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Optimists Make More Money

by Pat Dorsey | 08-15-01 | 06:00 AM | [E-mail Article to a Friend](#)

How fast do you think the stock market will rise over the next decade or so?

Although this might seem like an academic question, the answer has very real consequences if you're saving for some large future expense. For example, if you're saving for your retirement or your kids' college tuition, the amount you need to sock away depends on the rate at which you think your savings will appreciate. If you think your savings will grow at, say, 12% per year, then you don't need to save as much as if you assumed an 8% return--which implicitly raises your current "net" income.

The same is true for companies with traditional pensions that promise employees some fixed income stream when they retire. By simply assuming a higher future rate of return on their pension assets, companies can reduce their pension costs, since they don't need to contribute as much to the pension fund. Just as in the example above, this simple change in the expected rate of return implicitly plumps up the company's bottom line by reducing the amount of money it has to set aside to pay future retirees.

Pretty neat trick, huh? It's an even better trick when the company's plan happens to be "overfunded,"--in other words, when the value of the pension assets is bigger than the company's estimated future payments to retirees. You see, when a pension plan is overfunded, companies get to reduce some of their operating costs, which boosts their bottom lines.

IBM [IBM](#), for example, reduced its costs by about \$1.2 billion in 2000 just because its pension plan was overfunded, and a billion

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dollars isn't chump change even for a firm as gargantuan as Big Blue. IBM's pretax income last year was about \$11.5 billion, so the pension plan contributed meaningfully to the company's 2000 results. The real kicker is that about \$200 million of the gain is attributable simply to IBM's decision to raise its expected future return on plan assets from 9.5% to 10%. That's it--an extra \$200 million in profits simply by assuming that pension assets will appreciate at 10% per year in the future.

IBM's not alone in assuming a rosy future, by the way. Qwest [Q](#) raised its expected rate of return on pension assets from 8.5% in 1998, to 8.8% in 1999, to 9.4% in 2000. Boeing [BA](#) has followed a similar path, bumping up its rate from 8.75% in 1998 to 9% in 1999 to 9.2% in 2000. Of course, none of these companies is as optimistic as the folks at forest-products giant Weyerhaeuser [WY](#), who expect an 11.5% return on their pension's assets.

Just how realistic are these assumptions, anyway? Not very, I think. For one thing, the long-term real rate of return on stocks is about 10% for large companies, and maybe 11% to 12% for small companies--but pensions are typically not 100% invested in equities. Generally, pensions are split 60/40 or so between stocks and bonds, and since bonds have returned a lot less than stocks over the long haul, it seems pretty darn optimistic to assume that a stock/bond portfolio will appreciate at 10% over the next several years--especially after the market's recent run.

Just for kicks, I looked at historical returns on "balanced" open-end mutual funds, which own both stocks and bonds (as well as some cash, usually). Although this group isn't a perfect proxy for pension funds by any means--pension funds are typically managed quite conservatively, and also often own assets like real estate and private equity that aren't found in the typical balanced fund--it's probably a reasonably representative group in aggregate.

Now, the average balanced fund has returned about 10% to shareholders each year for the trailing 10- and 15-year periods, which means that any company expecting 10% returns in the future is implicitly assuming that the next 10 years will be just as good as the last 10. Seeing as how we've just finished the biggest bull market in history, that seems like a pie-in-the-sky assumption to me. Heck, if Weyerhaeuser really can deliver an 11.5% annual return over the next decade, I suggest the company should shut down its forestry business and go into competition with Fidelity.

So what if these rosy predictions don't come true? Well, if the returns on pension assets turn out to be appreciably worse than the approximately 9% that the average large company is expecting, all that juicy pension income will go away, and

companies will have to start paying into their pension plans as well. Moreover, the absurdity of these high expected returns will become increasingly apparent, and when companies revise them downward, the funding status of their pension plans will look even worse.

The bottom line is that if you own shares of a company with a traditional pension plan, make sure you check to see how much of its profits are coming from pension assets rather than its core operations--not to mention the profits that flow simply by virtue of unfettered, unrealistic optimism.

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Pat Dorsey is director of stock analysis for Morningstar.com. He can be reached at patrick_dorsey@morningstar.com.

Pat Dorsey does not own shares in any of the stocks mentioned above.



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