Q&A November 2024

Trends in the Public Pension Space

Over many decades, public pension plans must navigate ever-changing demographic trends, fluctuations in interest rates and a myriad of other economic obstacles so that when the time comes, beneficiaries have access to the monies they were promised. To gain a better understanding of recent trends in the public pension plan space and the obstacles they face, we conducted the following Q&A session with Floyd Simpson III, CFA, CAIA, CFP. Floyd is a portfolio strategist in our OCIO Portfolio Strategies Group.

How would you describe the state of government pension plans across the U.S.?

Simpson: Pension plans have, by and large, bounced back from the pandemic period and ensuing drawdown in the capital markets. Current funding levels stand at 80%.[1]

However, this is no time for celebration because underlying demographics are likely to be a growing concern for pension plan administrators in the future. Per the Congressional Budget Office (CBO), by 2040, U.S. deaths are expected to exceed births and the 65+ age group will be growing faster than the 25-64 age group.[2] Not to mention, individuals have a longer life expectancy than they did decades ago. As a result of these daunting demographic trends, some plans will soon have more retirees than active members for the first time. These changes will likely have marked implications when it comes to how plans invest and upon their growing need to maintain a greater degree of liquidity (to pay benefits).

An increase in the retiree-to-active member ratio also isn't particularly welcome news because it comes at a time when some plans are in the process of reevaluating their actuarial assumed discount rate as expected future returns from investments are now expected to be lower. This change in expectations has prompted some boards to lower their discount rate, which can negatively impact the funding rate at a time when assumed contribution rates are being increased for both active members and municipalities.

1 Rob Kozlowski "U.S. public pension funding improves to over 80% — Equable Institute" Pensions & Investments, July 2024.
2 "The Demographic Outlook: 2024 to 2054," Congressional Budget Office, January 2024.

These headwinds have led pension plans to ponder allocations to private markets or increase their equity exposure to avoid altering their discount rates. While many of the larger plans have had a prior allocation to private investments, this is still relatively uncharted territory for some of the smaller plans.

Other post-employment benefit (OPEB) funds also deserve a mention, because for municipalities this may be the so-called "canary in the coal mine." An aging population coupled with increasing healthcare costs will equate to a higher payout of funds in the future. And while most funds have opted for a pay-as-you-go model, this could become a burden on future budgets as our nation continues to age.

How will higher interest rates and inflation impact pension plans?

Simpson: The higher-for-longer rate environment has, in some sense, been beneficial for plans as it may lessen their reliance on extreme equity allocations or the risk associated with taking on highly illiquid assets. That said, fixed income has had a higher correlation to equity returns over the past couple of years and has been more volatile than expected, which can negatively impact monthly budgets if contribution rates increase more than expected for municipalities that are struggling to run a balanced budget.

Inflation is a different animal altogether. Inflation can have a marked impact on defined benefit plans since there will likely be pressure to provide for or increase existing cost-of-living adjustments (COLA), which in turn bumps up the monthly payout and could also lead to an increase in the discount rate. For active employees, it increases the salaries, which in turn increase the liability down the road. While higher inflation can lead to higher equity returns, it can also be a headwind for bonds.

How have asset allocations started to adjust based upon the factors previously discussed?

Simpson: Anecdotally, there have been more conversations and a greater willingness to include private markets investments within portfolios. While reports of the death of the 60/40 (60% equities, 40% fixed income) portfolio have perhaps been overblown, years such as 2022, when stocks and bonds had a historically high correlation, have only accelerated this inquiry/trend towards alternatives.

From our perspective, alternatives are not ideal for every plan because while this asset class does increase diversification, it also introduces liquidity concerns, which are a risk that some plans might not be able to entertain based upon the financial health of both the pension plan and the municipality. That said, there are ways to add diversity to portfolios by incorporating, for example, dedicated exposures to liquid real estate investment trusts (REITs) and adding global public infrastructure to equity allocations to help mitigate the volatility of portfolios.

The push for alternatives has come at a time when even this area is expanding beyond the traditional private equity, hedge fund, and real estate classification. The ability to access areas such as private debt and private infrastructure has allowed plans and advisors to think about different ways to construct portfolios to meet intermediate and long-term goals for the plan.

Indirectly, this broadening of the investment universe has and will require both boards and plan employees to become more investment savvy than in the past. The concern here is that in some cases there may still be a substantial gap in the knowledge necessary to invest in these vehicles and particularly around the illiquidity associated with them. In short, board members and plan employees must have a deep understanding of this asset class prior to ramping up allocations.

How has the increased complexity of asset allocations impacted plans?

Simpson: The increased complexity with regard to allocations has increased the competition and need for proficient investment personnel. Government/state/municipal employers are now effectively battling with Wall Street firms for talent. By extension, this also has the propensity to increase costs associated with running an investment office/department for a public entity.

The need for additional customization has also led to interest in the outsourced chief investment officer (OCIO) space, which by extension has caused more

competitors to enter that business. Of course, competition can be good for the end consumer because it has the potential to drive down prices. But at the same time, asset owners and plan fiduciaries will have to be able to differentiate between OCIO service providers, which can be difficult given wide variation in the scope of services, resources, expertise and cost structure across different OCIO firms.

Any parting thoughts for the reader?

Simpson: Factors impacting portfolio performance in the past may not be the main drivers of future performance. As the world and investable universe has grown more complex and difficult to predict over the last decade — due to geopolitical developments, global macroeconomic trends, deglobalization developments, climate, etc. — more has been demanded of the fiduciaries responsible for the assets that fund long-term employee retirement plans. This has necessitated greater oversight, due diligence and care of fiduciaries who must be sure to consider additional factors (both investment and non-investment related) when building out a portfolio, whether it is a simple 60/40 or something more complex. In short, the world is experiencing a significant shift, and it will impact not only pension portfolios, but broader plans and budgets as well. Now is the time to prepare.

For additional information regarding this report, please reach out to your relationship manager.

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