

# Frequently Asked Questions

## WHY DO PENSION FUNDS INVEST IN A DIVERSIFIED PORTFOLIO?

Public pension funds generally have long investment horizons, and thus can invest for the long term. Because investment returns on a diversified portfolio are expected to be higher than fixed income returns over longer periods, investing in a diversified portfolio of return-seeking assets, including equities, is appropriate. In essence, these investments are held through up and down cycles, which offset each other.

This is the same dynamic in personal investing, as younger people generally are encouraged to invest their retirement dollars more aggressively in stocks than older retirees. For example, lifetime funds are designed to invest more conservatively as a plan participant approaches retirement and has a shorter investment horizon. The difference is that an ongoing public pension plan always has a long investment horizon.

## CAN A PLAN SIMPLY BE SETTLED IF ITS ASSETS EQUAL THE LDRM?

The LDRM really presents more of a theoretical value of settling a plan's liabilities than is practical. This is true for a few reasons.

First, plan benefit payments can stretch out for seventy years. There are few, if any, bonds that you can purchase that match benefit payments past 30 years. This means that a plan would have to reinvest at some point in the future and the cost of bonds at that future date is uncertain. However, the LDRM inherently assumes reinvestment at the same rates.

Secondly, the LDRM essentially assumes that all dollars are invested at today's bond yields, though plans already hold bonds. Next year, when the LDRM is calculated again, it will again assume all investments are liquidated and used to buy new bonds again with pricing based upon more recent prices.

Third, if many large plans were to do this, it would add significant buy-side pressure on the bond market and could impact bond yields, given the trillions of dollars in pension plan assets.

In the public sector, where plans remain open to new hires, it is rare that plans choose to give up the additional investment returns of a diversified portfolio in favor of an all-bond strategy.



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## WHAT SPECIAL ISSUES DOES THE LDROM PRESENT TO RISK-SHARING PLANS?

Risk-sharing plans face additional considerations when calculating the LDROM, as many have adopted cost-sharing and automatic benefit adjustments that are triggered by the plan's fiscal condition. Ultimately, plans need to project future benefit payments and discount them in order to calculate the liabilities under any scenario.

This presents a decision point: Does the LDROM return assumption trigger these plan changes?

If the LDROM is viewed as an attempt at mapping out a scenario where future returns are set equal to a portfolio that only achieves returns equal to today's bond yields, a plan may choose to assume that these risk-sharing provisions are triggered repeatedly in the future due to the inferior returns of the all-bond portfolio (lowering benefits or shifting more costs to workers).

In contrast, a plan may choose to assume the funding status in the future is based on their actual assumptions, which would result in less, or no, risk-sharing in the future.

## WHAT DOES THE DIFFERENCE BETWEEN A PLAN'S FUNDING LIABILITY AND THE LDROM TELL US?

Stocks and bonds have different expected returns over time, with stocks expected to provide higher returns. Over short-to-medium timeframes, stock market volatility is the tradeoff.

As such, funding a stream of benefit payments that stretch out over many decades is more efficient when investing in a diversified portfolio, as opposed to an all-bond portfolio.

In practice, if a plan reports a funding liability of \$1 billion and an LDROM of \$1.5 billion, that means that investment professionals expect it would cost an additional \$500 million to liquidate the plan's investments and buy bonds (at recent prices) in order to meet the plan's benefit obligations.



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