



Levy Economics Institute of Bard College

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# ***Public Policy Brief***

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## **THE TROUBLE WITH PENSIONS: TOWARD AN ALTERNATIVE PUBLIC POLICY TO SUPPORT RETIREMENT**

YEVA NERSISYAN and L. RANDALL WRAY

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## Preface

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Pension funds have taken a big hit during the current financial crisis, with losses in the trillions of dollars. In addition, both private and public pensions are experiencing significant funding shortfalls, as is the U.S. government's Pension Benefit Guaranty Corporation, which insures the defined-benefit pension plans of private companies.

Yeva Nersisyan and Senior Scholar L. Randall Wray argue that the employment-based pension system is highly problematic, since the strategy for managing pension funds leads to excessive cost and risk in an effort to achieve above-average returns. The average fund manager, however, will only achieve the risk-free return. The authors therefore advocate expanding Social Security and encouraging private and public pensions to invest only in safe (risk-free) Treasury bonds, which, on average, will beat the net returns on risky assets. According to Nersisyan and Wray, the best solution is to eliminate government support for pension plans and private savings, and to ensure that anyone who qualifies for Social Security will be rewarded with a comfortable retirement. And since Social Security is a federal government program, it cannot become insolvent.

In the early postwar period, Treasuries comprised a large portion of public and private pension plan portfolios, until factors such as competition and bankruptcies endangered firms' ability to meet pension liabilities and threatened the survival of "legacy" firms (and associated pensions). In response, firms sought higher rewards by investing in relatively higher-risk financial instruments such as corporate bonds, equities, and mutual funds.

Nersisyan and Wray point out that pension funds are part of what Hyman P. Minsky called "managed money," and that these funds are huge relative to the U.S. economy. They are large enough to destabilize asset prices (e.g., the boom and bust in the commodities markets) and any financial market they are allowed to enter. The willingness of government and employers to allow pension fund managers to risk retirement accounts meant that workers were subject to the whims of these money managers, and to the lack of government oversight and protection of these accounts.

Innovations such as securitization, plus leverage, led to exceedingly risky positions in assets that ultimately collapsed. In order to restore funding levels, managed money has tried to continually innovate and speculate on new kinds of assets. Thus, financial firms on Wall Street not only create and market complex (risky) instruments but also design "risk management" instruments to hedge and diversify the risk, in addition to selling commodity futures indexes (to satisfy the demand they have created) and a host of other products. Workers are left with fees that drain their pension funds, and with massive counterparty risk. By charging fees for all of these instruments, the financial firms ensure that pension funds will, on average, net less than a risk-free return.

The financial industry can be justified only if pension fund management can beat the average risk-free return on Treasuries (including industry compensations), but this standard cannot be met, say the authors. Therefore, workers would be better off if they and their employers were required to return to a portfolio of safer, longer-maturity assets such as Treasuries, which are automatically backed by the U.S. government. This approach would require a very small management staff, and would negate the use of fund managers and Wall Street sales staff.

As always, I welcome your comments.

Dimitri B. Papadimitriou, *President*

February 2010

## The Trouble with Pensions

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No one needs to be reminded that pension funds have taken a big hit over the course of the financial crisis. Private pensions have gone from being 109 percent funded in 2007 to 79 percent funded in 2008—meaning that the value of accumulated assets falls short of meeting promised payouts of defined-benefit pension plans by more than one-quarter, amounting to a \$400 billion shortfall. The shortfall in public pensions provided by state and local governments is estimated to run as high as \$2 trillion. By any reasonable accounting standard, the Pension Benefit Guaranty Corporation (PBGC) is troubled because its reserves will be wiped out by the failure of just a couple large firms on “legacy” pensions. There has been a long-term trend to convert defined-benefit plans to defined-contribution plans—which means that workers and retirees take all the risks. Indeed, this is often the outcome for “legacy” defined-benefit plans that require bailouts. In spite of some attempts to improve the management and transparency of pension funds, it is likely that the PBGC itself will need a government bailout, and that retirees now face a more difficult future.

In this policy brief we examine how we got into this mess—and how deep the hole is. More important, we argue that the current approach to managing pension funds leads to excessive cost and risk, both for covered individuals and for society as a whole. We advocate a different approach, one that would rely more heavily on government support for retirement through expansion of Social Security.

### How Did We Get into This Mess?

It is important to understand how we got into this predicament. During World War II, government wanted to hold down wages to prevent inflation, given that much of the nation’s productive activity was oriented toward the war. Unions and employers negotiated postponed payment in the form of pensions, which pleased all three parties: big firms, big government, and big unions. Unions got to deliver decent retirement income to members—a useful recruiting tool. Government promoted this with tax advantages for contributions to pensions, and by pushing spending into the postwar years it reduced inflationary pressure. And firms loved postponing costs to an indefinite future: rather

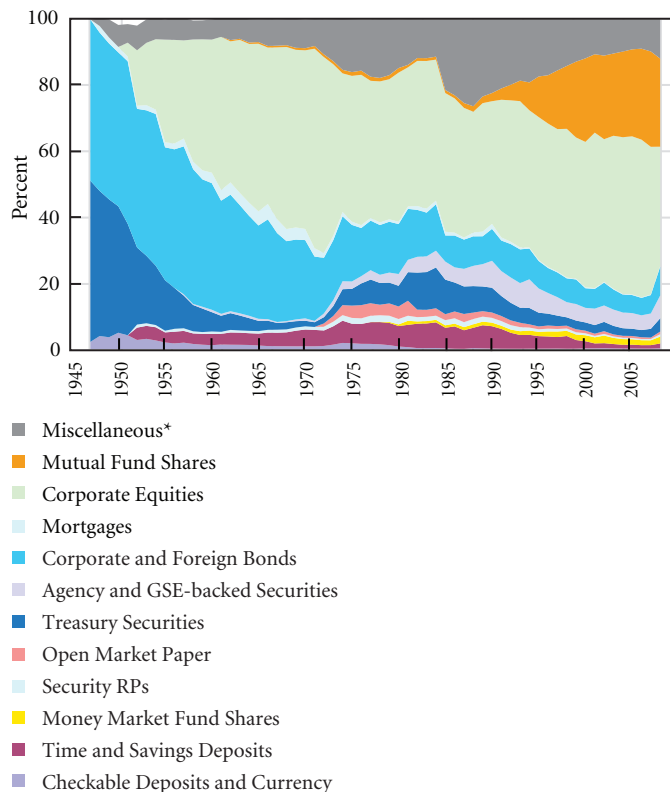
than paying wages, they would promise to pay pensions 30 or 40 years down the road. Much of the promise was either unfunded or met by stock in the firm. This meant that pensions could be paid only if the firm were successful for a very long time. In those heady days of industry’s domination by powerful American oligopolists, that seemed a fairly safe bet. After all, it was the era of John Kenneth Galbraith’s New Industrial State, when it appeared that the coalition of government, business, and labor interests could ensure preservation of market share and maintain the power both to set wages and to set prices at a level to cover wages and benefits such as pensions.

Unfortunately, that did not last as long as many thought it would. Competition (especially foreign) chipped away at market power, while bankruptcies, downsizing, and leveraged mergers and acquisitions endangered firms’ ability to meet pension liabilities. As time went on and it became apparent that “legacy” firms might not survive for the necessary half century (or more), unions and government felt that a mere promise to pay pensions would not suffice. Firms would have to kick in a huge amount of cash to fully fund the pensions—something the corporations were loathe to do. The grand compromise was that firms would increase funding a bit, and government would provide insurance through the PBGC. Effectively, Uncle Sam was going to be on the hook for any underfunding. Funding did increase, although the more frequent and more severe crises experienced after 1970 always wiped out enough assets in each crash to cause pension funding to dip below prudent levels. Only a financial bubble could get them back to full funding. To make matters worse, firms were allowed to reduce contributions during speculative bubbles (since asset values would be rising), thus ensuring that the funds would face a crisis whenever the economy was not bubbling.

Obviously, the riskiest portfolio would be one that was invested in the employer—effectively doubling down the bet that the firm would not face financial difficulties. Hence, a move to diversify was under way.

In the early postwar period, safe Treasuries comprised a huge portion of private pension plan portfolios, as shown in Figure 1. In the first years after the war, private pensions held nearly 50 percent of their assets in Treasuries and almost all the rest in corporate and foreign bonds. However, Treasuries were sold off, and corporate bonds, usually considered safer than equities, were largely replaced with the latter over the course of the 1960s. In recent years, equities plus mutual funds (indirect ownership of equities) represented the vast majority of holdings.

**Figure 1 Private Pension Fund Assets, 1947–2008 (in percent)**



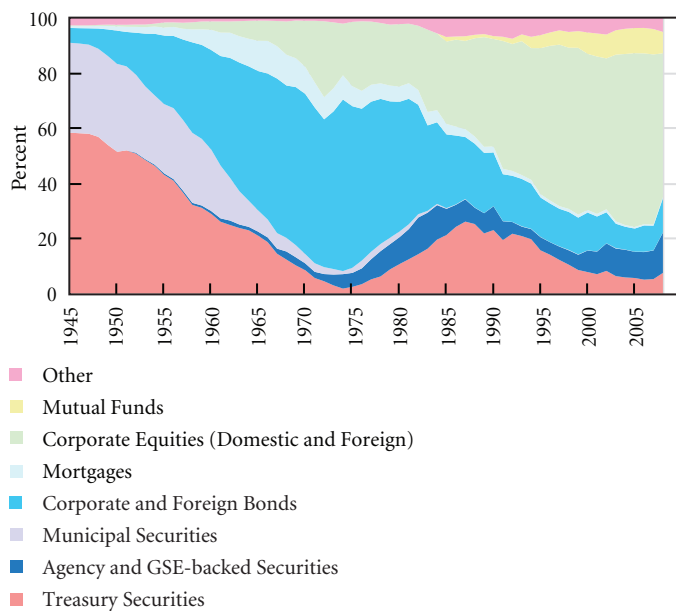
\* Includes unallocated insurance contracts, contributions receivable, and other assets

Source: Federal Reserve Flow of Funds Accounts

Figure 2 shows the allocation of public pension funds. Here the story is slightly different: it took these funds longer to divest themselves of Treasuries (although the share allocated to Treasuries increased again to a peak of 20 percent around 1990), and they were slower to move into equities. Still, at the recent peak, equities and mutual funds accounted for about two-thirds of assets even among public pensions.

The total volume of pension funds has grown rapidly in the postwar period, especially since the late 1970s, and is now huge relative to the size of the economy (and relative to the size of financial assets). Figure 3 shows private and public pension funds relative to GDP. Together, they have climbed to about 70 percent of GDP. As alluded to above, there has been a trend toward replacing defined benefits with defined contributions, as shown in Figure 4.

**Figure 2 State and Local Government Employee Retirement Fund Assets, 1945–2008 (in percent)**

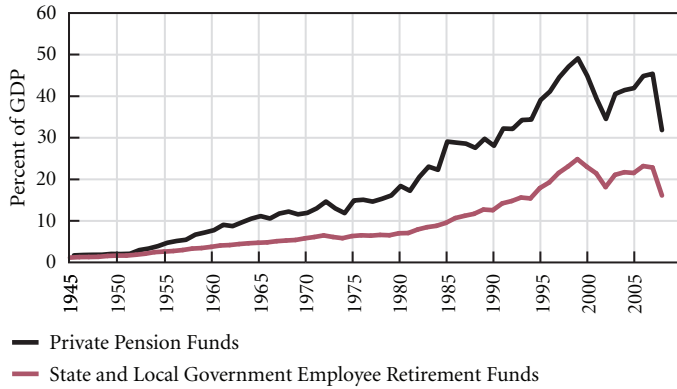


Source: Federal Reserve Flow of Funds Accounts

Defined-contribution plans such as 401(k)s were initially set up as supplements to other sources of retirement income, namely Social Security and employer-sponsored defined-benefit plans. But being much cheaper (and less risky) for employers than defined-benefit plans, by 1996 they had surpassed the latter. Today, 401(k)s and individual retirement accounts (IRAs) have become a major source of retirement income for many Americans. Currently, 55 million Americans are covered under defined-contribution plans, with assets reaching about \$4 trillion at the peak of the market (Ashworth 2009). Even the companies that used to offer defined-benefit plans have used the current crisis to either stop offering them to new employees or to freeze them for existing ones (EBRI 2009).

This has placed almost the entire burden of saving for retirement on workers, as there is no law requiring employers to match employee contributions to 401(k)s. Moreover, a study by Watson Wyatt found that defined-contribution plans have been continuously underperforming defined-benefit plans by an average of 1 percentage point per year since 1995 (Watson Wyatt Insider 2009). From 2007 to 2008, defined-contribution plans lost over \$1.06 trillion on their assets, with corporate equities and mutual funds contributing \$1.03 trillion to the losses (FRB 2009).

**Figure 3 Pension Fund Assets, 1945–2008 (in percent of GDP)**



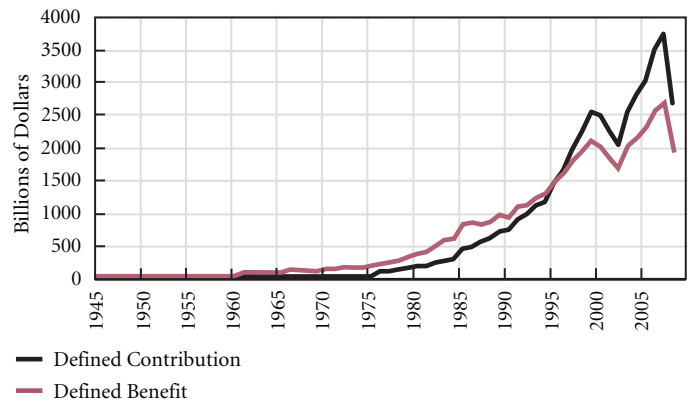
Source: Federal Reserve Flow of Funds Accounts

Employees that are enrolled in 401(k)s are usually presented with a menu of investment alternatives that they may choose from. The Pension Protection Act of 2006 amended the 1974 Employment Retirement Income Security Act (ERISA) to give participants the opportunity to “exercise control over the investment of assets in their plan accounts” (DoL 2008). A participant is considered to have exercised control over assets if the plan’s fiduciary invests them in one of the qualified default investment alternatives (QDIAs), unless otherwise directed by the beneficiary.<sup>1</sup>

The amendment offers three types of QDIAs: life-cycle or targeted-retirement-date funds, balanced funds, and professionally managed accounts. One characteristic that unites all three of these alternatives is that they move away from stand-alone, fixed-income capital preservation vehicles and toward alternatives that provide for capital appreciation as well as capital preservation. In other words, they are riskier but supposedly offer higher returns.

Employees can choose the so-called “life cycle” or “target date” alternative, which becomes more conservative as the retirement age nears. However, the *Wall Street Journal* reports that fund companies have “raced to roll out target-date products, often stuffing them with their own pricey mutual funds and adding an extra layer of fees on top” (cited in Laise 2009). But even this investment alternative, which is the most conservative of the three QDIAs, can be very volatile, as it can include a large proportion of stocks. This is the main reason why target-date fund assets lost 32 percent of their value on average last year, with

**Figure 4 Defined-contribution vs. Defined-benefit Plans, 1945–2008 (in billions of dollars)**



Source: Federal Reserve Flow of Funds Accounts

funds due to lose about 25 percent in 2010 (Laise 2009). EBRI has estimated that it could take two to five years for 401(k) balances to return to their January 2008 levels, assuming a 5 percent equity rate of return (Wharton School 2009).

A simulation by Boston College’s retirement-research center demonstrated that even if a worker had contributed 6 percent of his pay to a 401(k) plan for 40 years, had invested in a target-date fund, had never borrowed from the fund until retirement, and had invested in annuities at retirement, he could only replace 28 percent of his preretirement income, if he retired in 2008 (Laise 2009).

The recent decline of asset values both in absolute terms as well as relative to GDP has been historically large. The following numbers give some idea of the significance of the problems faced by pensions. Private plans (defined contribution and defined benefit) lost about \$1.79 trillion of their financial assets between 2007 and 2008, with equities and mutual fund shares losing \$1.82 trillion. As a share of GDP, private pensions fell by nearly 14 percentage points between 2007 and 2008. The Millman 100 Pension Funding Index, which tracks the nation’s 100 largest defined-benefit plans, reported a decline in the funding ratio from 99.6 percent to 71.7 percent (FPA 2009). Public plans fell by about 9 percentage points of GDP. IRAs (another form of tax-advantaged retirement savings) have lost \$1.1 trillion, bringing total losses of private retirement funds to about \$2.9 trillion (FRB 2009).

The outlook becomes even grimmer as we look into the finances of the PBGC, which insures defined-benefit private pension plans. The relation between the PBGC and defined-benefit

pension plans is similar to that of the Federal Deposit Insurance Corporation (FDIC) and commercial banks. Private pension plans pay premiums to the PBGC in return for its taking over payments when plans go bad, up to a monthly limit set annually under the Employee Retirement Income Security Act (ERISA). The PBGC's funding comes from returns on invested assets and current premium inflows, as well as the assets of the bankrupt pension plans and anything it recovers from the plan sponsors.

The PBGC's total benefit payments increased to \$4.48 billion in 2009, while another \$168 billion's worth of plans, those whose sponsors had credit ratings below investment grade or were in financial distress, were classified as possible terminations. This was up from the 2008 total of \$47 billion (PBGC 2009).

Although the PBGC has enough liquidity to meet its commitments for the next several years, it is underfunded in the long term, and none of its programs has sufficient funds to meet their long-term obligations. The single-employer program, for example, had assets of over \$68.7 billion, with liabilities increasing to \$89.8 billion in 2009. The multiemployer program was also underfunded, with over \$1.4 billion in assets and \$2.3 billion in "present value of nonrecoverable future financial assistance" (PBGC 2009). This makes the PBGC \$22 billion short of funds, double the 2008 level, or about 76 percent funded.

We want to be clear here: the PBGC is a government operation, like the FDIC, and as such it cannot go bankrupt. Rather, its long-term funding deficit or its shortfall of inflows can always be made up by Treasury payments. The point is that private as well as public (state and local) pensions are in trouble, and exactly how they will be bailed out will ultimately be determined by the Congress. There is no reason to believe that the bailout will be dollar for dollar. This means that retirees will suffer. And let us remind readers that retirees will suffer not because of mistakes they have made but rather from pension shortfalls that are due to the "grand compromise" that allowed employers to only partially fund pensions, to the government's unwillingness to fully guarantee pensions, and to the government's and employers' willingness to allow pension fund managers to take risks with workers' retirements. Indeed, even if workers had wanted to invest their pension funds in a safer manner, most of them would not have been able to make such a choice. In truth, they were subject to the whims of money managers chosen by firms, plus the lack of government oversight and protection of their funds.

Obviously, pension funds suffer when financial markets crash. It is important to understand, however, that this is a two-

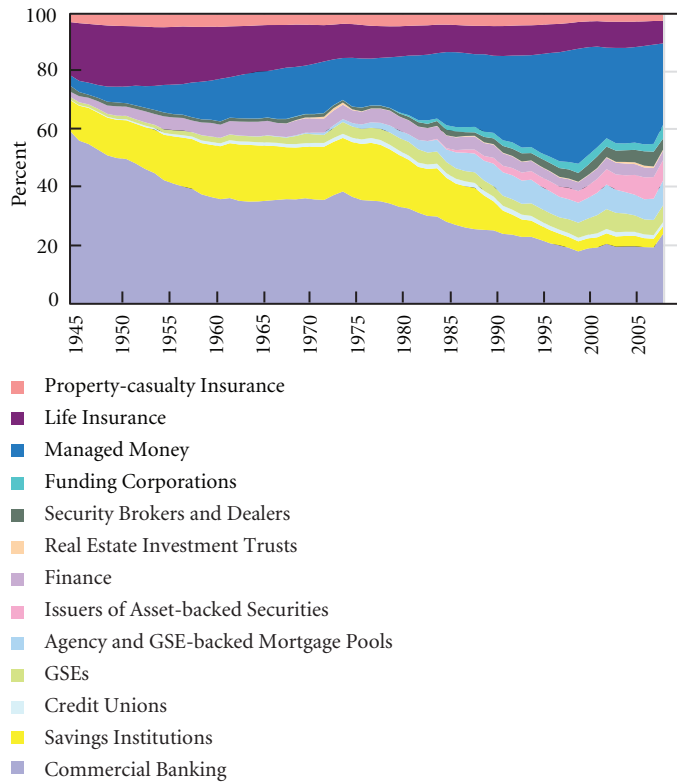
way street: pension funds have become so large that they are capable of literally "moving markets." As they flow into a new class of assets, the sheer volume of funds under management will tend to cause prices to rise. Pension funds often follow a strategy through which they will allocate a percentage of funds to a particular asset class. This can occur on a "follow the leader" basis as the popularity of investing in a new asset class increases, pushing up prices and rewarding the decision. To increase portfolio returns, managers might decide to increase the allocation to well-performing classes of assets. This could contribute to a speculative bubble. Of course, trying to reverse flows—to move out of an asset class—will cause prices to fall, rapidly.

A good example is the commodities boom and bust during the aughts, and today's boomlet—which might be coming to an end. As explained in Wray 2008, the deregulation at the end of the 1990s allowed pension managers to invest in commodities for the first time. Previously, pensions could not buy commodities because these are purely speculative bets. There is no return to holding commodities unless their prices rise—indeed, holding them is costly. However, Goldman Sachs (which created one of the two largest indexes) and others promoted investment in commodities as a hedge, on the argument that commodity prices are uncorrelated with equities. In the aftermath of the dot-com collapse, that was appealing. In truth, when managed money flows into an asset class that had previously been uncorrelated with other assets, that asset will become correlated. Hence, by marketing commodity indexes as uncorrelated assets, a commodities bubble ensued that would collapse along with everything else. This is because when one asset class collapses—say, securitized mortgages—holders need to come up with cash and collateral to cover losses, which causes them to sell holdings in other asset classes. This is why silver and cattle became correlated when the Hunt brothers' attempt to corner the silver market failed: they had to sell their cows in order to cover their losses on silver.

We will not repeat the analysis in Wray 2008, but in brief, most of the position taken was actually in commodity futures indexes, as pension funds decided to allocate, say, 5 percent of assets under management to commodities. However, there is a close link between index prices and spot prices. While pensions allocated only a small proportion of portfolios to these indexes, this amounted to a huge volume relative to the size of commodity markets. For example, Mike W. Masters, managing member / portfolio manager of Masters Capital Management, LLC, testifying before the Permanent Committee on Homeland Security



**Figure 5 Financial Assets, 1945–2008 (in percent)**



Source: Federal Reserve Flow of Funds Accounts

and Governmental Affairs, United States Senate, showed that the allocation by pension funds (and other index speculators, with pensions accounting for about 85 percent of all index speculation) to oil was equivalent to the total growth of Chinese demand for oil for the half decade following 2004. Index and spot prices literally exploded, in what was probably the biggest commodities price bubble ever experienced.

The bubble was also fueled by a policy change. As pension funds poured into commodities and commodity futures, driving up the price of energy, metals, and food, Congress mandated biofuels use—which added to pressures on food prices and contributed to starvation around the globe. When pensions started to move out of commodities in the late summer and fall of 2008 (pulling about one-third of their funds), prices collapsed; oil prices fell from about \$150 a barrel to \$40. Because other asset classes have performed poorly in recent months, pensions briefly moved back in, and commodities prices regained some ground. While it is too early to tell, it looks like this little boomlet may

have come to an end—probably not because pensions have moved out again but rather because demand for the actual commodities remains sluggish in the face of the global downturn. The point, however, is that pension funds are big enough to destabilize asset prices.

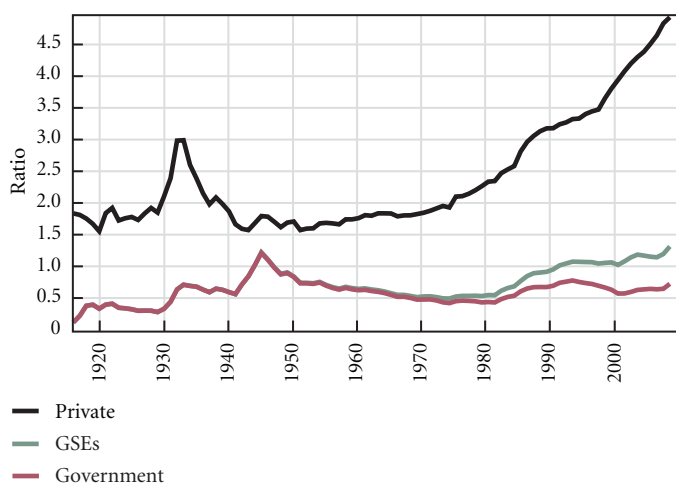
More generally, pension funds are part of what Hyman P. Minsky called “managed money,” and it could be argued that the global financial crisis really resulted from the way that managed money operates (Wray 2009). Again, this is a huge topic, and beyond the scope of this policy brief. But in short, huge flows of managed money have built up over the postwar period. These seek the highest total return, and in many cases use high leverage ratios to increase return. Innovation plus leverage led to exceedingly risky positions in assets that finally collapsed, beginning in the market for securitized subprime loans. Pensions are just one component of managed money, which also includes hedge funds, sovereign wealth funds, and university endowments. Managed money is a large and growing portion of the financial sector, as shown in Figure 5.

What is most important to see is that commercial banking had been becoming increasingly irrelevant for some time, as had other traditional lines of business such as thrifts and credit unions. Securitized products—agency and government-sponsored-enterprise (GSE) pools included—and managed money had taken over. Just before the current global crisis hit, pension funding was, on average, doing well—thanks to the speculative bubble. The crash caused the current underfunding. In order to restore funding levels, pensions need a new asset bubble. Indeed, pensions are looking into placing bets on death through the so-called “life settlements” market, securitized life insurance policies that pay off when people die early (Auerback and Wray 2009). Ironically, this would be a sort of doubling down on the death of retirees, since early death reduces the amount of time that pensions have to be paid, even as it increases pension fund assets.

Pension funds are so large that they will bubble-up any financial market they are allowed to enter—and what goes up must come down. The problem really is that managed money, taken as a whole, is simply too large to be supported by the nation’s ability to produce the output and income necessary to provide a foundation for the financial assets and debts that exist even in the aftermath of the financial crisis. Hence, returns cannot be obtained by making loans against production (or even income); rather, they can be generated only by “financialization,” or layering and leveraging existing levels of production and income.



**Figure 6 Ratio of Total Financial Liabilities Relative to GDP, 1916–2008**



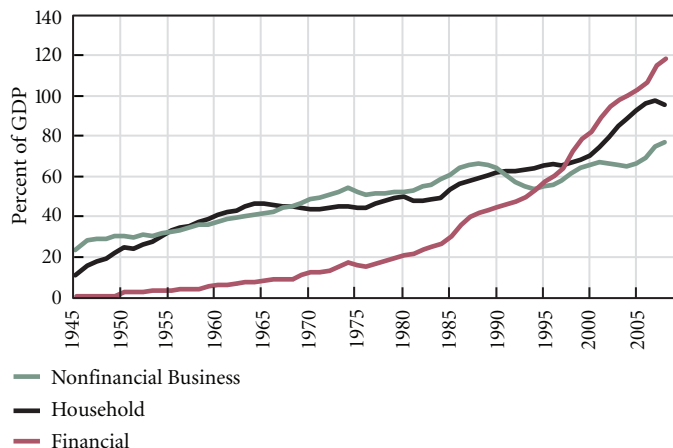
Note: Prior to 1945, net public and net private debts are used (as defined by the Census Bureau). From 1945 onward, Census data are replicated by using data about total financial liabilities provided by the Flow of Funds Accounts. Data for net public debt are approximated by taking total financial liabilities for each level of government and by removing any monetary, life insurance, or pension liabilities (the government sector excludes monetary authorities). Private debt is computed by starting from “total finance total financial liabilities” and “domestic nonfinancial sectors total financial liabilities,” and by removing some items to get as close as possible to the definition used by the Census Bureau (which excludes monetary instruments and other liabilities of financial institutions). GSEs include the liabilities of government-sponsored enterprises and of agency- and GSE- backed mortgage pools. The liabilities of monetary authorities are not included anywhere.

Source: *Historical Statistics of the United States: Millennium Edition* (Tables Cj870–889 and Ca9–19). NIPA, Flow of Funds (from 1945).

This is why the ratio of financial assets and debts grows continually—and why managed money has to continually innovate new kinds of assets in which to speculate. Figures 6 and 7 are instructive, showing a debt level that is growing much faster than GDP.

Before we conclude this section, it is worth noting the similarities between the U.S. health care system and its pension system. Firms also offered health care as a tax-advantaged benefit in lieu of wage increases. Over time, this became our current “managed care” system. Like pension funds that are controlled by money managers, our health care is largely managed by highly oligopolized financial firms run by well-compensated executives (with Medicare and Medicaid providing a third leg—much as Social Security is the third leg of the retirement stool). In this case, these financial firms are insurance companies. Workers have little control over their health care or their pensions, which are frequently chosen by employers. Workers are not really “sover-

**Figure 7 Credit Market Debt Outstanding by Sector, 1945–2008 (in percent of GDP)**



Source: Federal Reserve Flow of Funds Accounts

eign consumers” in this case because they have neither the knowledge nor (usually) the ability to shop around for health care or pensions—in both cases, employers negotiate with providers and pass fees along to workers. With others in control, there is little to hold down costs—even as wages are sacrificed on the argument that workers are receiving valuable nonwage compensation. Pensions are threatened by underfunding, by the transition to defined contribution, and by a declining proportion of the workforce that is covered. Likewise, the number of workers (and others) without health care coverage has been rising, while even those who are covered face exclusions, denial of care in the case of preexisting conditions, and higher premiums and copayments. The health care “reform” under way in Washington could be seen as a partial answer, or as a further financialization of health care through mandates that individuals must buy insurance—effectively turning over more of the national income to financial institutions (in this case, insurance companies). Those with decent pensions face taxes on “Cadillac” policies, with higher copays and more exclusions to follow.

### Pension Fund Strategy

In this section we turn to the strategy followed by pension fund managers. Essentially, each manager has a strong incentive to meet or beat the average return of pension funds, or face getting fired. Of course, except in Garrison Keillor’s Lake Wobegone, not

everyone can be above average—but that does not stop everyone from trying.

There are two fundamental principles widely believed to operate in financial markets: the risk-return relation and the efficient markets hypothesis. Higher risk is rewarded with higher returns; hence, fund managers must take on more risk to get the reward of above-average returns. But since higher returns only reward higher risk (and thus, higher losses), with competitive markets the average fund manager will only receive the risk-free return. The higher returns of the brighter or luckier managers will be offset by the lower returns of the dumber or less lucky ones.

With efficient markets, prices reflect all available information. Hence, there really is no reward for skill when it comes to managing pension funds, so it boils down to above-average luck. In other words, if your fund manager does not come from the lucky land of Lake Wobegone, pensions would do just as well by investing in riskless Treasury bonds (plus, perhaps, the highest-rated state, municipal, and corporate bonds—essentially what pensions did in the initial period following World War II).

Indeed, a simple strategy of buying Treasuries should do better than the average managed pension because hiring an above-average fund manager would require above-average compensation—so even those funds with B-rated managers would probably provide lower net returns than Treasuries. To be sure, there is some shuffling of the deck, so that one manager with a run of good luck can beat the average for a while, but she will probably fail and wipe out several years' worth of winnings in one swoop as some other lucky manager takes her place in the Wall Street lottery. Only the fortunate few can permanently live in Lake Wobegone and thereby beat Treasuries over the long run—and so deserve the higher management fees.

To be fair, these two principles may not be entirely correct—or, there could be other forces at play that allow for a positive return to risk even after subtracting losses. If so, that would go against the conventional wisdom that has been driving Wall Street. It does seem plausible that over long periods of time markets do tend to push risk-adjusted returns toward equality, so that, on average, safe Treasuries will beat net returns on risky assets. There is, however, a positive return to taking illiquid positions. And all things being equal, it is probable that longer-term maturities (more technically, long-duration maturities) receive a premium. Still, when all is said and done, pension managers that follow similar strategies, including taking positions in traded, liquid assets, will push risk spreads toward to the point

that they just compensate for expected losses due to risk and illiquidity.

Each time there is a financial crisis, the funds tank and managers look for strategies to reduce risk. Enter Wall Street sales staff with an array of instruments to hedge and diversify the risk. There is one sure bet when it comes to gambling: the house always wins. In financial markets, the institutions that create and market complex financial instruments are the house, and they always win—as Satyajit Das (2006) and Richard Bookstaber (2007) show. Even if we leave to the side their ability to dupe and defraud pension fund managers, these institutions charge fees for all of the instruments they are selling. This ensures that pension funds will on average net less than a risk-free return. But wherever high finance intrudes, sucker bets and fraud usually exist. So the average return should be way below that of Treasuries, and even the lucky managers from Lake Wobegone will probably net less than the risk-free return.

To recap the argument to this point: pension fund managers assume risk on the assumption that with higher risk comes higher returns. Financial institutions manufacture risky assets such as securitized subprime mortgages, or even more esoteric collateralized debt obligations, or CDOs, cubed. It then convinces pension funds that they ought to diversify to reduce risk, for example by gambling on commodities. And under ERISA, pension fund managers have to diversify: “A fiduciary shall discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries and . . . by diversifying the investments of the plan so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so” (*ERISA* 1974, § 1104 [a]). By coincidence, Wall Street institutions are marketing commodity futures indexes to satisfy the demand they have created. Wall Street also provides a wide array of complex hedging strategies to shift risk, as well as credit default “insurance” and buy-back assurances in case anything goes wrong.

Ironically, if all of these “risk management” strategies were completely successful, the pension fund would achieve a risk-free portfolio. Of course, it could have achieved this much more directly if it had bypassed Wall Street entirely and gone straight to the Treasury. However, Wall Street would then have had a reduced market for the risky assets and hedges it was pushing, and pension fund managers would not have received their generous compensations for engaging in complex and risky trades (see Das 2006 for many examples). So workers are left with fees

that drain their pension funds, and with massive counterparty risk as the hedges, insurance, and assurance go bad.

### **An Alternative Public Policy Strategy**

As mentioned above, we reward pensions with tax advantages and government guarantees. Before this crisis, as we have shown, private pension fund assets reached about 50 percent of GDP, and state and local government pension fund assets reached almost 25 percent. With assets equal to three-quarters of national output, these funds represent a huge industry that owes its existence at least in part to government support. It has created a lot of well-compensated jobs for managers, as well as the financial institutions that manufacture and sell the assets purchased.

In a sense, the entire industry can be justified only if through skill or luck pension fund management can beat the average risk-free return on Treasuries by enough that it can pay out all of those industry compensations plus add growth to the fund portfolio. Yet the expectation should be that fund managers are significantly less skilled and less “lucky” than, say, the highly compensated employees of the financial institutions they are dealing with. Hence, workers would be far better off if their employers were required to fully fund pensions with investments restricted to Treasury debt. At most, each pension plan would require a very small management staff that would log on to [www.treasurydirect.gov](http://www.treasurydirect.gov) to transfer funds out of the employing firm’s bank deposit and into Treasuries, in an amount determined by actuarial tables plus nominal benefits promised. Unlike pricing packaged subprime loans and derivatives, this is not rocket science. Good-bye, fund managers and Wall Street sales staff.

Indeed, this raises the question, should the federal government promote and protect pensions at all? Surely, individuals should be free to place savings with fund managers of their choice, and each saver can try to find that above-average manager from Lake Wobegone. But it makes no sense to promote a scheme that cannot succeed on average at the aggregate level—the typical fund manager probably cannot beat the average, so there is no strong reason to believe that managed funds will provide a net return that is above the return on U.S. Treasuries. It would be far better to remove the tax advantages and government guarantees provided to pension plans, and instead allow individuals to put their savings directly into Treasuries that are automatically government-backed and provide a risk-free return. Perhaps this sort of saving should still enjoy tax-advantaged

status—but we remain ambivalent about tax-advantaged saving. It is not clear that there is a strong public purpose in promoting private saving—which, after all, is a deduction from aggregate demand and hence generates a bias toward demand gaps and slow economic growth.

Is there a better alternative that would allow us to provide a safe, secure, and decent living for our retirees?

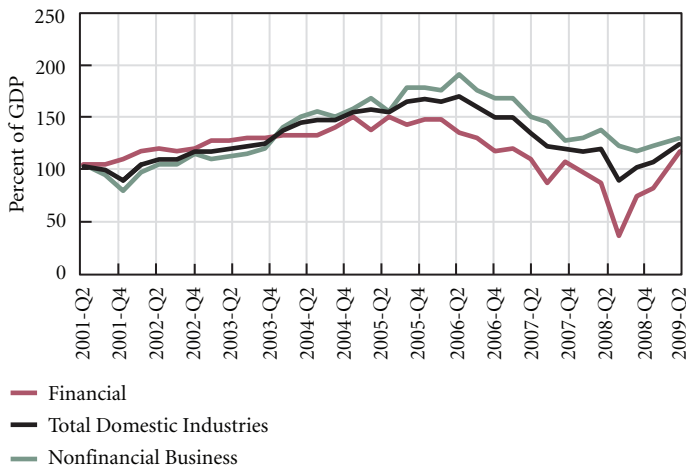
The U.S. retirement system is supposed to rest on a three-legged stool: pensions, individual savings, and Social Security. Pensions are mostly employer-related and are now seriously underfunded (and the general trend is toward defined-contribution plans, which make no promises about the level of retirement benefits or the living standard that will be provided). There are also huge and growing administrative problems posed by the transformation of the American workplace—with the typical worker switching jobs many times over the course of her career, and with the lifespan of the typical firm measured in years rather than decades. This makes the employer-based pension system less suited to current and future realities. And, finally, as discussed here, the most plausible long-term net return on managed money would be somewhat below the risk-free return on Treasuries.

The problem with private saving is that Americans do not save enough for their retirement. They never have. That is why government created Social Security, and why unions pushed for pensions. Even if individuals tried to do so, there is no reason to believe that they would achieve better returns than pension fund managers. Worse, they could be duped out of their savings by unscrupulous financial institutions selling risky investments.

Thus, the best solution would be to eliminate government support for pension plans and private saving, and instead boost Social Security to ensure that anyone who works long enough to qualify will achieve a comfortable retirement. Certainly, individuals are free to supplement this with private savings, according to ability and desires. And employers, unions, and employees can continue to negotiate pensions, as desired—but without public subsidies and guarantees.

We anticipate two main objections. First, such a scheme could put a lot of money managers and financial advisers out of business. True. The U.S. financial system is still far too big even after the crisis. In our view, it makes no economic sense to send as much as 40 percent of corporate profits to the finance, insurance, and real estate (FIRE) sector, as we did at the peak of the bubble—and we seem to be restoring the sector’s share even

**Figure 8 Profits as a Percent of GDP, 2001 Q2–2009 Q2 (2001 Q1=100)**



Sources: Bureau of Economic Analysis and authors' calculations

now—as it “Hoovers” up a record share of profits again. As Figure 8 shows, over the course of the boom the financial sector’s profits grew rapidly relative to GDP, and while the crash wiped out profits, in recent quarters the financial sector has rallied.<sup>2</sup>

Second, there is a concerted effort to convince Americans that Social Security is broke; hence, our proposal to ramp up benefits will be met with criticism and perhaps even fear. However, Social Security is a federal government program, and as such it cannot become insolvent. All payments can be made as they come due, even if benefits become more generous. We will not explain here why this is so because there have been a great many Levy Institute publications over the years that provide the details (see in particular Papadimitriou and Wray 1999).

We close with a statement of hope, that some common sense can be brought to bear on the problems facing both private and public pensions. This crisis has brought home the vulnerability that is always just below the surface. And longer-term trends that will surely continue mean that, even without financial crises, the employment-based pension system is highly problematic. Finally, we have questioned the wisdom of current strategy regarding management of pension funds, arguing that it makes most sense to return to a portfolio of longer maturity and safe financial assets such as U.S. Treasuries. This should provide safety without sacrificing net return—especially if we use Social Security to provide this safe retirement. No accumulation of financial assets will be required to back up Social Security, since the full faith and credit

of the U.S. government stands behind the promised benefits. That is exactly what stands behind U.S. Treasuries, so there is no reason for a ramped-up pension plan using funds to accumulate Treasuries. All we need is a strengthened Social Security program with a government guarantee behind the promised benefits.

### Notes

1. A QDIA must be diversified so as to minimize the risk of large losses; it may not invest participant contributions directly in employer securities (DoL 2008).
2. Profits relative to GDP are indexed to 100 in the first quarter of 2001; at the peak of the bubble, the financial sector’s profits relative to GDP had increased by 50 percent. In the crash, the financial sector’s share fell to less than half of its 2001 value. However, it has now already recovered to its 2001 share. The nonfinancial sector’s profit share also rose in the boom, but it did not fall nearly so far in the crash—and its recovery has been far less robust.

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