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WINTER WARNING



The Pension Predicament

For several years, the Long Wave Analyst has been predicting that numerous corporate and government pension plans would be adversely affected in a very meaningful way during the next global economic depression, which is now upon us. Indeed, in our Winter Warning newsletter of December 15, 2008 - *The Penchant for Pensions*, we stated that *“both defined-benefit and defined-contribution pension plans have been severely impacted by the global financial and credit crises; and if the rate of corporate bankruptcies increases, pension benefits may be cut. In July, 2009, when scores of Canadian pension funds begin filing their valuation reports, regulators could be faced with a myriad of plan restructurings.”*

The Canada Pension Plan

Canada Pension Plan assets totaled \$105.5 billion (CAD) at its March 31, 2009 fiscal year end; down 18.6% from the previous year. Privately managed by its Investment Board, the Canada Pension Plan administers the pension assets of 17 million Canadians. The Investment Board uses a performance measurement service that reports returns on a 4-year moving average basis. By that measure, the most recent 4-year return of 1.4% is less than the 4.2% average real return required to make the pension program sustainable over time. Having benefited from a significant increase in the value of its government bond portfolio over the last year, the Board recently, expressed a reluctance to maintain its current weighting in government bonds over the near term. David Denison, President and Chief Executive Officer, stated *“Our view is that all (the new issue supply) will only meet willing buyers if (bond) yields go up. It would be dangerous to increase the fixed income portion of our portfolio at this point.”*

An increasing supply of new government bond issues alone will not be sufficient to force bond yields appreciably higher. While we agree that yields are likely to be somewhat higher than at present by March, 2010, capital preservation should be of paramount importance through a diversification strategy of owning Canadian high grade credits. At this point in the long term business cycle, now is not the time to assume additional market risk. The stock market has already exhausted its reactionary rally off the March, 2009 lows and the North American economies will not be expanding again anytime soon, as most media reporters and politicians expect. The month of March was also the time to take profits in the fixed income sector, when the U.S. Treasury Department announced the launching of its quantitative easing policy: see Winter Warning, March 30, 2009 - *Never Look a Gift Horse in the Mouth*.

The Global Pension Report Card

In its annual analysis of the health systems globally published last week, the Paris-based Organization for Economic Co-Operation and Development (OECD) reported that private pension plans lost 23% of their



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value last year; and that strains in pension systems threaten to turn the financial crisis of the past two years into a social crisis lasting for decades. Indeed, losses in private pension plans were the highest – at over 25% – in Ireland, America and Australia where the greater proportion of assets was invested in equities. Losses registered in Germany, Mexico and the Czech Republic, however, were fewer than 10%, since most private pensions in those countries, were over-weighted in bonds. OECD secretary-general Angel Gurría stated that *“Reforming pension systems now, to make them both affordable and strong enough to provide protection against market swings, will save governments a lot of financial and political pain in the future.”* Mr. Gurría notes that the global financial crisis is focusing policymaker’s attention on the short-term, threatening to postpone long-term strategic planning. OECD officials are most concerned about a repetition of the mistakes of the 1980’s which encouraged early retirement. While such initiatives may improve unemployment figures today, they are offset by a greater pension burden emerging tomorrow.

The U.K. Retirement Age Strategy

As their populations age, planned increases in the pensionable age, less generous early retirement plans and public pensions; as well as cuts in pay for public officials are all examples of strategies which advanced countries are using to reduce the future financial burden of pensions. In the United Kingdom, retirement spans are lengthening as life expectancy beyond age 65 is rising rapidly. According to the Office of National Statistics, those over the age of 80 represent the fastest growing segment of the population and their numbers have increased by 1.1 million between 1981 and 2007. Moreover, a recent Financial Times/Harris survey found that in Britain, there is a consensus that retirement is a responsibility best shared between the state, employers and individuals. The suggestion that a majority of the British electorate are now in favour of working beyond the age of 65 in exchange for a better pension, indicates growing support for a fundamental reconsideration of what constitutes retirement. Indeed, according to the OECD, there is growing acceptance of longer working lives in the industrialized world, with rising work force participation rates among older people in many countries besides Britain.

America’s Albatross – Unfunded Government Pension Liabilities

In the past year, many state and local government pension plans have lost up to 40% of their value, as a result of the collapse of the stock market. State pension benefits are protected by law and must be paid even if the pension fund is experiencing a loss. In the last year, the huge California pension fund Calpers with \$120 billion (U.S.) in assets, has incurred losses over \$70 billion (U.S.), but still must pay out \$11 billion (U.S.) this year. Unless Calpers can recover its investment losses soon, the State legislature, already mired in a \$26 billion (U.S.) deficit situation, will have to increase its pension fund contributions sooner rather than later. At present, we are not optimistic regarding the State’s economic outlook: see *Winter Warning, June 8, 2009 – California – The Golden State on the Brink of Collapse*. U.S. pension plans are generally in worse condition than those in Europe. They were more underfunded, meaning they did not have the money to meet future pension commitments, even before the financial crisis began in earnest. Moreover, their investment losses over the past year have been greater due to larger equity allocations.



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As desperate as their cash flow crisis is, the accompanying 50% collapse in funding levels is of equal, if not greater importance. Bill Atwood, the Executive Director of the Illinois State Board of Investments recently announced that *“Right now, it’s very bad. For the full year ending June 30, 2009, Illinois’ 5 State retirement systems have a \$270 million (U.S.) negative cash flow on \$8.5 billion (U.S.) in assets.”* Other state and municipal governments whose pension funds are less than 50% funded include Arkansas, West Virginia, Philadelphia, Atlanta and Pittsburgh, to name a few. While successive state governments have expanded pension benefits over the years, many legislatures have failed to provide the funding.

Life Is Unfair, Fragile and There Are No Guarantees (2)

As previously mentioned, for many years, the Long Wave Analyst has been forecasting the collapse of the retirement benefit system during the next global economic depression. Now that hard economic times have become a reality for millions of workers in the public and private sectors alike, employees should not assume that all of their pension expectations are guaranteed. Naturally, while no corporation or government wants to willfully cut pension commitments, during difficult economic periods, eventually, it becomes a matter of affordability; witness General Motors and Nortel Networks.

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