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Calpers Cuts Investment Targets, Increasing Strain on Municipalities.

The board of California's state public pension system, Calpers, voted Wednesday to lower expectations for future investment returns, a step that will increase pressure on the budgets of towns and cities across the state.

Calpers, a giant with roughly $300 billion in assets, has long been a bellwether among America's thousands of public pension funds because of its sheer size and influence in the investment industry. It manages the investments for more than 1.7 million current and future retirees, making it the nation's largest public fund outside the federal government. Calpers' move to lower its investment expectations is likely to prompt pension systems in other states to do the same.

"This is very monumental for the organization," one trustee, Richard Costigan, said at a public meeting just before the vote.

With the move, Calpers is changing its business plan, so that investment returns will cover less of the cost of retirees' pensions than previously. That will force local governments to pay more, either through higher taxes or reduced public services. Public workers in California will have to chip in more, too.

At the same time, the move has little chance of satisfying critics of public pension systems who have argued for years that the sector's methodology is dangerously flawed — not just because many investment projections are overly optimistic, but also because pension plans use those projections to calculate their liabilities, violating basic economic principles.

Such critics, many of them economists, say that because public pensions are virtually risk-free for recipients, their values should be based on the returns of safe investments like Treasury securities, which have recently hovered around 2.5 percent for 10-year bonds. Calpers now uses Treasury rates only when a city wants to drop out of its system.

Under all other circumstances, Calpers currently assumes that its investment portfolio will return an average of 7.5 percent a year over the long term, and bills its member governments accordingly. Its trustees agreed Wednesday to reduce that to 7 percent, phasing in the reduction over the next three years.

Many other state pension systems have even higher expectations, according to a survey of 127 plans by the National Association of State Retirement Administrators. Most were expecting to earn 7.5 percent to 8 percent over the long term. The second-largest group was counting on annual returns of 7 percent to 7.5 percent.

The differences may sound small, but just a slight reduction in the assumed rate drives up the cost sharply, because it is multiplied across decades and for thousands of retirees.

Shifting expectations down to 7 percent will force the State of California to contribute an additional

$2 billion a year for state workers, according to Eric Stern, a policy adviser for the California Department of Finance who briefed Calpers board members about the measure on Tuesday.

All public pension funds pool money and invest it in the hope that returns will cover most of the cost of retirees' benefits. But those costs are rising quickly now, as the baby boom generation retires, and investment returns have not nearly kept pace.

Even before the change takes effect, some cities in California have complained that their pension plans are too costly. Calpers bills them once a year for their share, assuming the investments will return 7.5 percent in the future. Calpers confirmed in a recent risk report that for some types of pensions — especially those for police — those bills are higher than ever before.

Some local governments say they simply cannot keep up, yet they are not allowed an easy exit from the system. Pensions thus played a prominent role in the municipal bankruptcies of Vallejo, Stockton and San Bernardino, with Calpers arguing that the cities could not lower their pension contributions or switch to less costly plans, even though companies routinely do so in bankruptcy. Those arguments prompted the judge in Stockton's bankruptcy case, Christopher Klein, to call Calpers "a bully" with "an iron fist."

The waning California town of Loyalton took matters into its own hands three years ago, voting to simply drop out of Calpers. In response, Calpers sent a bill for a hefty withdrawal payment; Loyalton said it was broke and could not pay.

In November, Calpers responded by cutting the pensions of each of Loyalton's four municipal retirees by 60 percent — the first time on record that Calpers had cut anyone's pension.

Marcia Fritz, president of the California Foundation for Fiscal Responsibility, said the additional pension costs might push more local governments over a fiscal cliff.

"The ones that are hurting the most are the small, non-volunteer fire districts in rural areas," Ms. Fritz said.

They lack a tax base big enough to cover the substantial cost of keeping firefighters on duty around the clock, she said. Some have been experimenting with other revenue sources but have not found a permanent fix, and rising pension costs could be their death knell.

Despite those concerns, Calpers board members decided they had no choice but to lower investment expectations. Outside advisers have been urging the system to do so for years. Its chief investment officer, Ted Eliopoulos, said last summer that investment returns for the previous year were close to zero, and that it would be a big challenge for Calpers to get through the next three to five years.

With rising numbers of retirees drawing their benefits, Mr. Eliopoulos said this week that he had been scaling back the risk level in Calpers' investment portfolio. Stocks — both domestic and global — had been reduced to 46 percent of the investment portfolio from 51 percent, for example.

Lowering risk, however, generally means lower returns as well.

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