# Dangerous Assumptions

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Highly Sensitive
Investing is Hard
Unfunded Security
Thoughts on Employment, Rates, and Fed Policy
Dallas, Denver, and Tulsa

Historically speaking, this phase of life we call "retirement" is a new concept. The idea you could stop working at a certain age was unknown until quite recently. People worked as long as they physically could, then died quickly unless they had family or servants to care for them. That was normal and accepted.

Now, we have different expectations, at least in the developed world. We think life should end with a decade or two of relative leisure. The challenge is that leisure isn't free. The population that isn't working to support itself needs some kind of funding mechanism... and that's where it starts getting complicated.

Ideally, retirement would be self-funded, with people accumulating savings during their working years to be spent in retirement. This is easier said than done. Many people either can't or don't save enough, for a wide variety of reasons.

But the real problem is the large number who *think* they're ready for retirement but actually aren't. I described some of the reasons last month in Pension Sandpile, but it's actually even worse. Not only are the sandpiles going to collapse, but millions will be under them when they do.

Today, we'll look deeper at this problem. As you will see, modern pension plans and retirement schemes depend on assumptions no one should take for granted, yet practically everyone does.

## Highly Sensitive

The "underfunded pension plans" we hear about are typically defined benefit (hereinafter DB) plans. That means the beneficiaries (i.e., retired workers) are promised certain payments on a defined schedule for life. Sometimes they get healthcare benefits, too. What *isn't* defined so clearly is where the money will come from and how much is needed.

We need to understand the difference between "underfunded" and "fully funded." I'm going to try and explain this with a simplified example. (Readers with pension expertise will recognize I'm omitting many details. They're important but tangential to the point here).

Suppose you are in charge of a local government's defined benefit plan: a fire department, for example. You know how many firefighters are vested in the plan, when they will reach retirement age and how much their monthly benefits will be. Add some life expectancy data, and you can build a liability schedule many years into the future.

Your estimate shows that in 2032 you will have 1,000 retirees each due to receive $50,000 a year. (I'm using round numbers for simplicity). So, you need to have $50 million in cash available to pay them—but you don't need it now. You have ten years to accumulate it.

With this knowledge, you can make a "present value" calculation. What amount of money do you need *today* to be confident you will have $50 million in ten years?

Of course, this depends on the return you can make between now and then. Assuming 3% annual returns for 10 years, $37.2 million now will become $50 million in a decade. The magic of compound interest.

But this is highly sensitive to your rate assumption. At 5%, you only need $30.6 million. Assume 7%, and it's only $25.4 million. Conservatively assume 1%, and you'll need $45.3 million. (You can play with the math yourself here.)

Naturally, since we all like to keep our problems manageable, pension sponsors gravitate to higher-return assumptions. This lets them minimize the current year's contributions, thereby pleasing both taxpayers and firefighters, but it doesn't change the math. Problems will follow if future returns don't match assumptions.

Note this example is only about one year of future liabilities. The real picture is much more complex, with liabilities extending far into the future. We call a plan "underfunded" when its current path will make them impossible to pay at some point. And those assumptions can be optimistic. If you project a 7% return and only get 4%–5%, your pension consultant can say you are funded correctly based on the assumptions, but the real-world, bottom right-hand corner number will say something else.

Sadly, in so many towns and states, they take the rosy projections and move on because to take the less optimistic (if realistic) projection means you have to take money from the current budget that is for police and potholes and parks. Too often, the decision is to put off the pension contribution another year and then another….

And it's critical to understand, pension benefits aren't optional. They *must* be paid as defined, and failure to do so constitutes default. In some states, governments are constitutionally required to pay the full benefit as promised. Seems fair, but what happens when pensions become 50% or more of your budget, and you want to raise taxes?

It's even more complicated, though, because the liabilities themselves also involve assumptions. I mentioned life expectancy. That's fairly predictable in a large enough group, but things can change. A cure for cancer or heart disease would be wonderful for humanity, but a big problem for pension liabilities.

Then, there's inflation. Many (most?) DB plans include cost-of-living adjustments based on CPI or some other benchmark. That means the calculations have to reflect real returns. They don't need just 3% (or whatever target they pick) for ten years etc. They need *3% more than inflation* for that period.

Positive real returns don't happen automatically, particularly in an economy as indebted as ours and with the kind of fiscal and monetary mismanagement as is now normal. Sheer size prevents giant plans from outperforming benchmarks. On a long time horizon, the best assumption is they will grow only to the extent the economy grows. Which, based on GDP in the last decade or so, means 2% real returns and probably less in the future. Few employers can afford the contributions needed to make a DB plan work at that rate.

But the real problem is uncertainty. Defined benefit pensions are structured around so many assumptions about things no one can know—the long-term risks are incalculable. That's why private businesses largely abandoned them long ago.

Those who have the luxury of imposing taxes think differently; hence DB plans are still popular in governments, which can transfer the problem to other people who didn't create it.

## Investing is Hard

In theory, DB plans *can* work with conservative management and some good luck. Those are uncommon. They are a bit like banks in a fractional reserve system. It's a giant juggling act in which some jugglers are going to miss. You just don't know who or when.

The banking system works because it has a lender of last resort: the Federal Reserve System. DB plans likewise have an ultimate guarantor, the federally chartered Pension Benefit Guaranty Corporation (PBGC). It lacks most of the Fed's powers and is itself underfunded. Even when PBGC works, the benefits it pays to workers in failed plans are often much less than the workers were promised. And it only covers private-sector plans, not the state or local governments where most of the problems lie.

As noted above, the private sector has mainly moved to 401K and similar "defined contribution" plans. Employers and workers contribute cash each year, after which the returns depend on how the worker chooses to invest. Employers like these plans because they don't create future liabilities *for the employer*. The risk doesn't disappear; it is simply transferred to the workers, who may or may not be able to retire with as much income as expected.

Here we have a disconnect. Many workers like 401K plans because they get to control their own fate. Others—maybe most—have no interest in making investment decisions and wish someone else would do it for them, as happens in a DB plan. It's not clear either group gets optimal results. Investing is hard even for full-time professionals. Sometimes it seems especially hard for full-time professionals.

Worse, workers get tempted to withdraw and spend their retirement funds every time they change jobs, which, in this economy, is pretty frequent. The tax penalty often doesn't deter them, particularly young people for whom retirement is a distant thought.

As a result, it is not a good assumption that someone is ready for retirement simply because they have (or had) a 401K or similar plan. Their assumptions may be as unrealistic as those defined benefit plan sponsors.

Then there's the awkward fact that many workers spend all or most of their working years without a 401K. Employers aren't required to offer them. Many don't—or didn't until quite recently. IRAs are more widely available, but the worker must take some initiative to make it happen. People have other things on their minds. And even if they recognize the need, saving is tough when you are in the bottom 2%–30% of the income scale with a kid and high gas and food prices.

All that means the "unfunded pension" problem is far bigger than some firefighters and teachers not getting the retirement benefits they expected. Millions more will reach retirement age in the same (or worse) position because their 401K and IRA plans didn't perform or they didn't save enough.

Strong stock market performance and generally falling interest rates (which help bond returns) insulated us from the consequences of this for a long time. Those days are running out, I think.

"But John," you say, "Those who didn't plan or had bad luck still have Social Security. They'll be all right, even if their golden years aren't so golden."

I wouldn't be so sure of that.

## Unfunded Security

In the United States, we have a Social Security retirement system covering, more or less, everyone who ever had a job. It is financed by a "FICA" tax levied on workers and employers. A retiree's benefits are calculated from a formula that considers their age and the wages earned from all their jobs.

Functionally, Social Security is basically a giant defined benefit plan. Participation doesn't require any action on your part. You do have some discretion over when you retire, which can make a difference. Otherwise, just have a job, and everything else is automatic.

The original idea was that Social Security would be self-supporting, with taxes from a much larger number of workers supporting a smaller number of retirees. That has been mostly true, but is increasingly difficult. The latest Trustee's Report shows the trust fund that covers retirees and their survivors will be depleted in 2034.

In other words, Social Security is "unfunded" in much the same way as many defined benefit plans—not a problem right now, but it will become one if nothing changes.

One hopes Congress won't wait until 2034 to address this. Delay will make it harder, not easier. Retirement ages, means testing, and benefit amounts will probably be on the table. Some of this is long overdue. The world has changed since the 1930s when age 65 was considered "elderly." We live longer, healthier lives now.

That brings us to another difference between Social Security and defined benefit plans. A DB plan is contractual. The employer and workers agree to do certain things, and it is very hard for the employer to escape its benefit obligations.

Social Security isn't like that. You don't have a contract with the government. Congress can change the rules any time, the fact that you paid all those FICA taxes notwithstanding. A 1960 Supreme Court case, Flemming v. Nestor, ruled Social Security is just another benefit program and FICA is just another tax. Paying the tax doesn't "earn" you anything in return.

Congress won't want to kick that hornet's nest, of course, but it also doesn't have magical powers. Faced with limited revenue, limited borrowing capacity, and many competing spending plans, it will have to make hard choices.

I think history will look back and see this dream of a long, leisurely retirement was never sustainable or scalable for the whole population. Most of those who expect such a retirement will be sorely disappointed.

My longtime mentor Dr. Gary North always said the best retirement plan is "Don't retire." He took his own advice, too, working almost to the end. Ideally, we should transition into a different kind of work that matches our changing abilities. Keep generating income however you can for as long as you can, reserving the portfolio assets until you really need them.

My part of this is helping readers like you make the most of your portfolios, however big or small they are. I intend to do it for many more years, too.

## Thoughts on Employment, Rates, and Fed Policy

There is so much more we will cover in the future on pensions, but I want to make a quick comment on the Fed, interest rates, and policy.

First, the jobs report was fairly solid, with a 261,000 increase, 70,000 more than projected. It wasn't so strong that it totally crushed hopes of an early 2023 pause, so the initial market response was positive. We'll see by the end of the day and next week. But there are some caveats.

First, this report continues a string of generally lower monthly job numbers:

> "Smoothing out the monthly volatility puts the 3-month payroll average at 289k vs the 6-month average 347k, the 12-month average of 442k and the 2021 average of 562k. Thus, the slowing trend is now obvious…" (h/t Peter Boockvar)

Second, government jobs were half the upside surprise. When looking at the Household Survey, we see LOSSES of 328K, and get this…those aged 45 to 54, which are prime earning years, had LOSSES of 406K. This shows a reluctance to hire and a willingness to cut more costly employees.

Third, the birth-death model added around 455,000 jobs, which was 100,000 more than the same month last year. I have been doing interviews recently where I point out the BLS employment numbers always miss the turning points, and the reason can often be found in the birth-death jobs assumptions. (Note: this is the birth and death of businesses, not people).

We are clearly at an inflection point. Jerome Powell seems ready to keep raising rates until he sees an unemployment number create more angst than the inflation number. We do not know what that number is. Certainly not this report's 3.7% unemployment (up 0.2%), which is historically still quite strong. I don't think Powell knows what inflation/unemployment combo will justify a pause. This is one of those "we'll know it when we (Powell) see it" things.

I still think a 5%+ Fed funds rate and a 5%+ unemployment rate is as good a guess as any. And that's what it may take to drive a stake through the vampiric heart of inflation. Instead of blood, the inflation vampire sucks buying power and retirement lifestyles of those on the pensions we mentioned above.

Will the Fed only hike rates by 50 basis points at the next meeting? Maybe, but Powell made clear that a lower trajectory does not mean a lower ending Fed funds rate. As I have been saying for a long time, Powell sounds and acts like he found his inner Volcker. Those hoping for a

"pause and pivot" may have to wait a lot longer than they think. I don't think Fed officials will cut rates until they see inflation under control and moving in the right direction.

Interestingly, once the Owner Equivalent Rent inflation numbers roll off and the current lower prices start showing up in the data, given all the other disinflationary forces out there in the supply chains getting fixed, we could see inflation retreat fairly quickly (over a quarter or two). THEN, just maybe, possibly, we'll get a rate cut or two.

In the meantime, the big wheel of interest rate hikes will keep on turning.

## Dallas, Denver, and Tulsa

I will be flying to Dallas November 16 and hope to do an event there to meet clients and friends that evening before flying to Denver to speak at the CFA dinner with Vitaly Katsenelson. It will be quite fun. Then back to Dallas, meeting up with Shane to visit friends and go through storage (the joys of moving and realizing it all won't fit into the container). After four years, maybe we need to move on, LOL. Except for my mother's cookbook. I really want to find that! Then to Tulsa on Wednesday to be with my family for Thanksgiving.

My $50^{th}$ reunion at Rice University was interesting and fun. More classmates showed up than I expected. We had a "group" meeting, and someone asked what the one thing that we learned at Rice that really made a difference was. Lots of very good, uplifting answers. When asked, I said that Rice taught me that I was just average at some things. I came from a large high school, never really had to study, etc. One of *those* kids. It took me about 6–8 weeks to realize that I was not going to get the next Nobel in physics, assuming I could get through that first semester. It wasn't that I couldn't do the math, etc. I could… just not at the level of my classmates. (And I had to learn to study my ass off in a few weeks—good training for my current life!)

Just like I don't walk onto the football field, I had to recognize where my talents lay. Turns out, I, over time, learned I had a talent for writing and interpreting data, and I could hold my own. It helps that I get to do what I love. It wasn't that I was completely average, which is the case for most things, except those at which I am quite below average (athletics). I just had to find a corner of the world where I could play at a higher level.

Follow your passion? I can get passionate about many things but still lack talent in them. So, follow your real talent and go there. Which brings up the question, which came first, the talent or the passion?

And you, gentle reader, make it possible for me to follow both passion and talent. Thank you so much. I hope my writing helps you follow your own path a little better.

And with that, I will hit the send button. You have a great week! And don't forget to follow me on Twitter. We are having a lot of fun there!

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