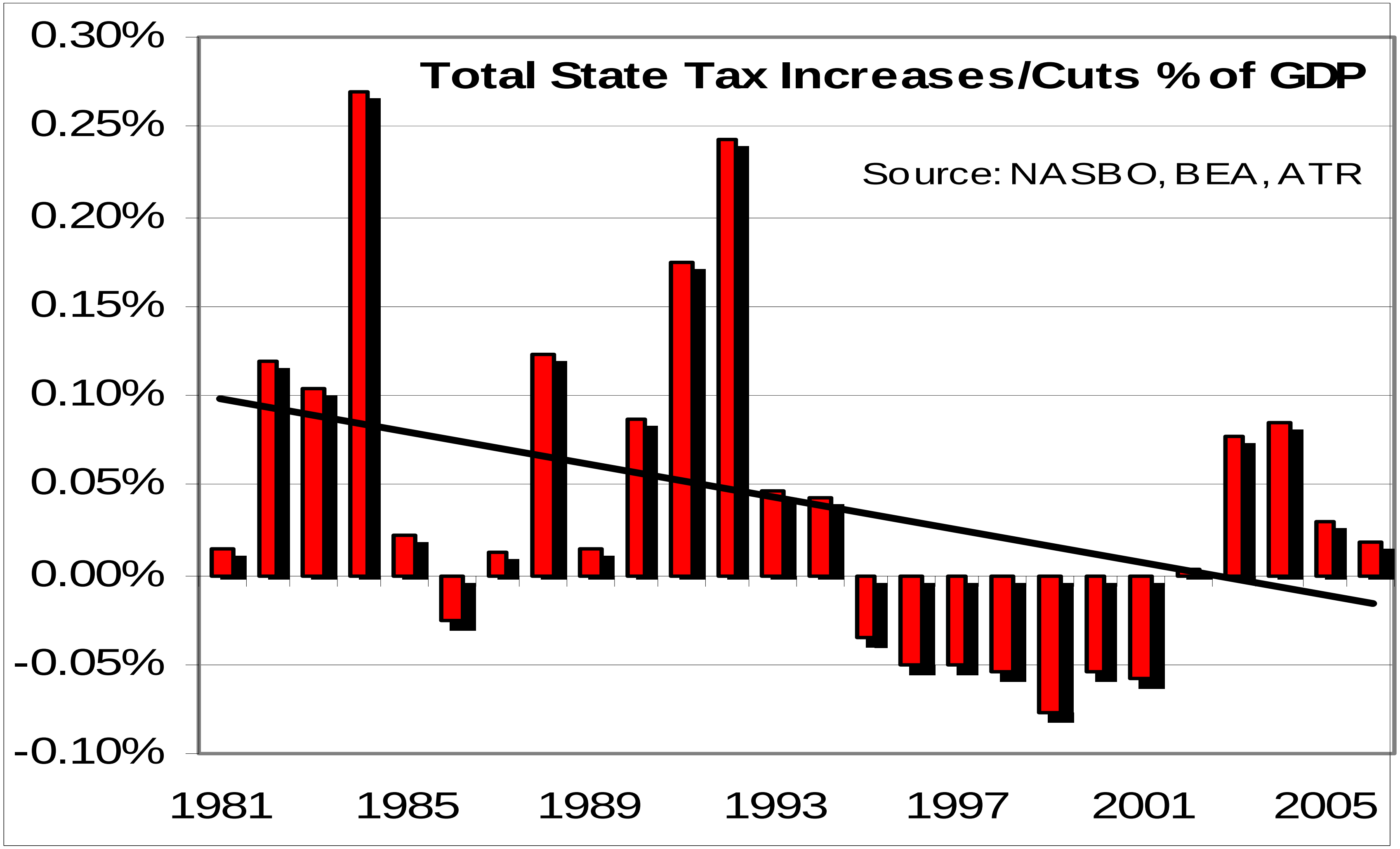
Annual Contributions Increase During Recessions…



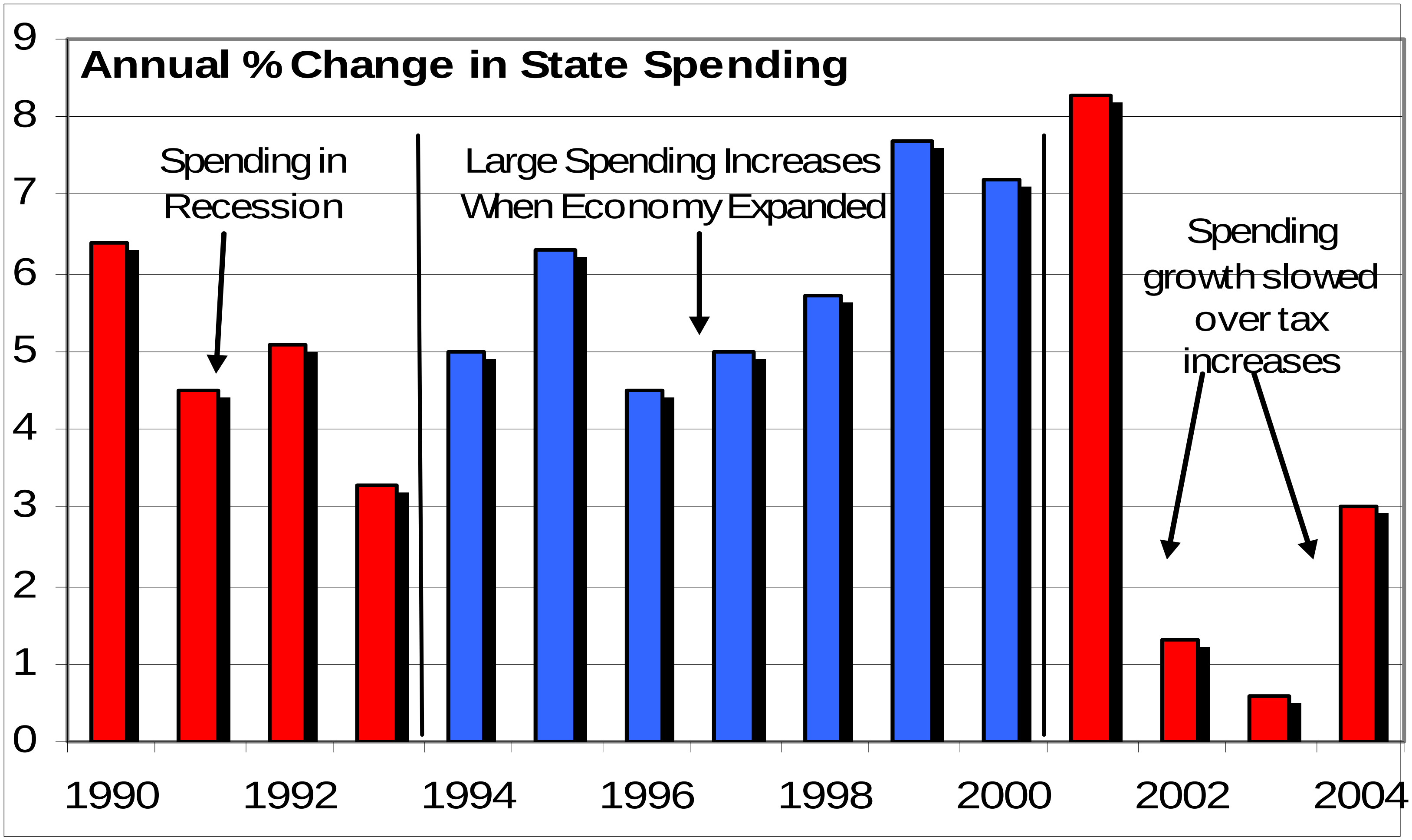
…While Tax Revenues Are Hemorrhaging



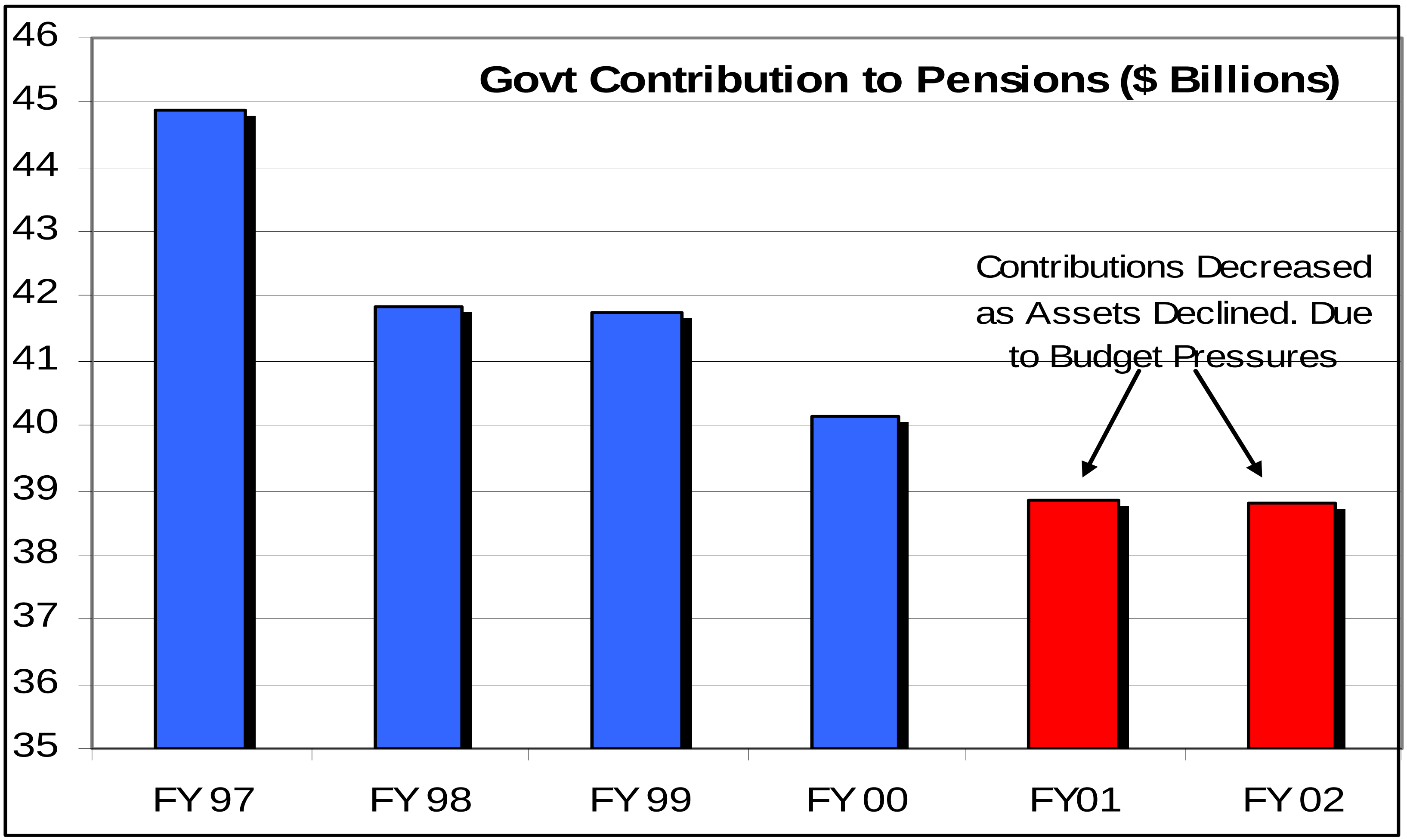
States Less Willing to Raise Taxes



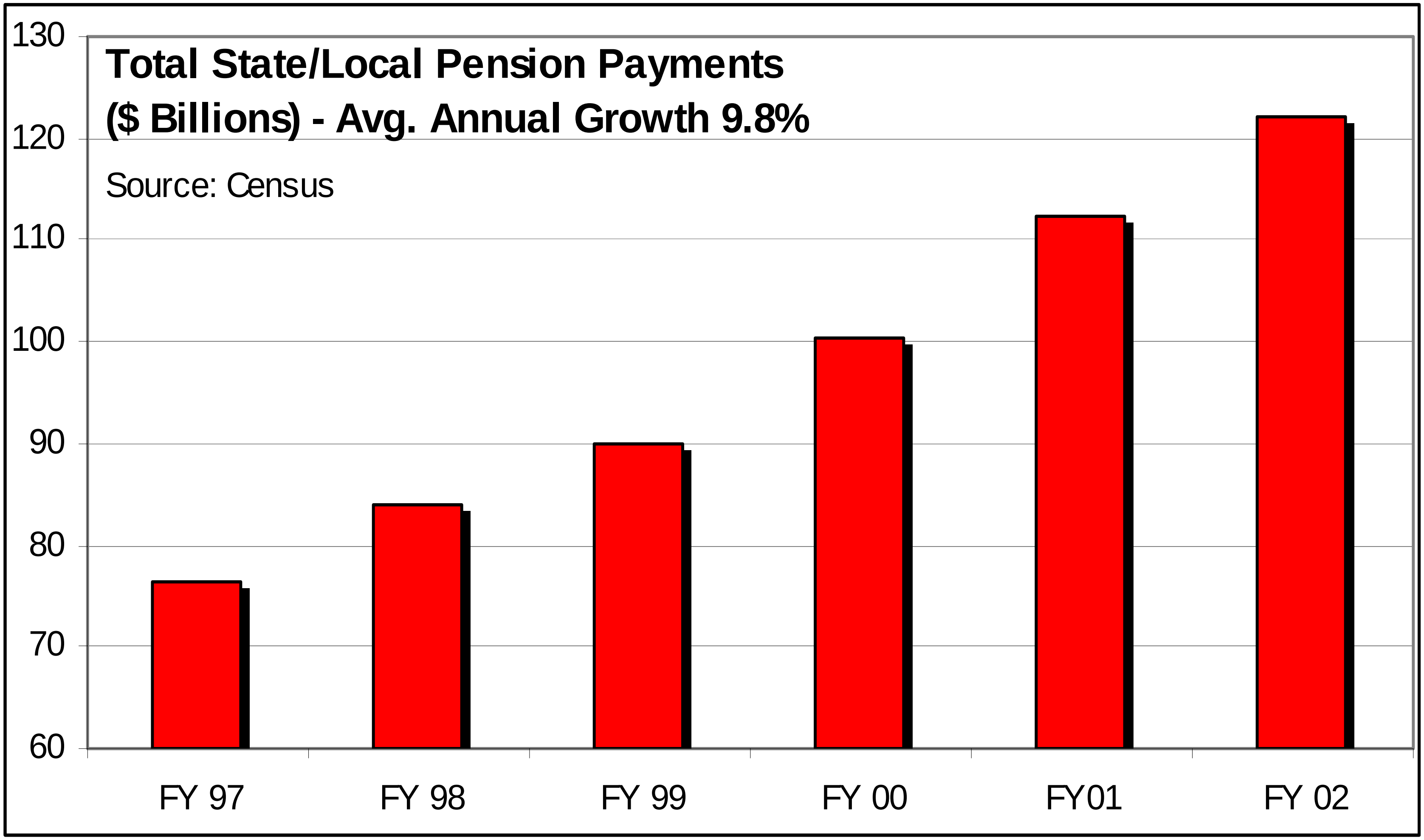
Less Spending in Last Recession



Pension Contributions Frozen In Recession Due to Deficits...



…While Payments Soared



Cost of Defined Benefit Plans

- Policymakers recognize this experience and our now looking at ways to avoid the problem in the future.
- Certainty of DC plans is becoming increasingly attractive to avoid these problems.
- Employer w/100 employees, $10 million payroll, 5% match = $500,000 contribution

Demographic Pressures

Taxpayers will not tolerate additional tax increases required to fund longer public employee retirements while fewer workers are available to pay for these retirees

CALSTRS $23 Billion Unfunded Liability: "We Can't Invest Our Way Out" (02/05)

Demographic Pressures

- Pre-Funded retirement systems should be less affected by demographics.
- But current unfunded liabilities are turning the system into a “pay go” system which requires more workers as a wave of retirements are getting set to hit state/local governments

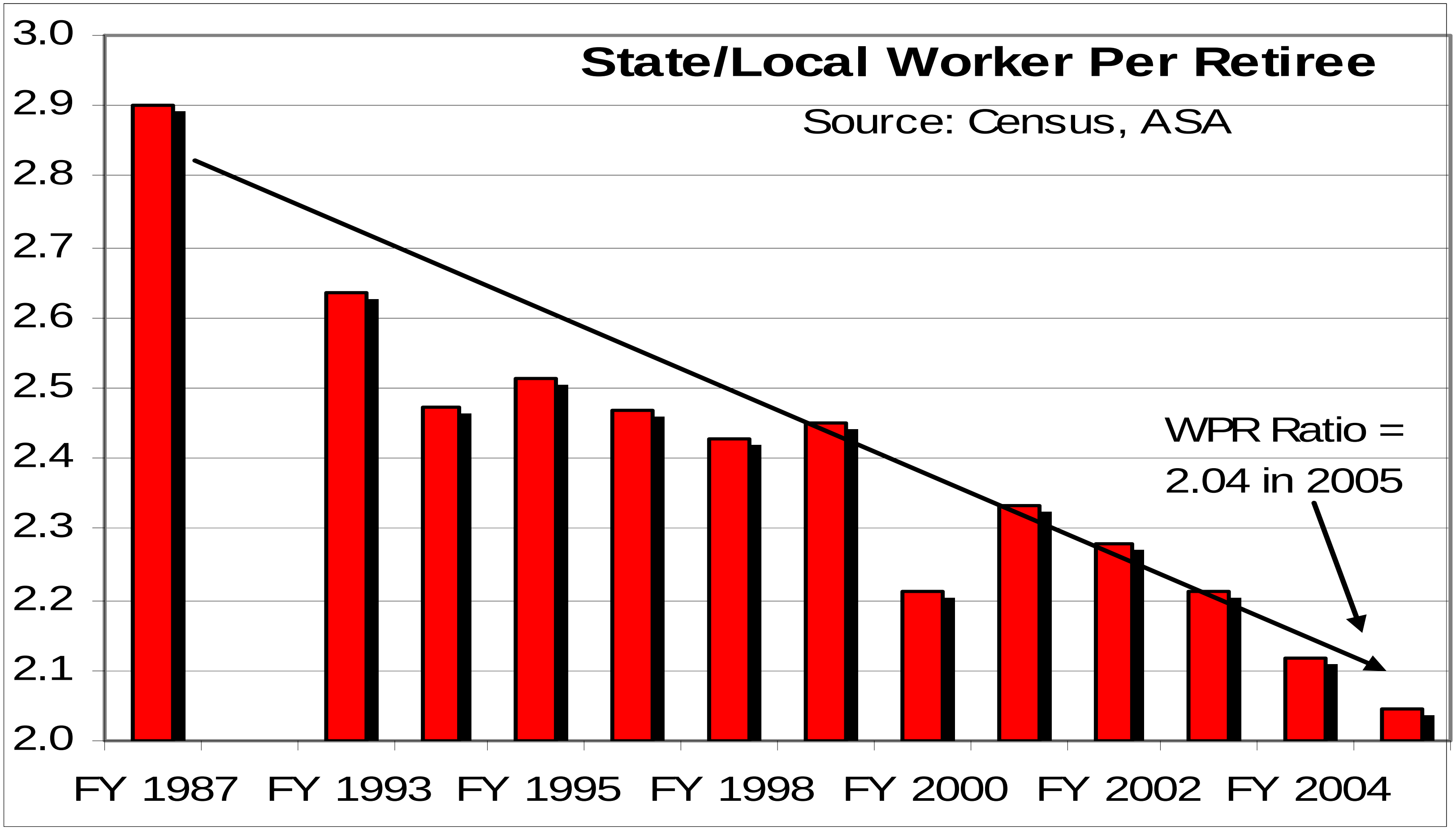
Demographic Pressures

Baby Boomers

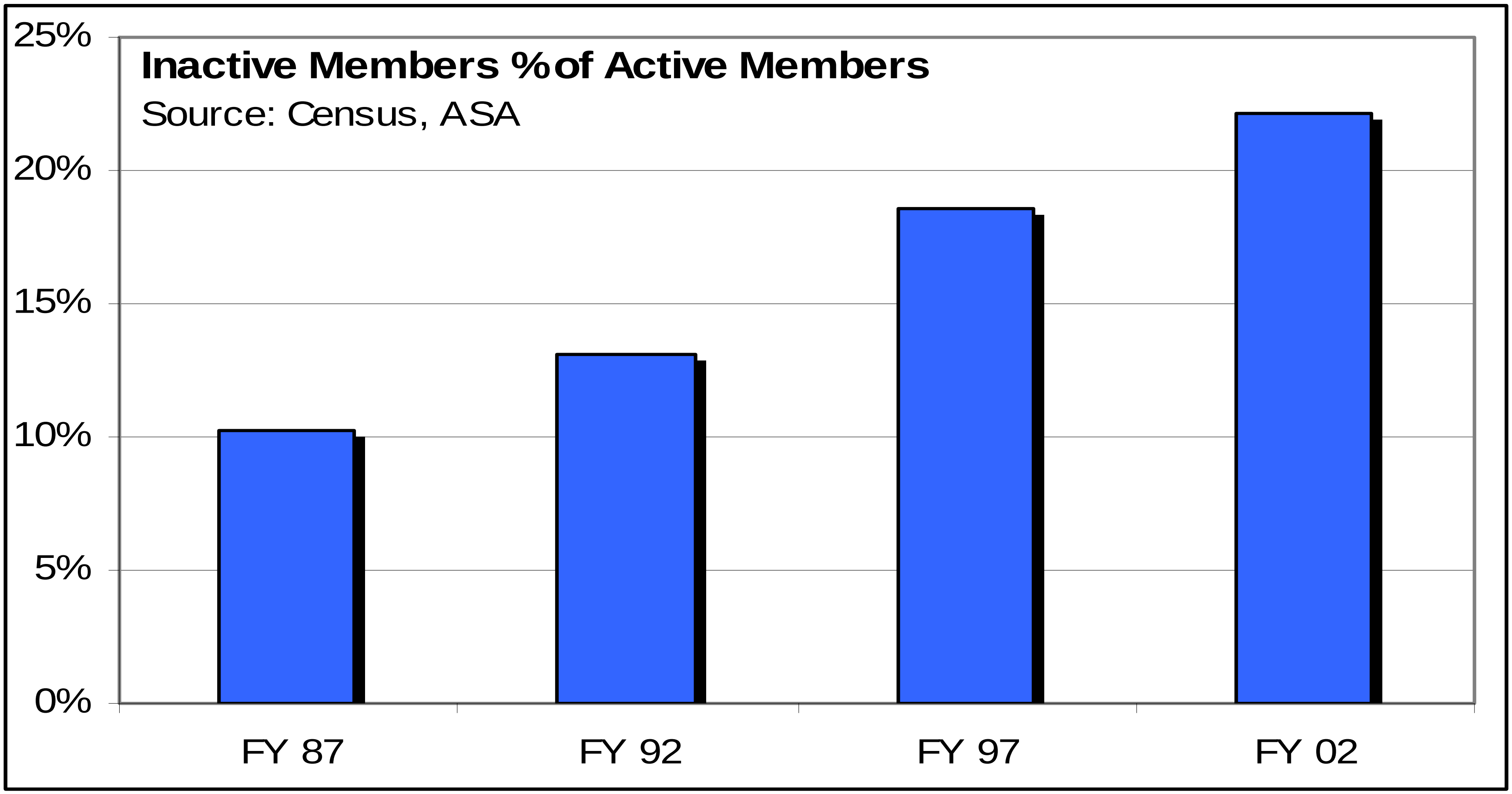
1. Retirement Tidal Wave Occurring/Coming

- Aging Workforce
- Employee to Retiree Ratio Significantly Declining; Inactive Members Soaring
- Next 5 years, more than half of states will lose 20 percent of their workforces to retirement.
- Difficult to Replace Workers 1 to 1 Basis
- Places Upward Pressure on Contributions
- Requires Higher Rate of Return

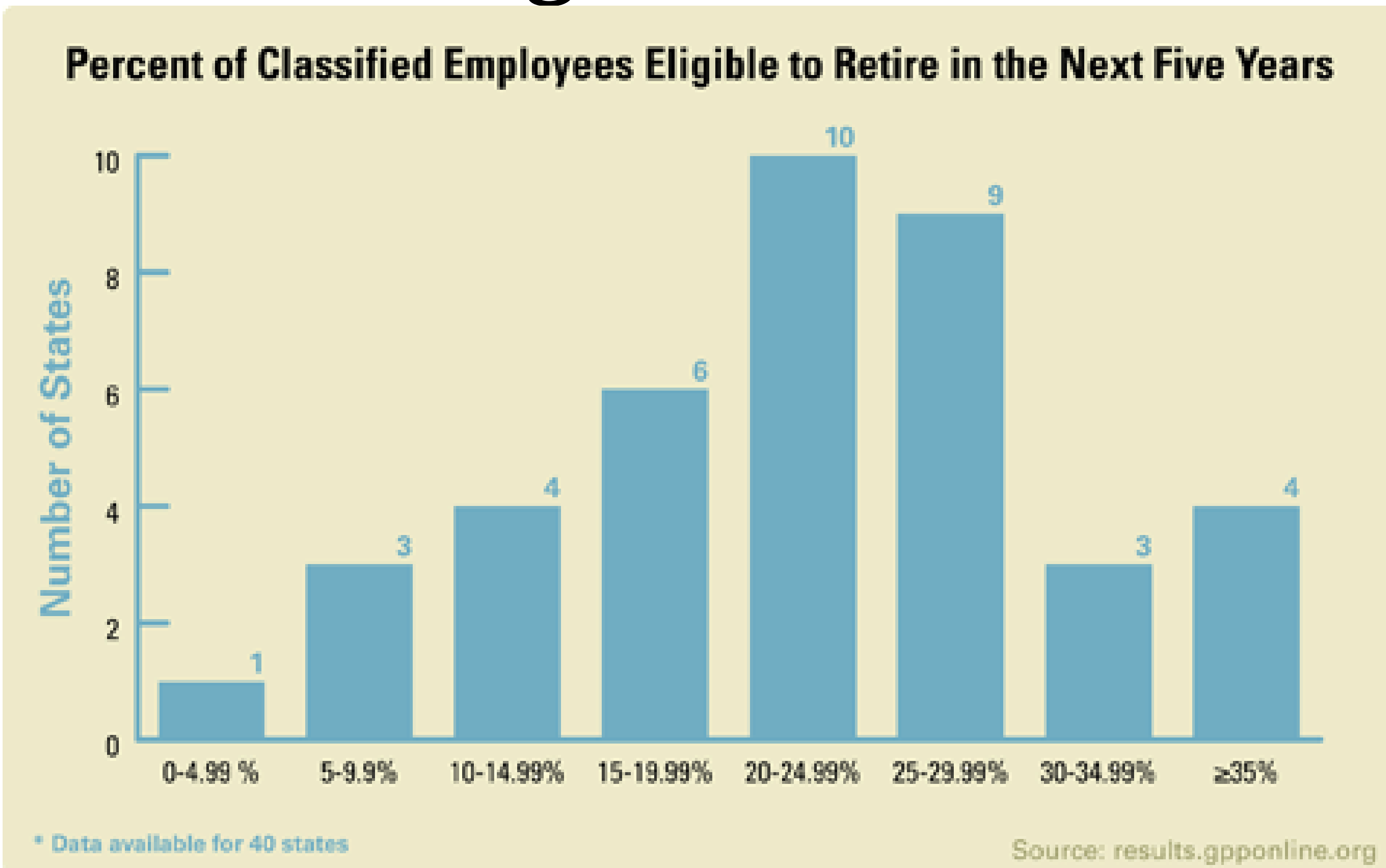
Retirements Already Rising, Acceleration Expected



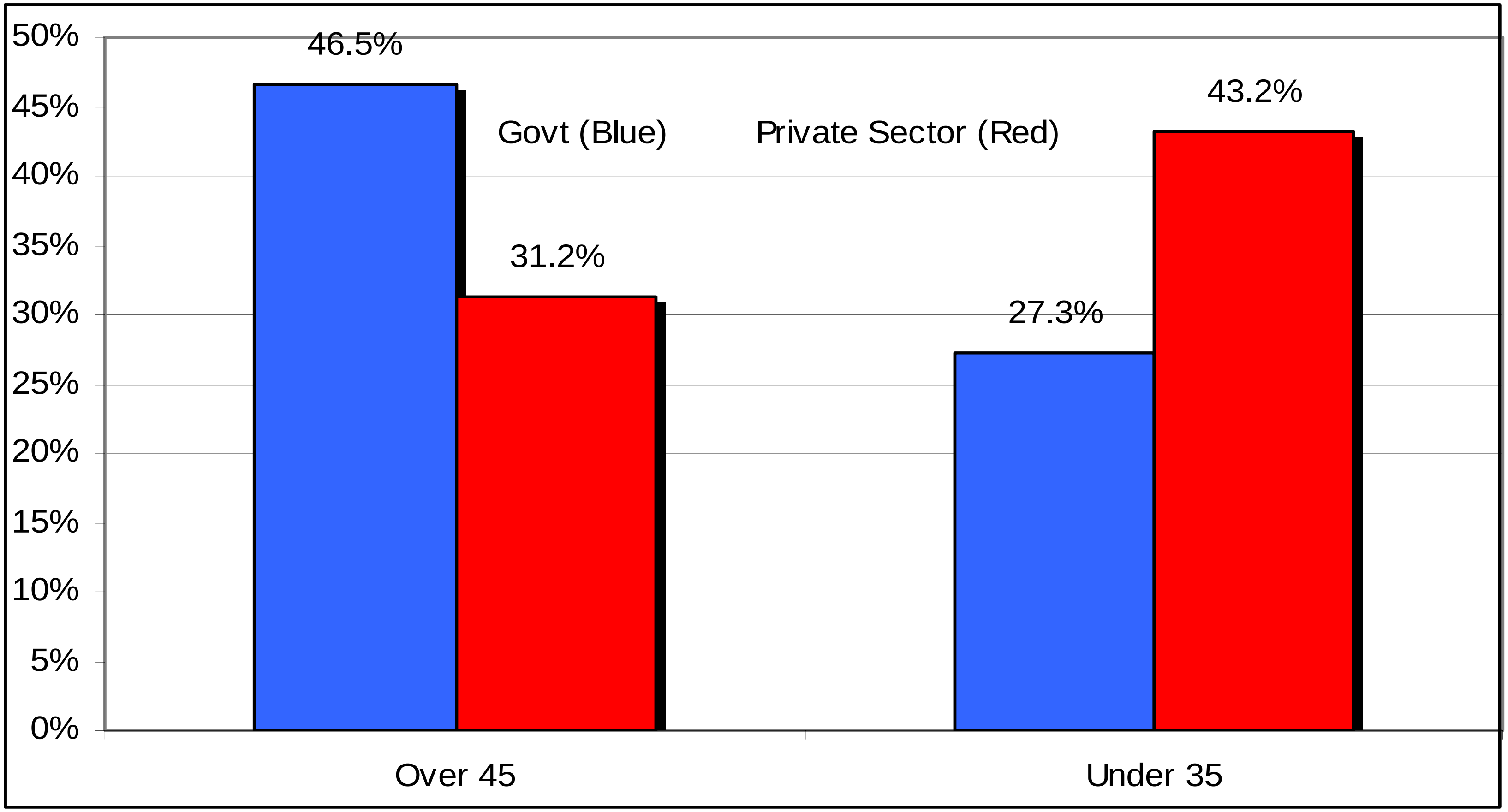
Inactive Members More Than Doubled in 15 Years



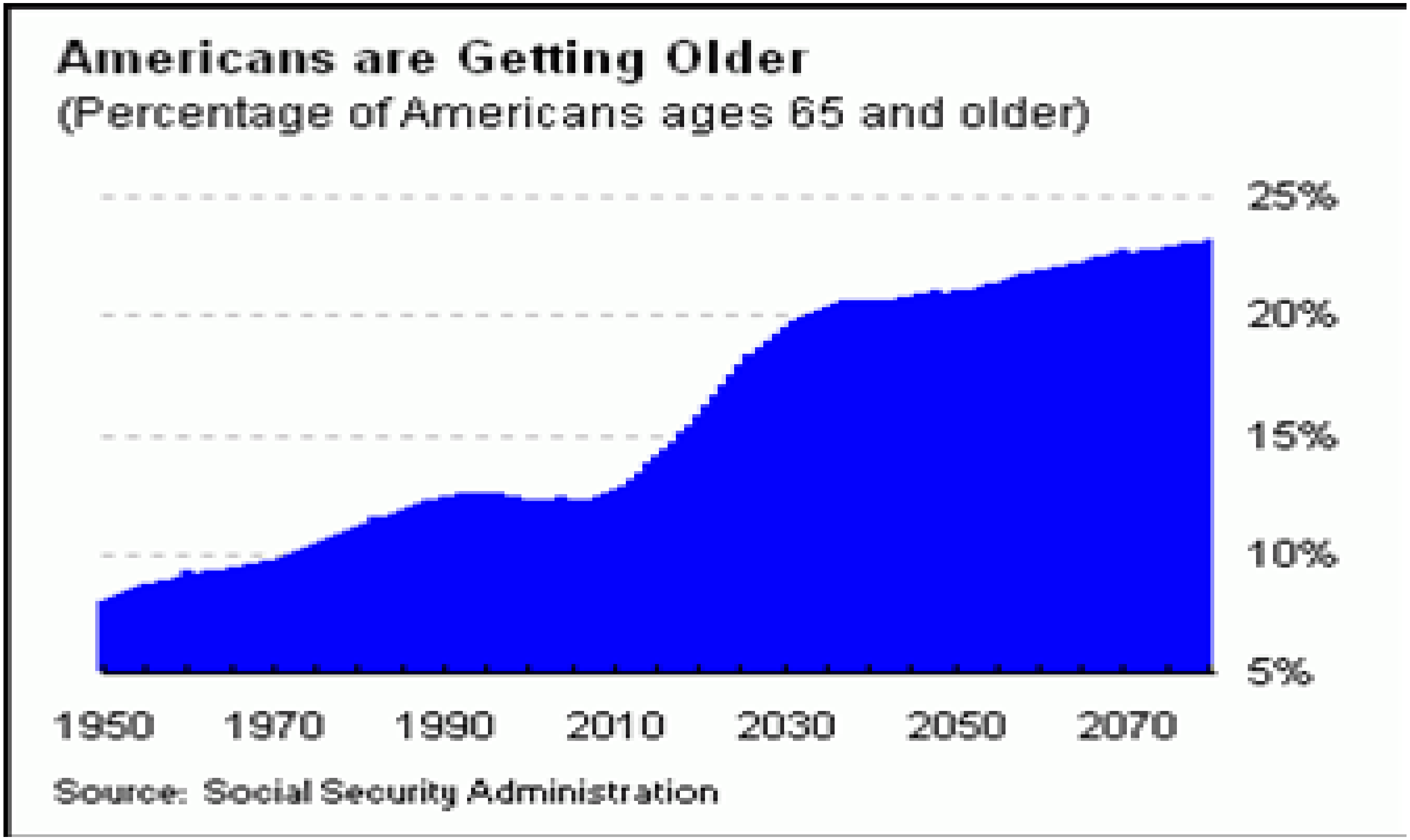
The Coming Retirement Wave



Government Workforce Much Older Than Private Sector



Longer Lives = More Benefit Checks



Demographic Pressures

Payments Rising Faster Than Income

3. Currently, total payments are rising at an annual average of 10 percent which is faster than the assumptions of investment returns plus contributions.

- This will only accelerate as the retirement wave hits, again putting upward pressure on rate of returns and contribution amounts

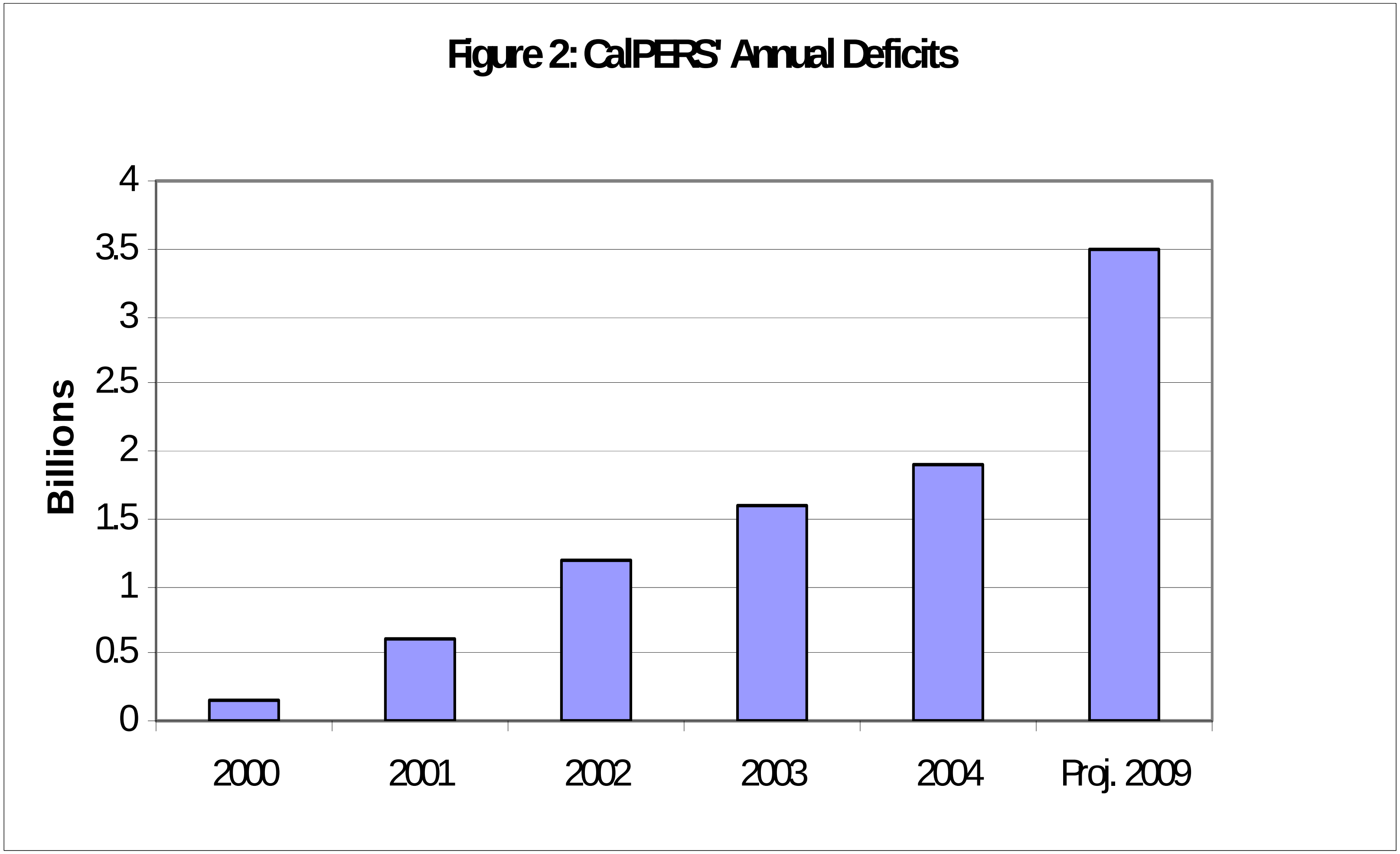
Demographic Pressures

Unfunded Liabilities

4. Demographic pressures would be less of an issue if systems were funded.

- However, aggregate unfunded liability estimates range from $250 to $700 billion.
- S&P estimates $274 billion, 84% funded
- Deficit is becoming structural – CALSTRS "can not invest our way out"

Now Is The Future: Structural Deficits Have Arrived



Demographic Pressures

Amortizing Dangers

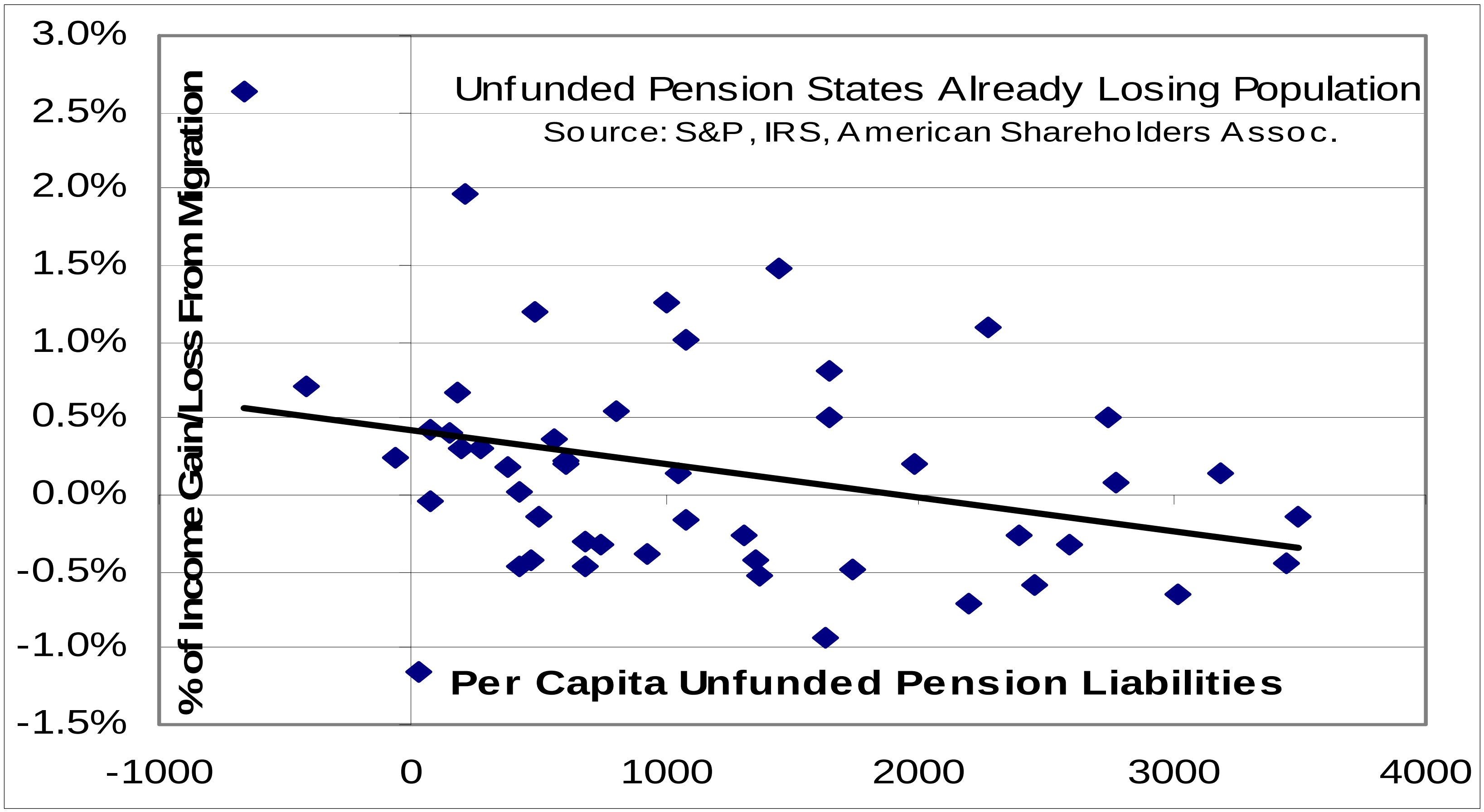
5. To cover the gap, pensions are “amortizing” newer workers payments to pay benefits.

- Proponents claim akin to mortgage payment
- Never would have received the loan in the first place – not enough assets to cover future liabilities.
- CALPERS wont be solvent through 50 years more than the lifetimes of workers
- Dog chasing own tail

States Impacted Differently

- Demographic pressures will increase pressure on all state pension systems.
- Under funded states will feel the most pressure.
- These states have older state workforces, high tax burdens, & suffering from out-migration of higher income taxpayers.

Most Strained Pensions Already Constrained to Raise Taxes



Demographic Pressures

- Given the current constraints on the system coupled with future expected strains, taxpayers will be forced to pay higher taxes to fund the retirement of public employees.
- Based on political realities, will taxpayers (struggling with their own retirement expenses) be willing to pay higher taxes for someone else's.
- This development will serve as an additional pressure for reform in the years to come.

Defined Contribution Solution

The DC Solution

- An aging population, increased labor mobility, perverse incentives of the public pension system, and taxpayer frustration has led to a new reality facing pension systems.
- Defined contribution plans are the natural alternative to meet these changing needs.
- Merging attractive features of a DB plan with individual ownership meets these needs.

DB Features in the DC Plan

- Automatic Enrollment in the DC Plan
- Index Funds Provide for Portfolio Diversification:
- [Equity, Bonds, Cash] - [Large Cap, Small Cap, Mid Cap] - [Value, Core, Growth] - [Domestic, International]
- Lifetime Fund option managed professionally
- Annuities Upon Disbursement, Unless IRA Roll Over

Benefits to Workers:

- The DC Plan is Fully Portable.
- Workers Control Their Own Funds.
- Worker Empowerment.
- Higher Returns for Workers, Especially Short and Mid Term Workers.

Benefits to Taxpayers:

- Unfunded Liability Hemorrhaging Ends
- Enhanced Worker Recruitment Ability.
- Administrative Cost Reduction.

Don’t Let Perfect Be The Enemy of Good

- Opponents of DC Plans Have Raised Important Concerns.
- Concerns Can Be Easily Fixed, Since Most Are Small Changes.
- In Contrast, DB Plans Will Wane In Importance Because of Structural Problems
- It Makes No Sense To Shoot Down What Is Best for Employees Over These Small Concerns

Countering the DC Myths

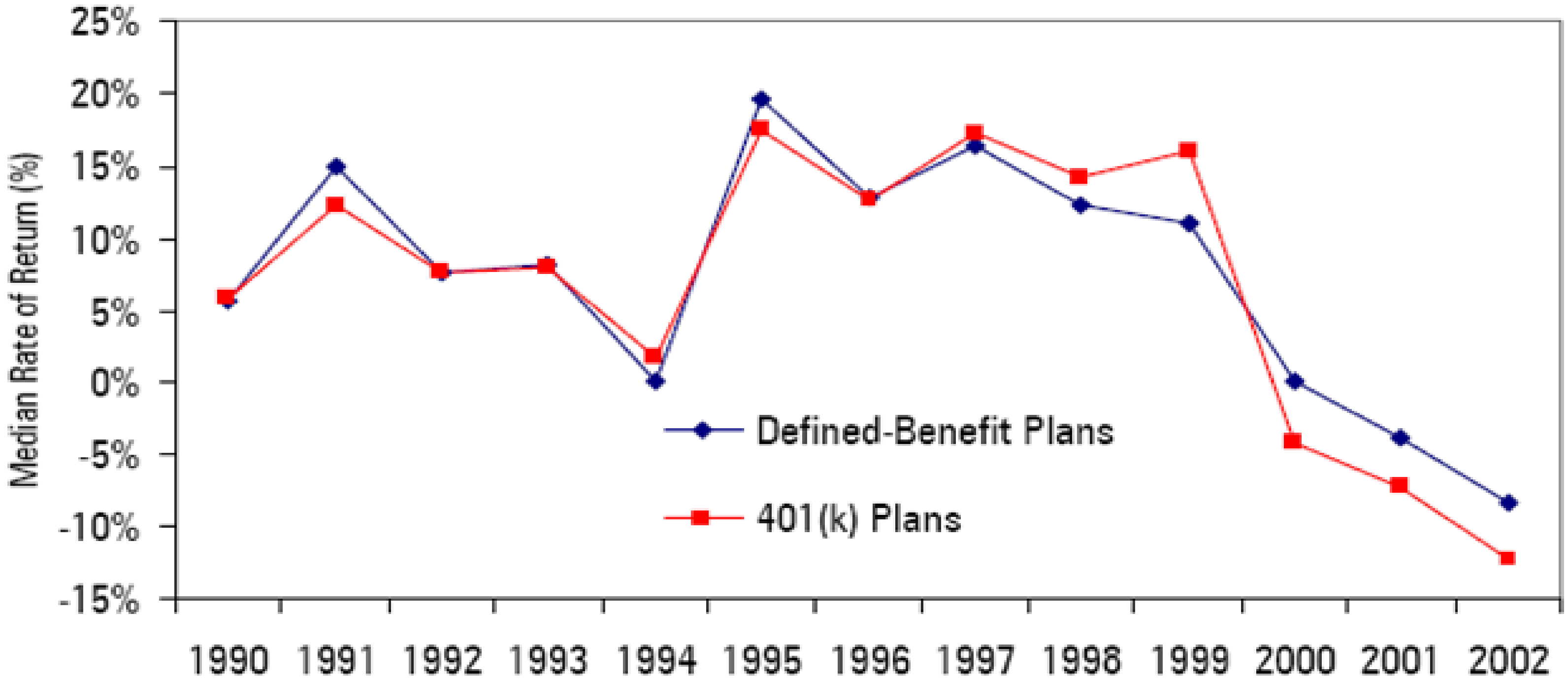
"Warren Buffett Myth"

New Trends Make It Easier to Invest

- Use Federal TSP program as a model
- 5 or 6 index funds for broad portfolio diversification, tracking indexes.
- Growing popularity of ETF's make this possible.
- Even w/o ETF's rates of return for DB and DC are very similar

Not Much Difference Between DB & DC Rate of Returns

Figure 4: Median Rates of Return for
Defined-Benefit and 401(k) Plans, 1990-2002



Source: Watson Wyatt & Co., "Defined Benefit vs. 401(k): The Returns for 2000-2002," Watson Wyatt Insider, October 2004.

The Nebraska Myth

Apples to Oranges

- 2000 Study 6-7% in DC v. 11% in DB
- Comparison is irrelevant because investment returns in DB does not directly translate into worker retirement income.
- True Comparison is DB Annual Income v. DC Annual Annuity.
- Legislators were duped with misleading information

Not Enough Retirement Income Myth

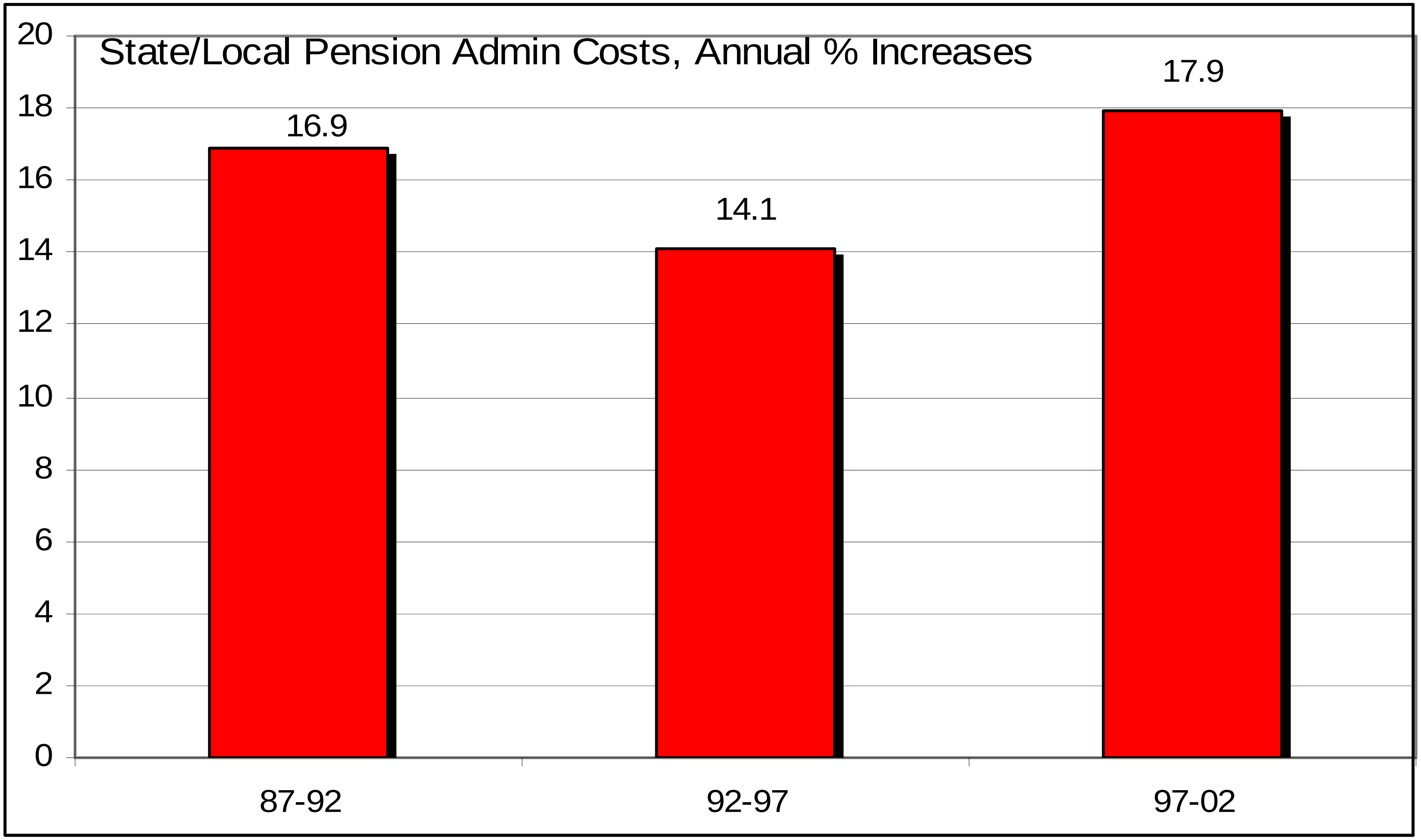
- Making the right comparison between DB annual payments and annuity payments demonstrates workers have more retirement income under DC.
- This is particularly true for shorter term workers, who benefit from the accruing gains over their careers.
- Pacific Research Institute analysis of CALPERS benefit v. DC plan shows nearly every state employee benefits under DC.

Administrative Cost Myth

Apples to Oranges Part II

- Proponents claim administrative costs are lower under DB plan and focus only on investing accounts.
- Fails to take into consideration the costs to administer the program itself
- 16.3% average annual increase since 1986

Admin. Costs of State/Local Plans Are Very Expensive



Administrative Cost Myth Part II

Ignoring Low Fee Investment Alternatives

- Proponents argue pool investment fees are less than under traditional mutual fund (20 basis points compared to 180-200 basis points)
- However, Federal TSP operates at 15-20 basis points.
- Movement toward ETF’s – 15 to 20 basis points. (Some quirks need to be worked out)

Increasing Unfunded Liability Myth

- If shift from DB to DC, employees get what they earned and there would be no cost.
- But since the plan is accruing unfunded liabilities their money would not be there for them.
- At some point the government will need to bail out the unfunded liability – it's a matter of timing and all that is occurring is taking an implicit cost to an explicit cost, which is actually sound accounting.

Increasing Unfunded Liability Myth

- Workers leaving are short and mid term so drop is not that great.
- In West Palm Beach, Florida 63% shifted to DC but only removed 14% of the assets.
- The assets of that plan actually continued to increase throughout the transition, climbing from $80.7 million before the conversion to $86.4 million after the conversion.
- Other counties report similar changes.

Lack of Cost Savings Myth

- If the shift from DB to DC did not save money, many of the private companies would not be doing this.
- 2 out of every 3 private retirement dollars are held in DC plans
- This shift will accelerate upon passage of the Federal Pension legislation which makes companies realize the true cost of their DB plan

Uncertainty Over Pension Amount or Over the Pension Itself?

- At the current rate, workers have the potential to lose their pension plans if sufficient tax increases are not enacted (private sector: airline cutting DB benefits 2/3)
- Under DC, the amount maybe uncertain, but what is certain is something will be there, unlike in DB plans today.