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FACT SHEET

The State of U.S. Public Pensions in 2023

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The last 12 months have provided many mixed signals for U.S. state and local pension funds: the 2022 bear market rolled into a community bank crash before markets rebounded into the summer of 2023. However, on net, investment performance of state and local pension funds fell short of important investment targets. Looking forward, Equable Institute's annual report finds that the long-term outlook for pension funds in 2023 and beyond will likely be shaped by converging pressures of risk addiction, market uncertainty, and increasing politicization of asset management activities.

PUBLIC PENSION FUNDING TRENDS

- U.S. state and local public pension funds still have not fully recovered from the global financial crisis, when funded ratios declined from 92.3% in 2007 to to 62.4% in 2009.
- The national funded ratio average is projected to increase marginally from 75.4% in 2022 to **77.4% in 2023**.
- The national public pension funding shortfall is on track to remain effectively flat, inching down from $1.57 trillion in 2022 to **$1.49 trillion in 2023**.
- Preliminary fiscal year 2023 investment data shows a **5.3% return** on average for state and local plans, an improvement over 2022's -5.94% return, but still below plans' average **6.88%** investment assumption.
- Most state and municipal pension plans in the United States are **distressed** or **fragile** based on Equable Institute's analysis of plan funded ratios.
- Pension funds have more money in alternative investments like private equity, real estate, and hedge funds than at any point in history — both in dollar terms (**$1.63 trillion**) and share of asset allocations (**34.0%**), as of 2022 reporting. Markdowns to values of these asset classes in 2023 emphasize how exposed public pensions have become to "valuation risk."
- Employer contribution rates have passed **30% of payroll** on average for the first time in U.S. history (during fiscal year 2023).
- Roughly two-thirds of employer pension costs (64%) are for unfunded liability payments. Unfunded liability payments have risen **2,089%** in the last two decades – from under $5 billion in 2001 to over **$100 billion** as of 2022 reporting.
- The average assumed rate of return for state and local pension plans is **6.88%** (as of June 2023), down from 8.1% in 2001.

WHAT'S DRIVING THESE TRENDS?

- **Underperforming Investments:** States have consistently overestimated their long-term investment returns. Even when performance has been positive, it has not always kept up with the assumed rate of return. As a result, states and cities taking on more investment risk by shifting pension assets to private equity, hedge funds, and other alternative strategies.
- **Lowering Assumed Rates of Return Too Slowly:** Pension funds have reduced their assumed rates of return from an average of 8% before the financial crisis to less than 7% today. This positive trend has meant recognizing unfunded liabilities on the books that weren't previously reported (and thus there is a larger pension funding shortfall). However, the current average is still relatively high. And states are continuing to use relatively high investment assumptions to avoid recognizing the level of contributions that are necessary to truly solve pension debt problems.
- **Interest on the Debt:** States and cities have gotten better at paying their full actuarially required contributions, but that has often not been enough to keep up with growing interest on unfunded liabilities.
- **Too Many Separate Pension Fund Managers:** Some states commingle the assets of various statewide pension funds to invest together, but many do not. With more CIOs and Investment managers in the market searching for the best investment opportunities, it creates outsized competition between funds with the largest funds often winning and smaller funds losing.
- **Negative Cash Flow + Low Funded Status:** Maturing pension plans with negative cash flow mean each year there is less additional money being allocated to asset pools. This creates a problem for already poorly funded pension plans as there is less of an asset base than there should be upon which to earn investment returns.

What's Not Driving These Trends: Two commonly citied factors are not major contributors to the current state of pension funding: mortality rates and failure to pay pension bills (after years of steady improvement, only a few large states are still paying less than their actuarial requirement). For more on this, see our preliminary analysis of historic actuarial gain/loss data.

TRENDS TO WATCH IN 2023 & BEYOND

VALUATION RISK

- The risk profiles of U.S. state and local pension funds have shifted significantly toward alternative investments in recent years. As of the end of 2022, 34% of pension fund assets are invested in alternatives, including: 13% in private equity investments, 5% in hedge fund strategies, and 9.5% in real estate. Just 8% of pension fund assets were allocated to these categories in 2001.
- Public pension funds now face an emerging concern: "valuation risk" — the reported value of assets used to determine contribution rates is dependent on the accuracy of "fair price" valuations. Roughly one-third of the $4.8 trillion in assets that pension funds reported having in 2022 was based entirely on non-transparent valuation approaches from asset managers (not market-based prices like stocks. If these valuations are off, then today's contribution rates have been miscalculated.
- The effect of valuation risk on pension funds is imminent. Private equity and real estate investments are spread across a complex range of funds and asset types. The process of updating the valuation of those investments typically has a three-to-nine-month lag from the point of time being measured. Widespread markdowns of asset values are likely to continue over the next several months, which will ultimately change the performance of public pension funds.
- Because the probability of earning just a 6% return over the next decade is less than 50% and most pension funds investment assumptions are considerably higher than that, pension funds must either contribute more money into their pension funds or seek out higher returns from riskier investments in the coming years.

POLITICIZATION OF ASSET MANAGEMENT ACTIVITIES

- More laws related to pensions and ESG were adopted in the spring of 2023 than any other legislative year on record. While only a few are likely to influence pension fund investing decisions, the politicization of asset management activities is a threat to the long-term health of public pension funds.
- Politicization of pension fund investments takes many forms. At present, there are 28 states with ESG-specific laws (for or against) or trustees acting in an explicitly pro- or anti-ESG capacity. Just 22 states have laws that dictate fiduciary responsibility without any kind of political consideration.
- There are significantly more pension fund assets that are being influenced by pro-ESG sentiments than anti-ESG views. More than $2.4 trillion in assets are under management in pro-ESG states compared to $708 billion in anti-ESG states.

MARKET UNCERTAINTY

- Pension funds experienced a roller coaster swing of a bear market in 2022 that rebounded in the spring of 2023. But the rebound was marked by asset shocks related to Fed interest rate changes, the SVB banking crash, and events like the FTX bankruptcy.
- Financial market volatility over the past five years has meant most plans' funded ratios declined between 2019 and 2020, then increased in 2021, and now are balancing out with weak investment performance for 2022-23. The result is a 6.15% average return for the Covid-19 era.
- Given the current economic landscape and uncertain interest rate environment in the coming months and years, mixed market signals and significant volatility are likely to be a significant influence on the funding and investment decisions of public pension funds.

READ THE REPORT

This fact sheet was released in conjunction with Equable Institute's annual report on the status of statewide public pension systems. The report analyzes trends in public pension funding, investments, contributions, cash flows, and benefits for 225 of the largest statewide and municipal retirement systems, covering more than 370 plans, in all 50 states to illuminate the scale and effects of these challenges.

STATE OF PENSIONS 2023