Understanding the Assumed Rate of Return



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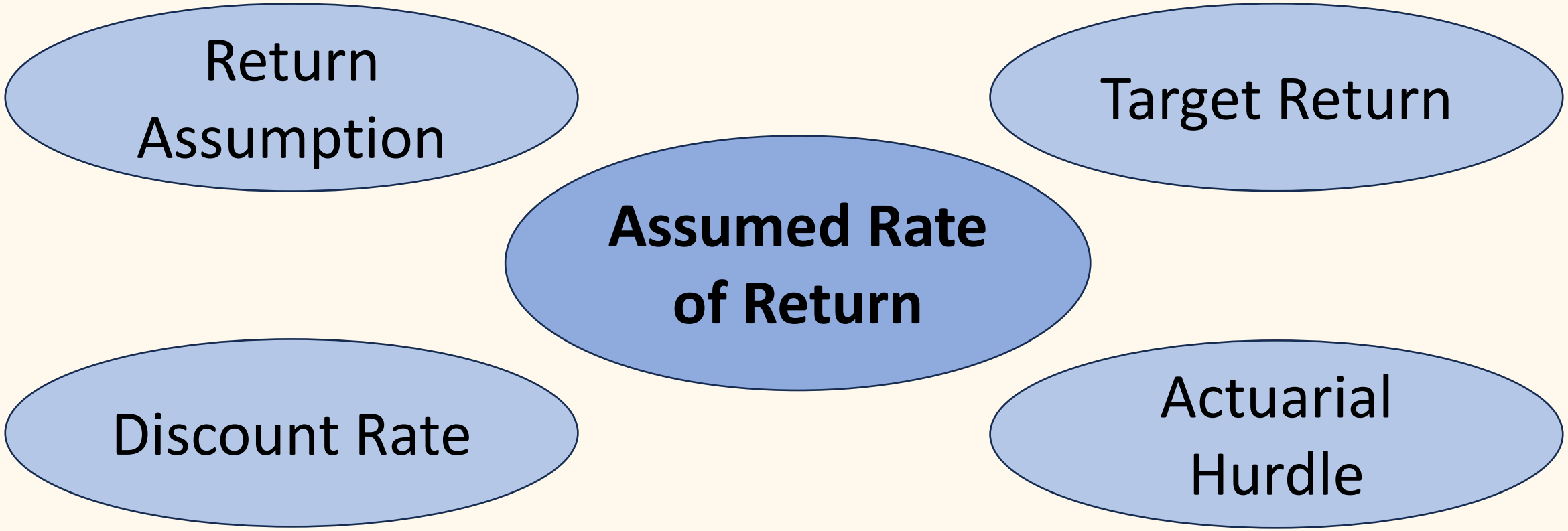
What Are We Talking About?



These terms are often used interchangeably

A Pension Is a Shared Funding Arrangement

“Three-Legged Stool”

1. Employee Contributions
2. Employer Contributions
3. Investment Earnings



Three-Legged Stool:
All Sources Must Contribute

The Actuary Estimates Future Benefit Payments

- How much will the plan cost?
- Key factors include:
  - Expected retirement ages
  - Salary growth
  - Benefit formula
  - Inflation
  - Mortality rates



Future Payments Are Converted Into Today's Dollars

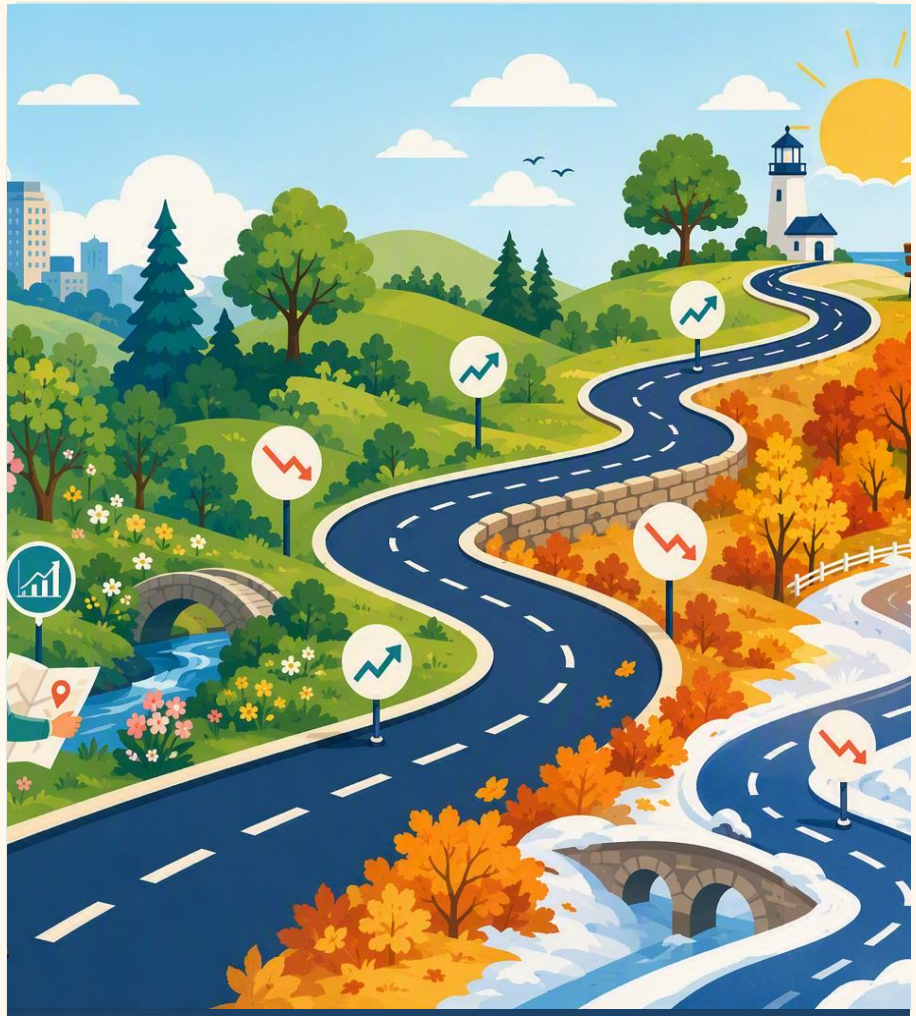
- Actuary converts future benefit payments into a present value.
- The assumed rate of return is the “discount rate” used in the formula.
- Helps determine the contributions needed today.
- Similar to calculating a monthly mortgage payment



Translating future cash flows into today’s dollars

The Return Assumption Is A Long-Term Concept

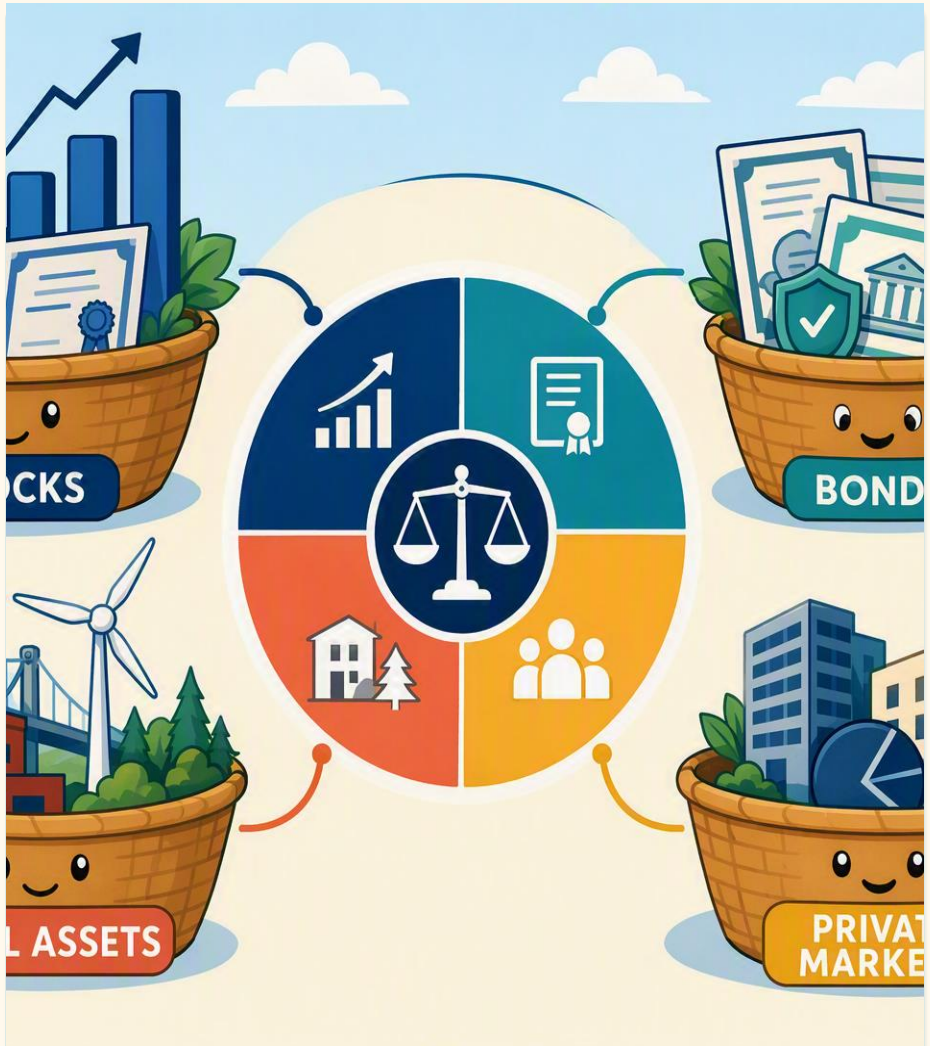
- The assumption reflects the average compound return expected over many years
- A single strong year does not prove the assumption is correct.
- A single weak year does not prove the assumption is wrong.



Focus on the journey, not one mile

The Assumption Should Reflect Reality

- Expected returns are developed for stocks, bonds, real assets, private markets, and other investments.
- Those expectations are combined using the plan's target asset allocation.
- The Consultant forecasts what they "think" the portfolio may earn over the next twenty years "on average"



Diversification shapes expected return and risk

Who Selects The Assumption?

- **No one and everyone!**
- The actuary does not necessarily set the rate alone.
- The actuary evaluates reasonableness and explains the basis for that assessment.
- The Board typically has final approval of the rate.

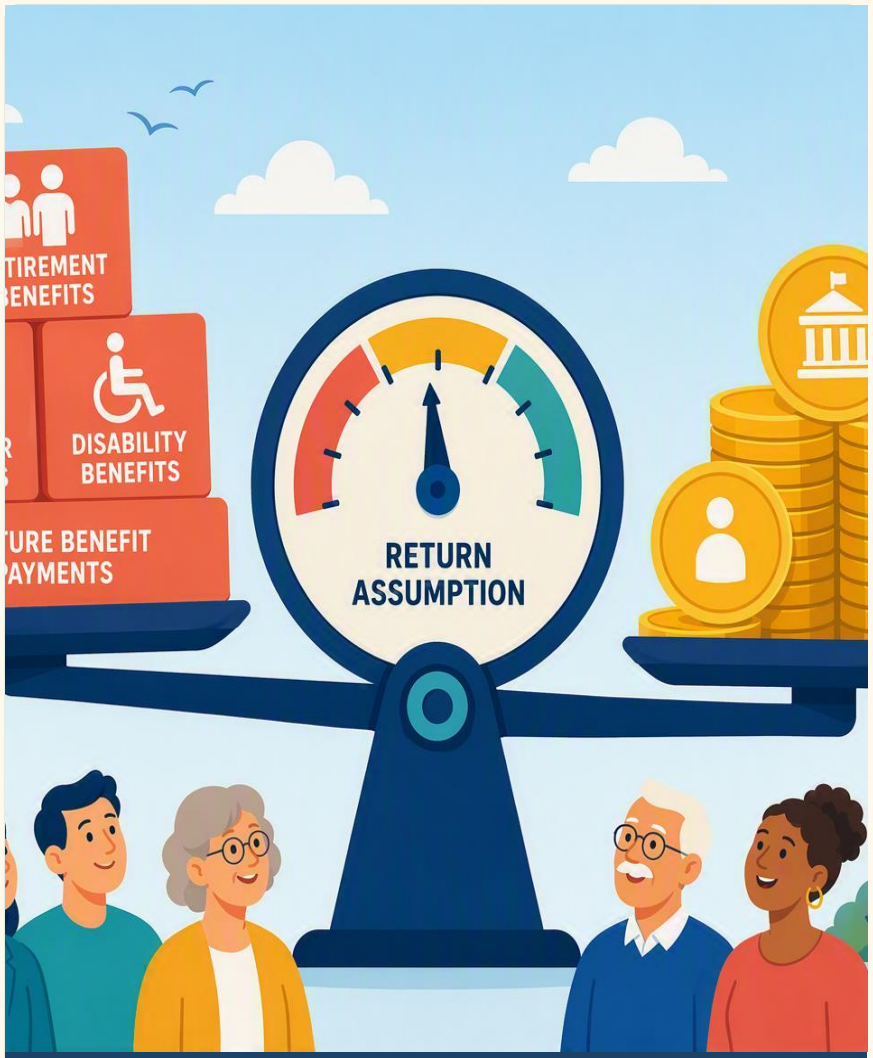


Board, sponsor, actuary, and consultant each have a role

The Rate Affects Cost and Funding

LOWER ASSUMPTION	HIGHER ASSUMPTION
Liabilities Generally higher	Near-term liabilities Generally lower
Required contributions Generally higher	Near-term contributions Generally lower

A higher assumption creates greater risk that future taxpayers or employers may need to make up an investment shortfall.



The assumption acts like a financial lever

The Assumed Rate Does Not Change Actual Benefit Costs

- Actual costs (benefit payments) are influenced by demographics, not assumptions
- Changing the assumptions changes the amount you need to save/contribute.
- Like saving for college (and paying for college) the actual experience will drive the actual cost.



Actual results determine the true cost

No Two Plans Are The Same

- Liquidity matters because benefits must be paid even during market stress.
- Sequence risk matters when poor returns arrive at an unfavorable time
- Or if good returns arrive when plan assets are too small to benefit from compounding.



The same destination can involve very different risks

The Assumption Should Be Reviewed Regularly

- **Review the assumption when:**
- Capital market expectations and inflation changes
- Changes to the target asset allocation
- Demographic experience studies
- Plan maturity, cash flows, or contribution policy change



Regular review keeps the plan on course

Don’t Be Unrealistic

- Setting an unrealistic return target hurts the plan.
- Funding will not be sufficient



A return target should be achievable with good confidence

Don’t Delay When Funding Status Starts to Slip

- Failing to achieve “actuarial determined contribution” year after year leads to larger funding problems over time.
- Often the solution is tough medicine to swallow:
  - Benefit reductions
  - Higher contributions



Don’t let a funding gap snowball out of control

Final Message

Investment returns help pay for retirement benefits, but the return assumption is only a planning tool.

Long-Term Pension Success Depends on all five:

- **Employer Contributions**
- **Employee Contributions**
- **Realistic Assumptions**
- **Carefully Planned Benefit Changes**
- **Regular Review**

Questions?

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