Future Assumptions

Thank you for tackling an important subject in Timotht J. Pratt and David M. Walczak's Tradecraft column, "The Future of Historic Studies" (March/April 2006). Many good thoughts, but I take issue with the basic assumption involved with "the actuary uses these assumptions to predict what will happen in the future" and "the future predictions become more accurate."

I addressed this question in a 1998 issue of the "Actuary and the Future" newsletter. I maintain that the actuary doesn't do any predicting. If we did, we'd be judged by how well we predict. The actual future will unfold as the experience emerges. Many forces have a bearing on this experience. The quality of the actuary's work doesn't depend on how close the projection was to actual experience.

I contend that the actuary's work involves the projection of actuarial assumptions into the future. The actuary uses appropriate actuarial assumptions to do the work. These assumptions are usually based on current experience and are used in the projection with or without margins. Trends can be taken into account under actuarial standards.

It's not our job to make the predictions as accurate as possible. It is our job to use the most appropriate assumptions. This involves actuarial judgment and can vary among actuaries.

W. HAROLD PHILLIPS
WESTLAKE VILLAGE, CALIF.

Timothy Pratt responds:

Thank you for your note regarding our article. You're correct, and we should have made some reference to "judgment." I note that the two comments you pulled from our article were from the introduction. We were trying to set the scene there for the non-actuaries in the audience, and so our discussion in the introduction was from a high level and very general in nature.

The overall thrust of the piece was that there are now new tools available to help actuaries interpret the information contained

in the data and to help them apply their judgment in drawing conclusions about the process that's generating the data.

The situation mentioned in our article concentrated on using new statistical tools to separate the "signal" (the process you're trying to understand and use your judgment to forecast) from the "noise" (the random fluctuation that increases the process of understanding).

A Case for Regicide

Richard Zatorski's End Paper, "Living like a King" (May/June 2006), resonated with me because I just returned from spending the winter on Florida's west coast where developers, in league with corrupt zoning and other officials, are buying up mobile home parks and literally throwing the (typically old and poor) residents into the street so they can build million-dollar condominiums.

Clearwater Beach on down to St. Petersburg Beach is now so lined with condominiums that a tourist can't see the Gulf, let alone reach it to go swimming.

A big part of the rise in home prices is speculation. Speculators, with no intention of making these places their home, are paying outrageous prices in the hope of "flipping" the property in a few years for a substantial profit. A recent story in the *St. Petersburg Times* told how a developer put the mayor of Clearwater at the head of the condo buyers list for strongly backing a condo development on Clearwater Beach. Two days after the then-mayor took possession for $250,000, he sold it for $500,000. He's still walking around free and is a poster boy for the Chamber of Commerce.

Businesses are becoming concerned because their employees can no longer afford to live near their jobs. Zatorski questions the lack of outrage, but the proper response to this situation is not yet lawful: The commissioners, the developers, and the speculators should be strung up from lampposts.

DONALD E. GOULD
MIDDLETOWN, CONN.

City Pensions

Having worked in public employee retirement systems for several years, I read "The Funding Crisis in Municipal Pensions" by James B. Davis in the May/June *Contingencies* with interest. As many articles have pointed out over the past few years, most public employee retirement systems in this country, including state and municipal plans, are not as well funded as they were in the late 1990s, when "irrational exuberance" contributed to a false sense of well-being.

I have some concern, however, about one of the options discussed in the article. Mr. Davis suggests that most cities are overly conservative in their investments, and implies that cities should invest in hedge funds to increase investment returns.

Actually, many cities, especially larger ones, already have a substantial portion of their retirement system investments in equities in the hope of maximizing their returns. A number of actuaries, financial economists, and other experts have recently been calling attention to the fact that investments of that sort match quite poorly with the cash flows and risk characteristics of retirement plan benefits—and on that basis, plans should invest less in equities than they currently do. The mismatch between plan assets and liabilities is a major reason why so many plans have become less well funded than they were in the late 1990s.

Hedge funds are not the same as equities, of course, but their risks and cash flows are, if anything, an even poorer match for retirement plan benefits than are equities. Many whose thinking is informed by financial economics and the process of asset-liability matching (ALM) would not

advocate anything above a relatively small investment in hedge funds.

There is also the question of whether hedge funds actually produce better returns than equities. A recently published survey of hedge fund results from 1996 to 2003 shows that the average hedge fund return is less than that of the S&P 500. Factors affecting the advertised hedge fund returns include survivorship bias and self-reporting bias. (Hedge funds were not required to publicly report their results; those that wanted to, did so.) The study was performed by Burton Malkiel and Atanu Saha, and is reported in the November 2005 *Financial Analysts Journal*.

MICHAEL J. LAMBERT
NEW YORK STATE INSURANCE DEPARTMENT
ALBANY, N.Y.

I enjoyed Mr. Davis' Commentary "The Funding Crisis in Municipal Pensions."

This is clearly a major problem in many cities today. I was, however, a little disappointed in his list of options for addressing the problem. He identified that: (1) plans need to earn more money; (2) participants must contribute more; and (3) municipalities must contribute more. One could argue that option (1) should be pursued regardless of funding adequacy. Conspicuously absent, however, is the idea of reducing (or eliminating) future benefit accruals. This would at least "wall off" the problem so as to limit its further growth. While not an easy thing to do, it could be an attractive option if accompanied by the offering of a defined contribution plan with respect to future service—or is there some legal reason why this isn't possible?

BILL HEZZELWOOD
NEWPORT BEACH, CALIF.

Mr. James B. Davis suggests that federal legislation may help resolve the funding crisis in municipal pensions. The minimum funding standards of the Employee Retirement Income Security Act of 1974 (ERISA) do not directly govern state and local government plans.

In the1970s, some jurisdictions did not systematically fund retirement benefits accruing to their employees. The U.S. Congress considered federal regulation of

IMAGES.COM

state and local government pension plans. Congress, however, would have exempted government plans from financial oversight by the Internal Revenue Service and from insurance charges by the Pension Benefit Guaranty Corporation.

State legislation created public retirement systems. The legislature and, in some states, a pension commission can directly or indirectly apply consistent policy to a stream of retirement legislation. The body of common law governing the public pension environment is also important to maintain good policy, particularly significant are cases addressing the law of trust. Professional standards and reporting requirements of various professions and associations also enhance fiduciary responsibility.

In the upside-down world of public policy, few people bother to examine the potential real-world consequences of direct federal oversight of government plans. As new needs and challenges arise, the consequences of federal rules may not be immediately evident but will invariably reveal themselves, not all of them benign.

A lack of federal oversight has been a key factor in the past successes of state and local pension plans. Retention of this advantage will be vital to their future. States and cities have constructed pension-funding laws based on two principal mathematical factors—theory of probability and present value of money—rather than political power.

Many municipalities face the consequences of underfunded pension plans, escalating benefit costs, and insufficient income on investments. Federal regulation has not eliminated these negative consequences for private plans. Why should federal regulation eliminate negative consequences for public plans?

Today, many jurisdictions struggle to control escalating compensation costs, especially taxpayer contributions for pension and health insurance benefits. Even so, numbers tell a success story. Public retirement systems administer pension and other benefits for a combined 14 million active public employees and 6 million retirees. They distribute more than $110 billion in pension and other benefits. In 2004, they had accumulated approximately $2.1 trillion in assets and $2.4 trillion in liabilities, reports the National Association of State Retirement Administrators.

State and local elected officials deserve credit for establishing state and local retirement systems. However, along with their state legislature, current officials must also shoulder the blame if they let ideology rather than sound guiding principles drive how they spend taxpayer money. Ultimately, the best public policy usually occurs when pension officials have the most direct relationship with those who must support funding of government plans.

Each state and local government (as employer) has unique and differing needs and priorities. Good public policy allows a public employer considerable flexibility when funding benefits.

James A. Beirne
Pearl River, N.Y.

I'm glad to see that *Contingencies* is willing to publish a variety of viewpoints. However, although the article entitled "The Funding Crisis in Municipal Pensions," by James B. Davis has a number of interesting points worthy of discussion, I'm concerned that we should be requiring higher standards of factual accuracy and support. For example:

➤ The article states that "In Florida, many local municipalities are facing a similar disastrous situation." While I am personally familiar with only a few Florida municipality plans, I've seen no evidence in my personal experience or media reports that such disasters are widespread. Perhaps the statement is true, but with no supporting evidence, this seems like fear-mongering.

➤ "Municipal employees have no federal agency…There's no one to bail them out." Municipal governments have the power to impose taxes to pay for a bailout. Private companies do not, of course, thus the premise behind the PBGC. The moral hazard inherent in the structure of the PBGC is already creating difficulties for the country; extending that hazard to governments that have the taxation power to preclude a bail-out need would be ignoring the fundamentals of government. Although the author never specifically advocates that municipal funds should be covered by the PBGC, raising the issue without explaining why the distinction exists is apt to mislead the reader.

➤ "Recent articles indicate that pension plans in general are considering a venture into the sometimes risky and murky hedge fund market…new and uncharted territory for pension funds." This indicates a fundamental misunderstanding of current pension funding and the use of hedges in general. A significant number of plans have used hedge funds for years, and hedge funds can be used in conjunction with related investments to reduce risk.

➤ "This [employee contributions] …is a funding option common in corporations." Very few private sector defined benefit plans have employee contributions.

➤ "One thing appears clear: defined benefit plans…are dangerous dinosaurs that should be discontinued…" Certainly defined benefit plans face significant challenges, not the least of which are concerns about volatility and sharing of bankruptcy risk. The public sector does need to be vigilant in understanding the cost tomorrow of promises made today. But defined plans are also the most efficient way to provide a secure retirement benefit, and have contributed to the financial security of millions of Americans and a stronger economy for all of us. As previously noted, everyone is entitled to an opinion. But to allow an opinion to be posited as fact, and to include such an opinion when it is unsupported by the rest of the article or external evidence, is inappropriate.

Contingencies is a respected publication of a profession known for intellect. The quality of published articles should be commensurate with that respect and intellect.

The opinions expressed in this article are my own, and do not necessarily reflect those of my employer.

James F. Verlautz
Minneapolis, Minn.
Chair, Pension Committee

Advertising placed by eConsulting and software solutions provider, Insureware Pty. Ltd. of Austrailia, ran incorrectly in the May/Jun issue and can be found in its proper format on pages 42 and 43 in this issue.