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News from EBRI

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New Research from EBRI:

Public Pension Plan Asset Allocations

WASHINGTON—A new report from the nonprofit Employee Benefit Research Institute (EBRI) reviews actual public pension plan contribution behavior from 2001 to 2006, pension asset allocations from 2003 to 2007, and the effect that investment performance has on employer contribution volatility.

Since public pension funding depends largely on investment earnings, market volatility can significantly affect the funded status of plans: the funded status generally rises in bull markets and declines in bear markets. Investment gains and losses are usually smoothed over five years, which serves to dampen the effect of market swings on both funded status and required contributions.

Plan sponsors review investment policy on an ongoing basis, but generally do not change it significantly in response to short term swings in the market. Thus, at least in the short run, plan sponsors are not likely to change to policies yielding significantly lower expected investment returns in exchange for reduced volatility in employer contributions for the following reasons:

- First, higher-return-higher-risk asset allocations are expected to add investment income that would not be earned under the more conservative strategies.

- Second, a high expected rate of return can be used as a discount rate to evaluate pension liabilities.

- Third, since pension plan investment professionals tend to follow peer group investment policies, as is encouraged by the “prudent person” fiduciary standards.

If economic changes suggest that future expected returns of asset classes will also change permanently, then the current investment policies may be adjusted to either raise or lower the level of expected return. This adjustment would lead to a higher or lower discount rate, and, in turn, would either decrease or increase the unfunded pension liability and therefore require either reduced or additional contributions.

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