United States: Projecting Returns When Crafting A Divorce Settlement

By Mark R. Ashton

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Ours is an age where hyperbole has not only become accepted, it is almost universally embraced as a part of American culture, and among the chief advocates of hype is the financial service sector of our economy. We lived throughout the 1980s, 1990s and early 2000s in an age when one could not open a newspaper or magazine without reading the amazing returns on investment that could be achieved by investing with this fund or that. In 2008, when the stock market imploded there was some respite from this enfilade of data on returns. However, as the traditional mutual funds were beaten into retreat, they were quickly replaced by a new creature; the hedge fund. These new investment vehicles promised a faster, better, ride because they would trade with and, when right, against the market. Money fled to these funds despite some enormous loads and aggressive profit sharing demands on the part of the smart guys who established them.

2016 was a watershed. The Dow Jones index grew by 15%; the S&P 500 by 11% and the NASDAQ kept pace at 11%. Meanwhile Barclays Hedge Fund Index barely cracked 6% in a world where the "house" routinely takes 2% up front and 20% of performance. So the 6% hedge fund yield was probably closer to 4%. The three-year average for the Barclays is a measly 3%, making even Treasuries look attractive.

These are the elements of the market that get the hype. And they all have teams of public relations and advertising officials to spin the story their way. However, today's big news comes from the seldom-heard giants of the investment industry; the defined benefit pension managers. They don't advertise. In fact, they don't take customer's investments. They take public employee retirement contributions and are charged with the duty to make certain the government's promise to pay monthly retirement payments are actuarially sound.

Today's news is from CALPERS, the largest public employee pension fund in America. This California agency and its analogues throughout the US manage $3.7 trillion in funds. Their customers are governments that have promised retirees a specified payment every month for life. If they cannot meet their projections, they have to demand that state and local governments pony up larger tax payments to fill the gap. And those governments are already screaming at the large percentage of government budgets allocated to covering pension costs.

So what are the big boys saying? In California's case, they expect annual returns averaging 6.2% for the next decade. Some years will be better, some worse as the projection is an average. After 10 years, they see returns moving back up towards 8%, but the lower returns in the short run will mean more stress on your local governments to increase taxes.

The Ohio Public Employees system has predictions not much different. 6.76% over the next 5-7 years but then a bounce back towards the 8% that California predicts. Canada and Europe in the past years had lowered their expected returns while the US pension plans retained more flowery predictions. The US plans did not anticipate how far and how long interest rates would crater. The long-term prognosis for higher overall rates of return is premised in large part on a gradual return to historic interest rates.

For public employees, the concern about underfunded defined benefit plans remains. Low rates of return in the past several years have a cascading effect because income projections were not met. The Rockefeller Institute reports that the likelihood of a shortfall in income to distribute is 10x what it was 30 years ago. Subpar returns mean that CALPERS pays out more in benefits today than it receives in retirement contributions. We wrote about this looming problem in May 2016. Recently we spoke with Mark Altschuler who runs Pension Analysis Consultants in Elkins Park, PA. While actuaries, like Mark can project things like present value, it is not within their customary orbit to try to evaluate whether pensions will be able to meet their contractual undertakings to pay each beneficiary the prescribed amount on time.

What does this mean for the divorce practitioner and the client? When looking at the historic rates of return on S&P stocks between 1928 and 2014 the average rate of return today is approximately 10%. Some of that return is consumed by inflation. The other factor demanding consideration is risk tolerance. In March 2000, the SP500 stood at 1,527. It did not return to that value until October 2007. It then fell by more than half and did not return to 1,527 until 2013. The only way to gird against these market fluctuations is to integrate investments in stocks with investments in less volatile bonds. This is strategy that major government pension and annuity managers must emulate. It is also a polestar for conservative money managers. The term "going for broke" can be a self-fulfilling prophecy in the world of investment. So while last year the S&P kicked out 11% and that is 1% more than the 1924-2014 historic average, it would be improvident to build a financial plan exclusively around indexed rates of return. If you choose to believe that kind of growth is sustainable on a long-term basis, we encourage you to read Robert Gordon's Rise of American Growth (Princeton 2016). So, for the medium term, prepare for 6% returns and be thankful if you do better.