

RATE OF RETURN EXPLAINED

Public pension funds get their money from three sources:

- 1 Employee Contributions
- 2 Employer Contributions
- 3 Investment Returns

On average, more than 60 percent of pension fund revenues come from investment returns. Professionals who work for the pension system invest the contributions of employees and employers to generate these returns.

The money contributed by employees and employers today will be invested and paid out as a pension benefit when an employee retires, in as many as twenty or thirty years. Since these benefits are owed so far in the future, pension systems need to know how much to contribute today in order to pay benefits decades from now. These decisions are made by professionals known as **actuaries**.

Actuaries also calculate the rate of return they expect the pension plan to earn on its investments. This is known as the **assumed rate of return**.

Actuaries have a good track record on predicting rate of return. When looking back over twenty or thirty years, the majority of public pension plans meet or exceed their assumed rate of return on their investments.

Year to year, investment returns may fluctuate significantly. Low returns one year, for example, 2% in 2012, may be followed by high returns the next year, for example, 12% in 2013. When looking over a 5, 10, or 20 year period though, those fluctuations smooth out and the returns are more consistent.

Actuaries are constantly adjusting their assumed rate of return on investments as they get new information about the financial markets. Over the past several years, the majority of public pension plans have lowered their assumed rate of return (from an average of 8% to an average of 7.5%) in recognition of the fact that economic growth has been slower. This is a responsible move that will ensure the long-term sustainability of public pension plans.

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Some have argued that public pension plans should use the so-called “risk-free” discount rate of U.S. Treasury bonds to determine their assumed rate of return. This would dramatically cut the assumed rate of return to as low as 2.5%.

Cutting the assumed rate this low is both unnecessary and damaging to the long-term health of the pension plan. Pension funding is far less volatile when using more stable, long-term return assumptions, not market rates that can rise and fall more quickly.

It would also significantly increase costs for taxpayers by increasing the amount that needs to be contributed to the pension fund each year.

EXAMPLE

Since its inception, the Oklahoma Teacher Retirement System has earned 9.35%, exceeding its assumed rate of return of 7.97%. The system recently generated one year returns of 21.11%.

