International Perspective, by Marshall Auerback

Weakness At The Core: The Looming Pensions Time Bomb

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If you can't fund your pension, don't bother paying into it any longer. This is the message United Airlines appears to be conveying, as it struggles to get out of bankruptcy. Operating under Chapter 11 protection, United is striving to attract the lenders and investors it needs to recover. One aspect of its "recovery plan" was revealed last month when the airline announced it would no longer contribute to its pension plans. In fact, United also seems intent on shedding some or all of its $13 billion in pension obligations as the only way to succeed in emerging from bankruptcy proceedings, hardly a ringing endorsement for the "friendly skies".

And if things look bad in the skies for America's troubled aviation industry, they look even worse on the ground. The problems of United are broader manifestations of a looming pensions fund crisis for American industry in general. Indeed, if one of the American worker's remaining institutional bedrocks of savings, the corporate pension fund, can simply vanish in the event of non-contribution from the employer, it hardly bodes well for future consumer confidence. If United manages to cut itself loose from the costly burden of its pension plans, it might force others determined to keep their costs similarly under control to emulate its move. "Rivals may feel they are at a competitive disadvantage and follow suit, raising the specter of a domino effect in the industry," said Bradley D. Belt, the executive director of the government's Pension Benefit Guaranty Corporation, which insures pensions. If every airline with a traditional pension plan were ultimately to default, the government would be on the hook for an estimated $31 billion because such pensions are covered by a federal government insurance program, the US Pension Benefit Guaranty Corporation, which provides partial pension protection to around 44 million American workers.

Clearly, it's not just the airline industry workers who would feel the impact were United and others about to repudiate their pension fund requirements: just two years ago, the PBGC swung from surplus into massive deficit when it was forced to assume the liabilities of the three major steel companies, Bethlehem Steel, National Steel, and LTV. Bethlehem, for instance, had 67,000 retirees receiving benefits, 15,000 laid-off workers eligible to receive pensions in the future, and only 13,000 current workers were producing profits for the company. Whither the American profits miracle?

The PBGC is already hobbled by debt, having picked up the pieces of more than 3,200 failed pension plans in its 30-year life. The scale of the failures has risen sharply in the last three years, but the agency has few tools at its disposal to prevent the situation from becoming worse.

What is most extraordinary is that this is coming at a time when the Dow still hovers around the 10,000 mark, less than a quarter off its all-time high. Imagine the calamitous situation likely to arise in many other pension funds (and the corresponding impact on corporate profitability) in the event that the market ultimately breaks to new lows?

How have things come to this pass? United's pension plan developed its multibillion-dollar shortfall, in part, because pension law allows companies to fund their plans with the assets that any prudent investor would select. Over time, that has meant a shift away from the very conservative bonds that companies used to secure pensions before the 1974 law, in favor of more aggressive investments. After all, if the investments paid off, the resultant boon to corporate profitability was huge, particularly as companies could by law raid their own pension funds and transfer the excess returns generated from these plans to the income statement and thereby flatter the bottom line. Of course, if things didn’t work to plan (as they clearly haven’t over the past 5 years), there was always a bailout waiting in the wings to draw a line under the whole mess, if the problem was big enough. This is yet another instance of the moral hazard dialectic of remedying successive crises in an ever more fragile financial structure with bailout measures that foster yet greater financial fragility

Stocks have become the investment of choice, but today many pension funds seek to bolster their returns even more by adding relatively small amounts of hedge funds, junk bonds and other risky assets. A notable recent example is General Motors, which last year announced an aggressive embrace of hedge funds in order to bolster pension fund returns. This investment approach can produce attractive returns in a raging bull market, but clearly pose risks in a market environment where no asset class appears to be generating anything near the 9-10% commonly assumed by today’s pension fund trustees.

But in today’s world we can only expect fixed income – dash shorts and longs, governments, corporates, and mortgages – to yield on average 5 percent or perhaps less. These overall return assumptions of 9-10 percent clearly imply equity returns of much more than 10 percent. Expected returns of 13 per cent or 15 per cent or more are still prevalent amongst investors lulled by the bull market of the previous 2 decades.

In the century prior to the bubble (pre-1995), however, historical equity returns were only 9 per cent per annum. Why were they only 9 per cent per annum? Because they reflected average annual economic growth of roughly 3 percent, price inflation of roughly 3 percent, and a cash dividend yield of roughly 3 percent. Cash dividend yields today are only 1.5 per cent. Price inflation today is now around 2.5 per cent. And despite all of the trumpeting of the “New Era”, and “productivity miracles”, there is nothing about the US today to suggest that economic growth going forward should be higher this century than it was prior to 1995. A reversion to mean returns in fact implies long term returns on equities in the range of 5 percent per annum, not the historical pre-bubble 9 percent per annum, let alone the 13 percent or 15 percent, or more still embedded in the return assumptions of so many pension funds today.

We have said time and again in prior writings that the market has remained at unprecedentedly overvalued levels. This should be apparent to anyone by looking at the ratio of the market cap in the US to GDP, or to Tobin's Q. It should also be apparent if one looks at price/earnings ratios, where earnings are appropriately cleansed and brought to reality, such as S&P's new core earnings.

The irrational rationalization of prevailing stock prices is best exemplified by the continued use of IBES long run earnings growth forecasts in valuation exercises. IBES profit forecasts, however, are derived from Wall Street sell side analysts. After all the commentary on the lack of objectivity of Wall Street analysts, why would anyone seriously use a profit growth rate based upon their forecasts? It is as though one would choose to use a growth rate forecast by a Henry Blodget

Yet, Wall Street strategists often used IBES profit growth forecasts in doing their valuation exercises. Money managers use IBES forecasts. Consultants use it.

Such absurd practices have been validated by no less than the Federal Reserve Chairman. As the second half of the '90s progressed, few references were made to the irrational exuberance Greenspan boldly warned of in late 1996. Instead, no doubt as part of his penance for introducing such doubt about the legitimacy of the equity bull market so soon after his flawed 1994 attempt to pop an alleged equity bubble, Greenspan's speeches increasingly began sounding like they were penned by Wall Street investment strategists. Odes to a productivity revolution built on the back of high tech innovation can be read in increasing volume and stridency across his speeches and testimony. These points were widely held justifications for the increasingly absurd equity valuations, and so the Fed was seen as essentially validating the euphoric expectations getting built into equity prices. The willingness of the Fed to let the economy run right through what were previously believed to be natural speed limits was considered by equity investors to be a sign that the Fed was now well on board the New Economy bandwagon.

The trajectory that has been taken by Fed policy actions and discussions over the past decade and a half has involved increasing attention to the equity market, perhaps to the point of placing the Fed in a position as a lender of last resort during equity market meltdowns. A collapse of the PBGC would almost certainly create further calls in this direction. The late economist, Hy Minsky, once delivered a succinct assessment of the unintended consequences of these lender of last resort operations:

"Federal Reserve lender of last resort actions, directly or indirectly, set floors under the prices of assets or ceilings on financing terms, thus socializing some of the risks involved in speculative finance…such socialization of risks in financial markets encourages risk taking in financing positions in capital assets, which, in turn increases the potential for instability"

Which is effectively what manifests itself today in the pension fund world. As the pension system has weakened, some specialists have called for measures that would discourage the riskiest investments. As a former director of the PBGC, Stephen Kandarian proposed charging higher insurance premiums to companies that invested their pension funds in riskier assets, particularly companies that were in bad shape themselves. No one paid attention.

What would destroy this complacency? Quite simply, a substantial decline in the price of equities from current levels. Investors adopt models that justify prevailing prices. Look back to the beginning of 2000 when the NASDAQ was at 227 times' phoney earnings. Investors assumed a new era economy with characteristics unlike any economy before it. And for this "new era" economy it invented one new era metric after another to justify stock prices. The investment process and its conventions morphed as rapidly as the bubble ascended. Swept up by the bubble these institutional investors made allocations to equities independent of historic valuations. They put most of their pension assets by the beginning of the year 2000 into equities. Most of those equity funds went into growth products, and at the peak, when they were herding into such growth products, 60 percent of those growth portfolios were in tech stocks selling at more than 200 times' phony earnings. Clearly the whole world of institutional investors had lost touch with history.

But as the United episode clearly demonstrates, history has a way of biting back with a vengeance. If and when stock prices fall too far and for too long, many companies will face a comparable dilemma to that of United because in that sort of context, the fictional conventions of the professional investor class will be dashed conclusively on the rocks of reality. Professional investors will no longer look to fictions like IBES earnings forecasts to analyze stocks. Notions such as "the cult of equity", "stocks for the long term", or "people's capitalism" will seem as outdated as the concept of a centrally-planned state economy. And once such myths are dissolved it is very hard to restore belief in them again.

History has told us that one must usually wait for another generation before such truisms gain popular acceptance again. If we get to that point where institutions and the investing public are no longer willing to suspend disbelief in such fantasies, then policy makers' armaments may not prove effective because then there will be a whole world of disappointed investors and a whole world of stocks for sale. Our colleague, Doug Noland, spoke last week of financial instability manifested itself at the core, rather than the periphery. The looming pensions' debacle provides yet one more illustration of the profound "Swiss cheese" quality lurking at the heart of the rotten American core, unfortunately with ominous implications for the rest of us.

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