Through the Looking Glass into Public Pension Accounting

The Economist has an interesting piece in Buttonwood this week about how U.S. public pensions do their accounting. Basically, they discount their liabilities using the expected return on their assets. It results in some curious outcomes. For example, since holding cash typically drags down return expectations, if a pension fund simply gave away its cash (or burned it as The Economist posits) by raising its expected return on assets (no longer burdened by the cash drag) they would reduce the value of their liabilities. Their funded status might appear better even with fewer assets.

This perverse accounting treatment got me thinking about why pension funds continue to invest in hedge funds seeking 8% returns, even though it's been many years since hedge funds made 8% and it's not likely they will in the near future either. Certainly not with over $2 trillion competing for opportunities. Based on the accounting, including an asset with an 8% return target helps reduce the value of their liabilities even if the 8% return expectation is an unreasonable one. So the motivation for a pension fund trustee could be to include hedge funds because of their helpful impact on the discount rate on their liabilities even while their continued failure to achieve that target doesn't cause huge immediate problems. Far better than lowering the discount rate to a more appropriate level and revealing the true shortfall with all its political consequences.

This is how the $3 trillion underfunded position is growing. Sometimes accountants can cause a lot of damage.