Pension Reform: Are Financial Markets the Right Way to go?

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Three-legged Stool of the U.S. Retirement System

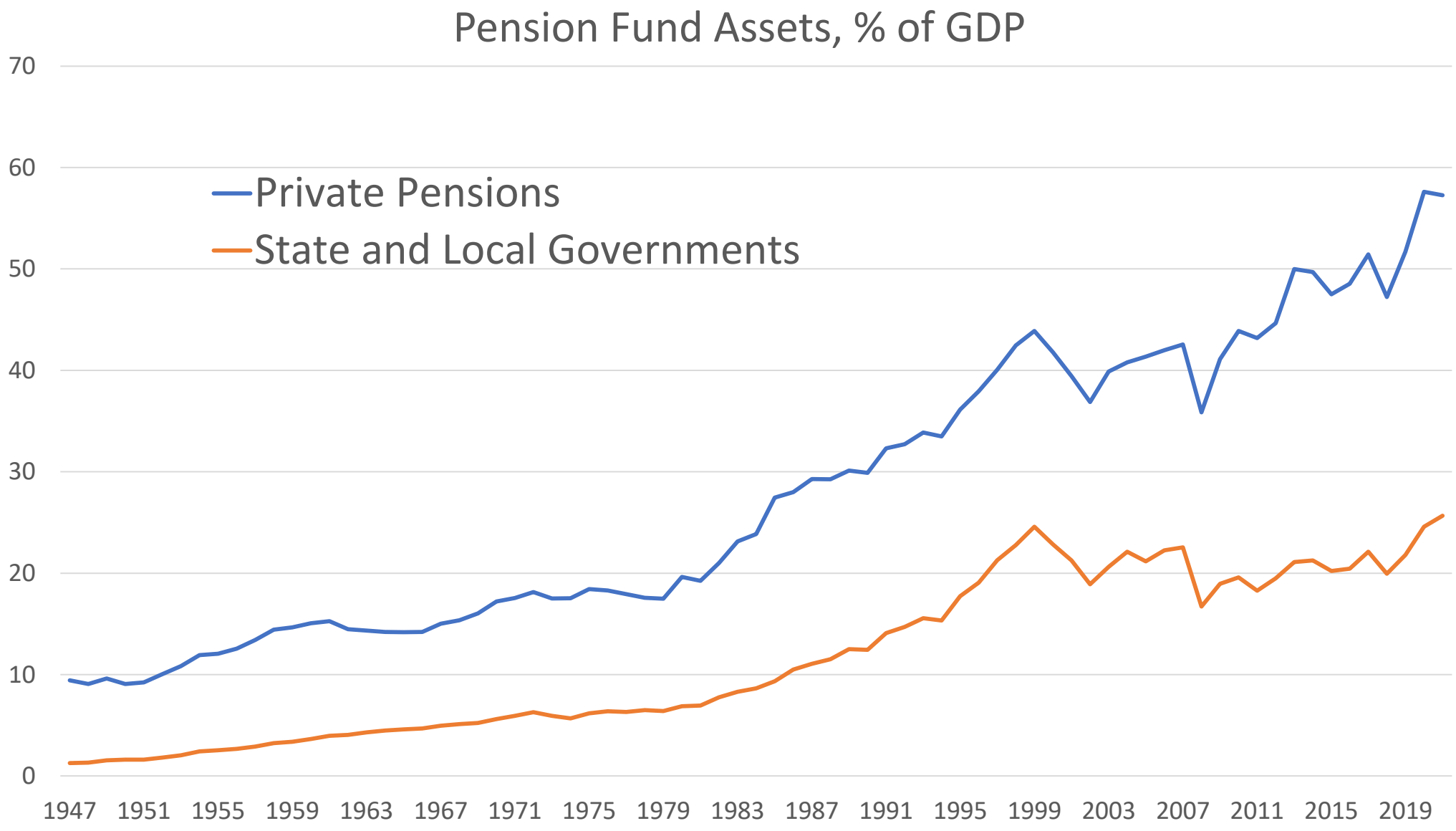
- Social Security
- Private Savings
- Private Pensions (e.g. 401k)
  - Defined benefit: amount of retirement income determined based on tenure with employer and salary.
  - Defined contribution
    - Employee contributes pre-tax income, up to a certain limit
    - Employer *may* match the contributions, up to a certain limit.
    - Pension at retirement depends on contributions and performance of account.
- State and local governments also have similar pension plans.

Creation of Private Pensions in the U.S.

- WWII: unions and employers negotiated postponed payment in the form of pensions – defined benefits.
  - Delaying spending to prevent inflation.
  - Allowed firms to push expenses into the future.
- U.S. firms ability to fund pension liabilities deteriorated.
  - Compromise: firms had to increase funding and the government established the Pension Benefit Guarantee Corporation (PBGC).
- PBGC guarantees defined benefit pensions up to a certain limit.
  - E.g. if a firm goes bankrupt and can’t fund pension obligations.
- But how pensions get bailed out will be determined by Congress.

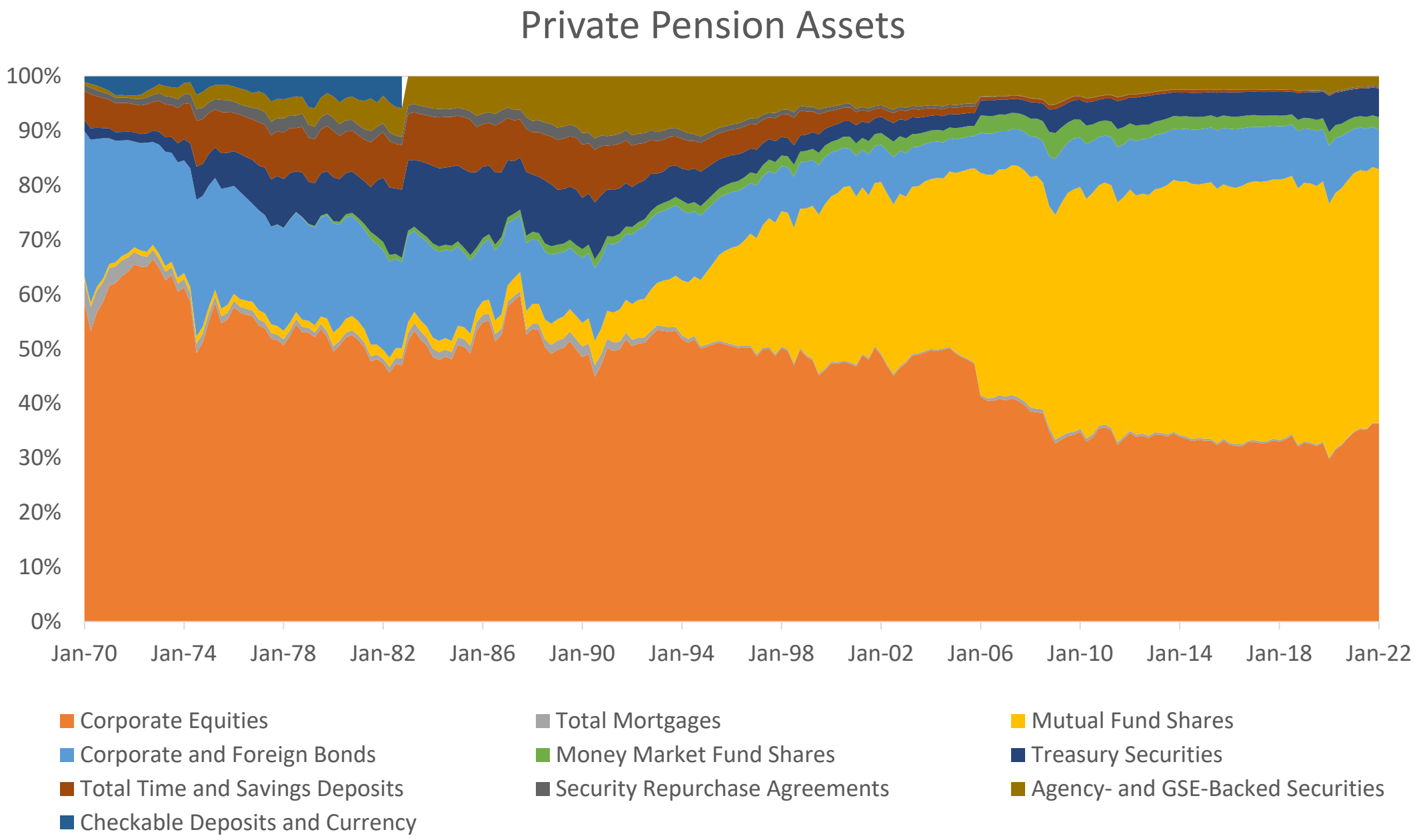
Rise of Defined Contribution Plans

- Defined contribution plans (401(k)s and IRAs) were supposed to be supplemental.
- They grew in 1970s due to tax legislation – allowing pre-tax contributions.
  - surpassed defined benefit plans by 1996.
- Currently they are the main source of retirement income for a large part of the US population.
- Companies used the 2008 Global Financial Crisis to further eliminate defined benefit plans.
- There is no law requiring employers to match employee contributions to defined contribution plans.


Pension Fund Assets, % of GDP
70
60
50
40
30
20
10
0
Private Pensions
State and Local Governments
1947
1951
1955
1959
1963
1967
1971
1975
1979
1983
1987
1991
1995
1999
2003
2007
2011
2015
2019

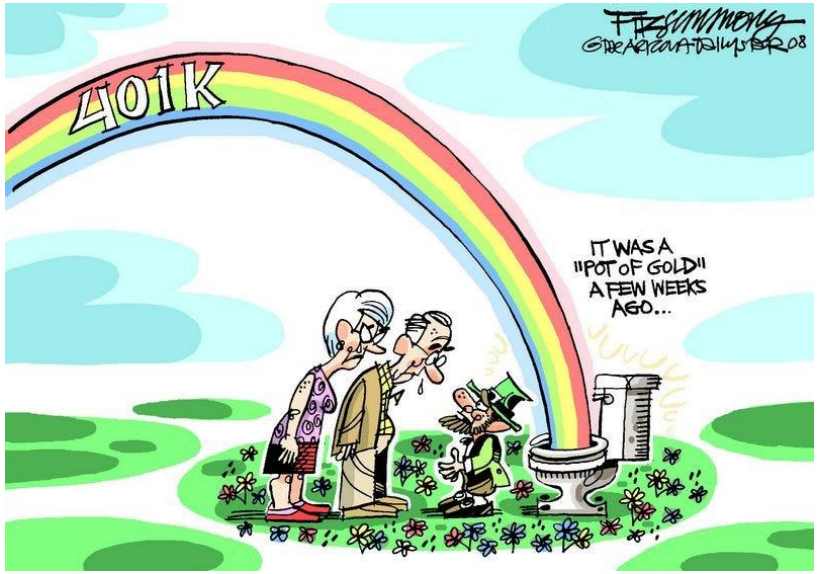
Burden of Retirement Pushed on Workers

- Workers rather than companies or the state responsible for their retirement.
- They need to contribute and decide how those contributions get invested.
- 2006 reform gives participants the opportunity to “exercise control over the investment of assets in their plan accounts”.
- Qualified Default Investment Alternatives: life-cycle funds, balanced funds, and professionally managed accounts.
  - All move away from fixed-income safer options to riskier options.
  - Even life-cycle funds (most conservative) can be volatile; includes a large proportion of stocks.


Private Pension Assets
100%
90%
80%
70%
60%
50%
40%
30%
20%
10%
0%
Jan-70
Jan-74
Jan-78
Jan-82
Jan-86
Jan-90
Jan-94
Jan-98
Jan-02
Jan-06
Jan-10
Jan-14
Jan-18
Jan-22
Corporate Equities
Total Mortgages
Mutual Fund Shares
Corporate and Foreign Bonds
Money Market Fund Shares
Treasury Securities
Total Time and Savings Deposits
Security Repurchase Agreements
Agency- and GSE-Backed Securities
Checkable Deposits and Currency

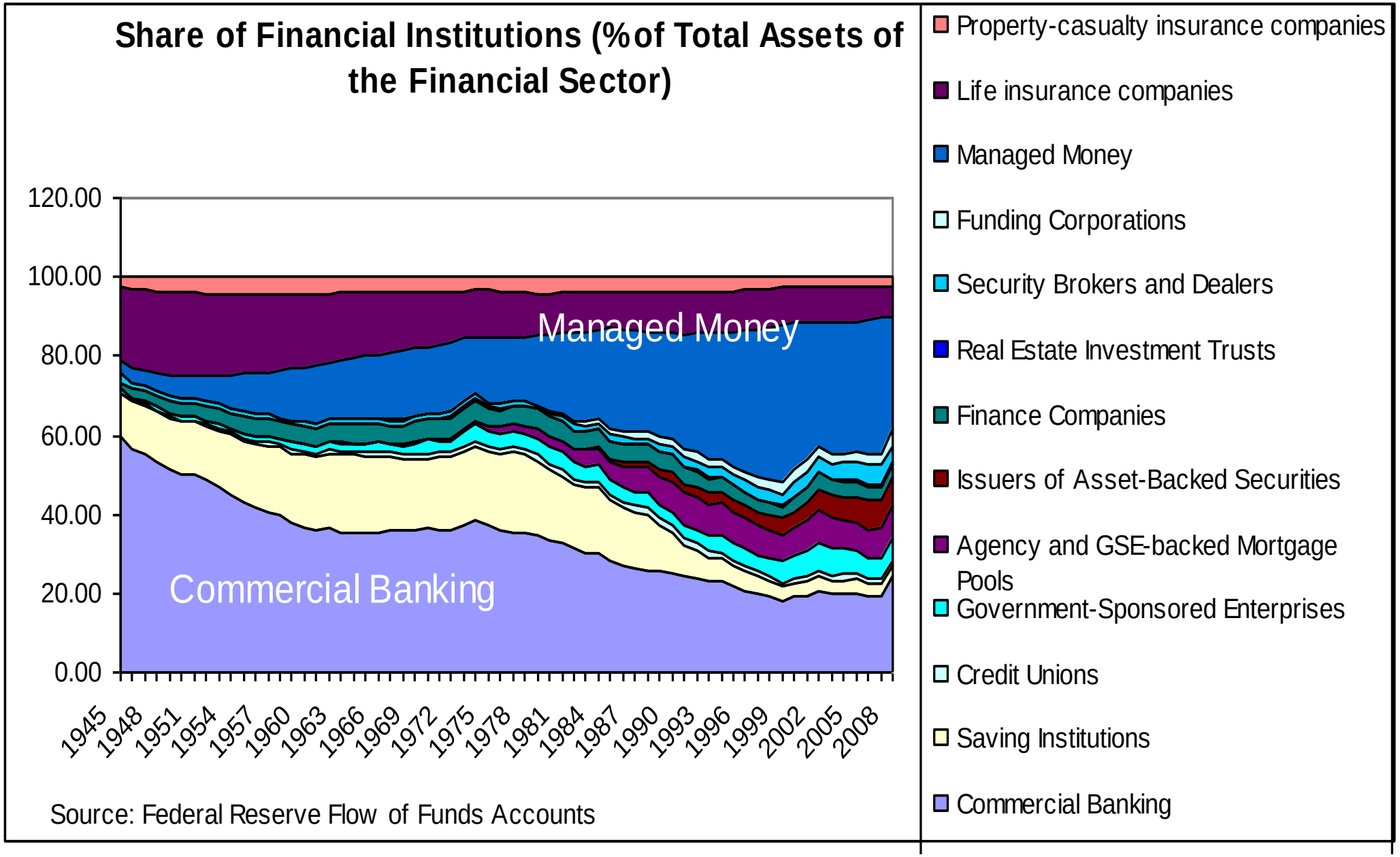
Retirement Timing and Benefits

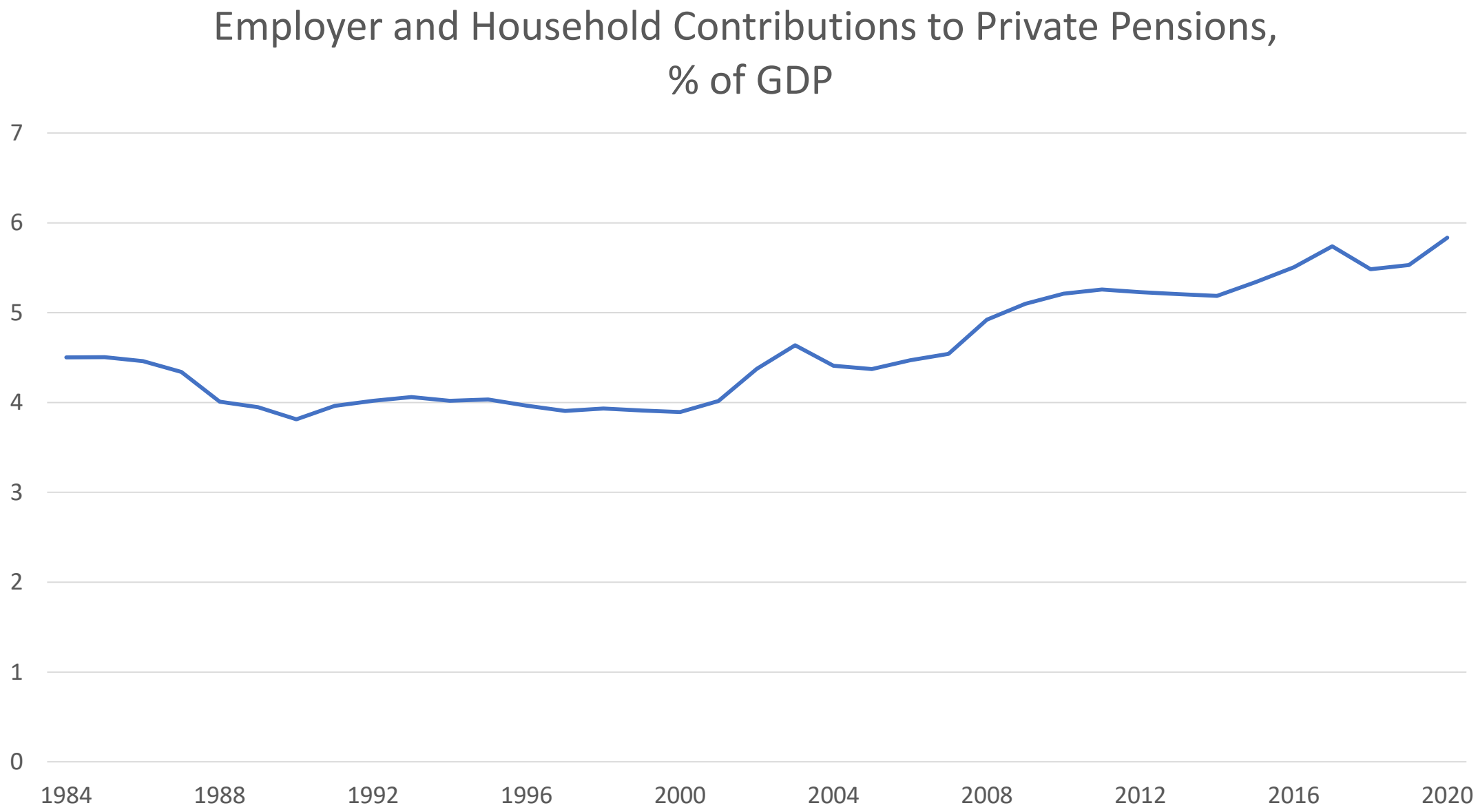
- Example of the Global Financial Crisis
- From 2007 to 2008, defined-contribution plans lost over $1.06 trillion on their assets; corporate equities and mutual funds drove $1.03 trillion of the losses.
- A worker who:
  - contributed 6% of her pay to a 401(k) plan for 40 years,
  - invested in a target-date fund,
  - and invested in annuities at retirement
- would only replace 28% of her preretirement income in 2008.



Money Manager Capitalism and Asset Price Bubbles

- Pension funds are a part of “managed money”.
  - Hyman P. Minsky: money manager capitalism.
- Managed money so big it can “move markets”.
- Asset price bubbles caused by the movement of managed money into a certain class of assets.
  - “Follow the leader” strategy which can become self-reinforcing.
  - Price increase validates initial strategy causing further flow of money into the asset class.
- When the bubble inevitably bursts, a portion of the managed money gets wiped out.


Share of Financial Institutions (% of Total Assets of the Financial Sector)
120.00
100.00
80.00
60.00
40.00
20.00
0.00
1945
1948
1951
1954
1957
1960
1963
1966
1969
1972
1975
1978
1981
1984
1987
1990
1993
1996
1999
2002
2005
2008
Managed Money
Commercial Banking
Source: Federal Reserve Flow of Funds Accounts
Property-casualty insurance companies
Life insurance companies
Managed Money
Funding Corporations
Security Brokers and Dealers
Real Estate Investment Trusts
Finance Companies
Issuers of Asset-Backed Securities
Agency and GSE-backed Mortgage Pools
Government-Sponsored Enterprises
Credit Unions
Saving Institutions
Commercial Banking


Employer and Household Contributions to Private Pensions, % of GDP
7
6
5
4
3
2
1
0
1984
1988
1992
1996
2000
2004
2008
2012
2016
2020

Boom and Bust

- 1990s New Economy and Nasdaq
  - “Irrational Exuberance”
- 2000s Residential Real Estate
  - Subprimes; foreclosures
- 2000s Commodity Markets
  - Quadrupled oil prices; food riots.

Money Manager Strategy

- Institutional investors are themselves enterprises concerned with making money.
  - Earn returns from fees, performance.
- Each manager has a strong incentive to meet or beat the average return.
  - Assume more risk on the assumption that with higher risk comes higher return.
- With competitive markets the average fund manager will only receive the risk-free return.
  - Hiring an above average manager would require paying above average fees leaving lower net returns.

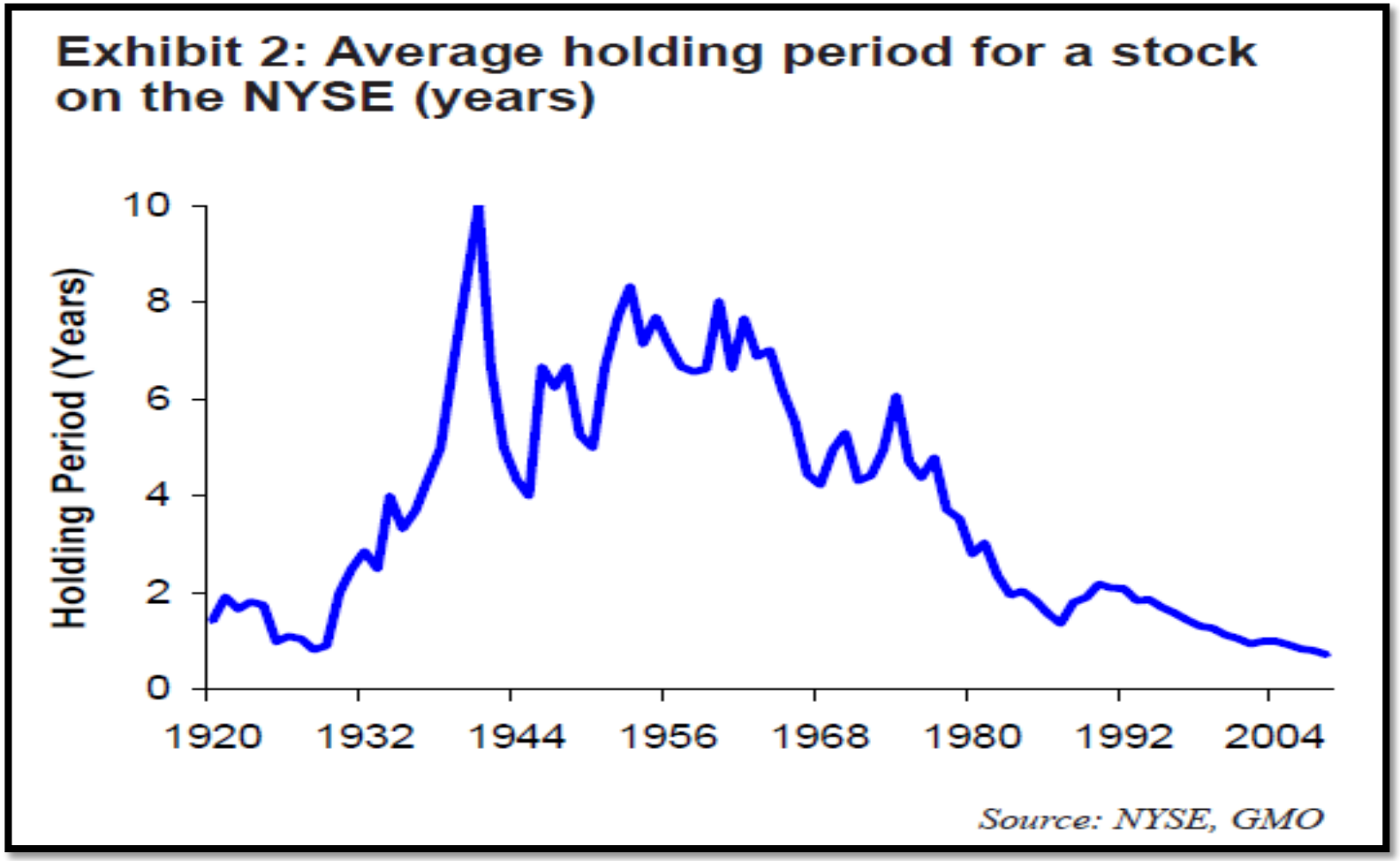
Liquification of the economy

- Managed money constantly looking for new financial products to diversify and to beat the mkt.
- “In a mature managed money capitalism enterprises and governments will have to create instruments that are attractive to market participants” (Minsky 1988).
- Constant pressure to make the economy as a whole more “liquid” - to make everything vendible.
  - Asset-backed securities, commodity futures, etc.
  - Securitizing any cash flow into standardized tradable financial instruments.
- E.g. the demand for short-term instruments from institutional investors drove the creation of short-term securitized products (Pozsar 2013).

Speculation vs. Enterprise

- Managed money enhanced “the predator nature of American capitalism” (Minsky 1996, 3).
- Keynes’s speculation: short-term gain and “vendibility” of capital.
- MMC is facilitating “market-based banking”/shadow banking.
- Money managers not concerned with development of capital assets.
  - “speculation” rather than investment.

Keynes: When speculation dominates enterprise the job is likely to be ill-done



Average holding period of an NYSE stock has decreased from 8 years in 1960s to 8 months in the recent decade.

Top Hedge Fund Manager Compensation

- The 25 highest-paid hedge fund managers made a record $32 billion in 2020.
- #1: Israel “Izzy” Englander of Millennium Management earned $3.8 billion.
- #2: Jim Simons of Renaissance Technologies earned $2.6 billion.
- #3 Chase Coleman of Tiger Global, $2.5 billion.
- #4 Ken Griffin of Citadel, $1.8 billion.

Corporate Manager Compensation

1.	Elon Musk	**Tesla** (NASDAQ:TSLA)	$6.65 billion
2.	Mike Pykosz	**Oak Street Health** (NYSE:OSH)	$568 million
3.	Trevor Bezdek (co-CEO)	**GoodRx Holdings** (NASDAQ:GDRX)	$497 million
4.	Douglas Hirsch (co-CEO)	**GoodRx Holdings** (NASDAQ:GDRX)	$497 million
5.	Eric Wu	**Opendoor Technologies** (NASDAQ:OPEN)	$388 million
6.	Alex Karp	**Palantir Technologies** (NYSE:PLTR)	$369 million

Money Manager Capitalism and Corporations

- Money managers act as the proximate owners of the corporation on behalf of the beneficiaries of the fund.
- ‘separation of ownership from ownership’” (Strine 2007)
- Corporations are focused on increasing stock prices, rather than making profits from production and trade.
- “the long view [is] a luxury that only companies which are essentially owned by a single individual … can afford” (Minsky 1996).

Changes in Corporate Governance

- Focus on short-term earnings “ignores the normal ups and downs of business revenues and expenses”.
- The active “earnings managements” prevents firms from taking the long-view and even encourages fraud.
- Movement away from “retain and reinvest” to “downsize and distribute” (Lazonick and O’Sullivan 2000).
- Graham, Harvey and Rajgopal (2005): “80% of survey participants report that they would decrease discretionary spending on R&D, advertising, and maintenance… to meet an earnings target”
- 55.3% state that they would delay starting a new project to meet an earnings target, even if such a delay entailed a small sacrifice in value...”

Everybody a shareholder?

- Workers invested in stocks – creates political impetus for preventing stock market downturns.
- 56% of American adults, or about 145 million people, own stock.
  - Ownership peaked at 65% in 2007 and fell due to the Great Recession.

The wealthiest 10% of American households own 89% of all U.S. stocks.

The bottom 50% of Americans in terms of net worth own 0.6% of stocks.

Policies for Retirement Security

- Society as a whole cannot save for retirement in financial terms.
- Key to retirement security is to increase productivity and capital to be able to produce enough in the future.
- How do we set up the financing? Trust fund? Stock market? Doesn’t make sense.
  - No need to privilege saving today –chronically insufficient demand.
- Better option pay as you go – withdraw demand with taxes and inject it with pension payments.
- Eliminate tax advantage for private pensions and boost SS.
  - Federal government program - cannot become insolvent.