
It Was a Great Year for America's Pensions, but Many Are Still in Crisis.

Large public pensions are facing a funding shortfall of as much as $4 trillion because their liabilities are so large

A run-up in stocks helped deliver a banner year for America's public pensions. But the gains won't be nearly enough to ensure all state and local retirees receive their promised future benefits.

Large U.S. systems that oversee retirement funds for police, firefighters, teachers and other public workers earned median returns of 12.4% in the fiscal year ended June 30, according to Wilshire Trust Universe Comparison Service. That is their best annual result since 2014.

Yet many of these public pensions remain severely underfunded despite the recent gains, meaning they don't have enough assets on hand to fulfill all promises made to their workers. Estimates of their collective shortfall vary from $1.6 trillion to $4 trillion.

"It's a hole that took a long time to dig, so it will take a long time to fill," said Fitch Ratings analyst Douglas Offerman.

The pensions' predicament is the result of decades of low government contributions, overly optimistic investment assumptions, over-promises on benefits and two recessions that left many retirement systems with deep funding holes. Demographics are also a factor: Liabilities are rising as waves of baby boomers retire, leaving fewer active workers left to contribute to pension plans.

For many pensions, funding problems worsened in the years following the 2008 financial crisis as interest rates hit—and remained at—rock bottom. Some states pushed through benefit cuts that moved new employees onto less-generous, 401(k)-style plans, but those changes often failed to alleviate funding woes because they didn't affect existing retirees.

Many funds tried to address the issue by ramping up their ownership of equities in the hopes of benefiting from an eight-year bull market. Public pension funds had a median 56.61% of their holdings in equities as of June 30, compared with 54.9% a year earlier, according to Wilshire TUCS.

But that level of exposure to stocks means public pensions will experience even more funding stress if a bear market returns.

Many pensions are preparing for lower returns by scaling back predictions of what they will earn in the future, an accounting adjustment that pushes liabilities higher. Public pensions use a combination of investment income and contributions from employees, states and cities to fund benefits.

Even if returns remain elevated, large public pensions won't be able to reverse their shortfall in coming years, according to Moody's Investors Service. Large public plans currently have just 70% of what they need to pay future benefits to their retirees, according to 2016 figures from Wilshire

Consulting.

Funding levels won't improve significantly unless cities and states ramp up their yearly pension contributions, according to a recent report by the Center for Retirement Research at Boston College. But budget problems in many states and cities mean governments either can't afford to make aggressive payments or opt to stretch them over decades so big outlays are delayed.

Few states are having more trouble with these issues than Illinois, which has struggled for years to agree on budget priorities and pay for mounting pension liabilities. One result is that the fund that oversees retirement money for state employees, judges and lawmakers now has just 35% of what it needs to pay for all future retirement obligations.

Funds overseen by the Illinois State Board of Investment earned nearly 12% in the fiscal year ended June 30—its best result since 2014—but Chairman Marc Levine said he expects the funding deficit to widen.

“Our liabilities are three times our assets,” said Mr. Levine. “Maintaining our funding level would require investment returns over 20% annually. That's not going to happen.

“Even in a fantastic year,” he added, “we can't keep up.”

Many other public pensions around the country reported robust returns in the year ended June 30 but warned of difficult budget choices ahead. The California Public Employees' Retirement System, the biggest in the U.S., earned 11.2% in fiscal 2017—largely because of stocks and private equity. But the fund, known by its acronym Calpers, noted that it has just 68% of the assets it needs to pay for future benefits. That is up from 65% in 2016.

“We welcome this fiscal year's strong returns, but we also remain about 68 percent funded and vulnerable to a downturn in stock markets,” Calpers Chief Executive Marcie Frost said in a statement. The fund has about $332 billion in assets for 1.8 million workers and retirees.

The California State Teachers' Retirement System, which sits roughly one mile from Calpers in Sacramento, Calif., reported a fiscal 2017 return of 13.4%. The fund's chief investment officer, Christopher Ailman, touted the number on Twitter as being higher than Calpers: “BOOYAH!!”

In a release, though, he offered some caution: “Just as one bad year will not break us, one good year will not make us.”

One of the best gains among public pensions happened in Connecticut, where retirement funds earned a collective return of 14.3% in the fiscal year ending June 30.

“It was a jackpot for the taxpayers,” said state Treasurer Denise Nappier.

But the fund that oversees retirements for state employees has just 35.5% of what it needs to pay for future obligations and a fund for teachers has 56%. The state, Ms. Nappier said, made a mistake by not contributing more to the funds in past years.

Now she wants the teachers' fund to reduce expectations for future gains, calling its current goal of 8% “an unrealistic expectation.” The state employee fund last year dropped its assumption to 6.9% from 8%.

“The robust returns in the past aren't in the cards for the future,” Ms. Nappier said.

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By Heather Gillers

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Write to Heather Gillers at heather.gillers@wsj.com