Dear Actuary:

The recent strong market performance has significantly improved my public pension plan's funded status – what now?

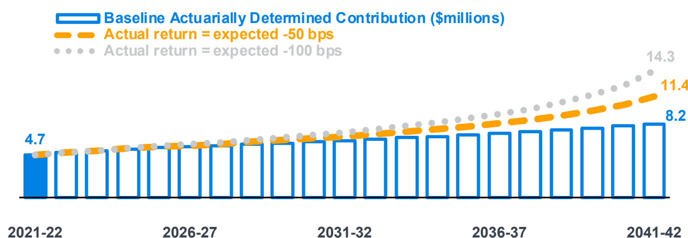
- Grateful in Greenville

Dear Grateful:

It is refreshing to be talking about how to react to good news for a change! The first thought for many plan sponsors will likely be to expect increases in their plans' funded ratios and reductions in the Actuarially Determined Contribution. However, actuaries are conservative by nature and are always waiting for the next bad thing to happen. In this case, we don't know whether a market correction is around the corner, so plan sponsors should not take it for granted that the current good news will continue indefinitely.

Plan sponsors should take this opportunity to shore up the actuarial assumptions being used to value plan liabilities, especially the investment return assumption. Many public pension plan sponsors have been working with their actuaries to lower the investment assumption for the past several years. Recent market gains may provide plan sponsors with the perfect opportunity to lower the investment return assumption to levels that are more in line with expectations without placing additional pressure on the budget. To the extent that actual investment returns differ from the assumed investment return, the plan's future assets, Actuarially Determined Contributions, and funded status may vary significantly. Figure 1 shows what happens to the Actuarially Determined Contribution if the plan's assets consistently underperform relative to the investment return assumption.

FIGURE 1: IMPACT OF INVESTMENT RETURNS



As you can see, over time the Actuarially Determined Contribution can be significantly higher if the actual investment return is always 100 basis points lower than the assumption. This can create considerable issues for a plan, as well as future generations of plan members and taxpayers.

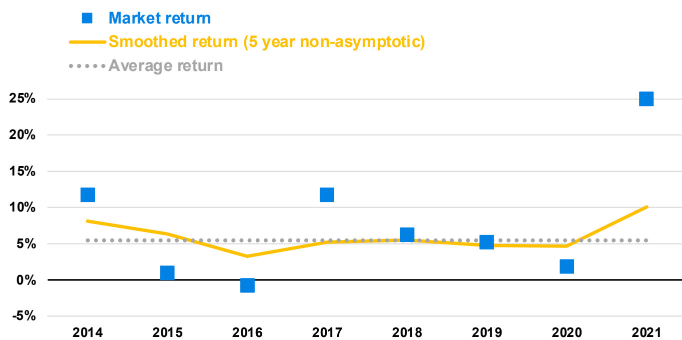
In addition, if plan sponsors have not had an experience study performed recently, now would be an appropriate time to do so to ensure that the actuarial assumptions are sound. Using accurate, up-to-date assumptions based on past and anticipated future experience allows actuaries to provide accurate valuation and financial reports to management, auditors, and other key stakeholders. In addition, reliable assumptions will help plan sponsors refine forecasts of future financial results and workforce trends. Reviewing experience reduces the risk of large fluctuations in results due to the use of outdated assumptions, thus mitigating the financial risk associated with the plan. An experience study can be a vital tool for successful financial plan management.

Here's another idea: set your sights higher than just getting to 100% funded! A plan that is hovering around the 100% funded mark can actually have quite volatile contribution levels. Why not aim to build up a cushion to protect against the next market downturn? Maybe your goal could be to become 110% funded, or 120%, or even 150%. Future generations will thank you!

Lastly, if you are not utilizing an asset smoothing method for funding purposes, you should consider adopting one now to help dampen the impact of future market fluctuations. An asset smoothing method, which determines an "actuarial" value of assets, recognizes market gains and losses over a period of years. Because of this, the great returns you saw this past year won't hit your actuarial value of assets all at once. On the flip side, any future poor returns won't get recognized immediately either. Remember, the goal is stability!

Five years is generally the sweet spot in terms of providing useful smoothing without having the actuarial value of assets stray too far from the market value of assets. There are many variations on the theme, including the smoothing period, the way that gains and losses are determined, and whether there is an explicit method for keeping the actuarial value within a certain range around the market value. Figure 2 illustrates market returns and smoothed returns over a seven-year period. You will notice that the market returns have big swings from year to year, whereas the smoothed returns over the same period have much less volatility.

FIGURE 2: ASSET SMOOTHING



While the recent great investment returns for public plans were welcome news and helped to improve the funded status of many plans, plan sponsors must continue to remain diligent to ensure that their plans are structured to meet the current and future needs of all stakeholders.

If you are interested in learning more about any of these topics, you should talk things over with your actuary about what the next best step is for your plan.

Your Milliman Actuary

P.S. Thanks so much to Jenn Castelhano, FSA for providing some insightful ideas to consider!

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