Pension return assumptions

Berkshire letters: 2007, 2016 · Difficulty: Advanced

Summary

Pension expense depends on the **assumed return** on pension assets. A higher assumption lowers reported expense and raises earnings, with no change in the plan's real economics. Buffett shows that many companies used assumptions (about 8%) that their actual asset mix could not support.

2007 letter

To avoid that bothersome rule, a numb er of companies surreptitiously backdated options to falsely indicate that they were granted at current market prices, when in fact they were dished out at prices well below market. Decades of option-accounting nonsense have now been put to rest, but other accounting choices remain – important among these the investment-return assumption a company uses in calculating pension expense. It will come as no surprise that many comp anies continue to choose an assumption that allows them to report less-than-solid "earni ngs." For the 363 companies in the S& P that have pension plans, this assumption in 2006 averaged 8%. Let's look at the chances of that being achieved. 18 The average holdings of bonds and cash for all pension funds is about 28%, and on these assets returns can be expected to be no more than 5%.

Higher yields, of course, are obtainable but they carry with them a risk of commensurate (or greater) loss.

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Many helpers are apparently direct descendants of the queen in Alice in Wonderland, who said: "Why, sometimes I've believed as many as six impossible things before breakfast." Beware the glib helper who fills your head with fantasies while he fills his pockets with fees. Some companies have pension plans in Europe as well as in the U.S. and, in their accounting, almost all assume that the U.S. plans will earn more than the non-U.S. plans. This discrepancy is puzzling: Why should these companies not put th eir U.S. managers in charge of the non-U.S. pension assets and let them work their magic on these assets as well? I've never seen this puzzle explained.

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After decades of pushing the envelope – or worse – in its attempt to report the highest number possible for current earnings, Corporate America should ease up. It should listen to my partner, Charlie: "If you've hit three balls out of bounds to the left, aim a little to the right on the next swing." * * * * * * * * * * * * Whatever pension-cost surprises are in store fo r shareholders down the road, these jolts will be surpassed many times over by those experienced by taxpayers. Public pension promises are huge and, in many cases, funding is woefully inadequate. Because th e fuse on this time bomb is long, politicians flinch from inflicting tax pain, given that problems will only become apparent long after these officials have departed.

2016 letter

Our cost basis for the shares is $9.8 billion. 12/31/16 Shares* Company Percentage of Company Owned Cost** Market (in millions) 151,610,700 American Express Company ..... 16.8 $ 1,287 $ 11,231 61,242,652 Apple Inc. ..... 1.1 6,747 7,093 6,789,054 Charter Communications, Inc. ..... 2.5 1,210 1,955 400,000,000 The Coca-Cola Company ..... 9.3 1,299 16,584 54,934,718 Delta Airlines Inc. ..... 7.5 2,299 2,702 11,390,582 The Goldman Sachs Group, Inc. ..... 2.9 654 2,727 81,232,303 International Business Machines Corp. ..... 8.5 13,815 13,484 24,669,778 Moody's Corporation ..... 12.9 248 2,326 74,587,892 Phillips 66 ..... 14.4 5,841 6,445 22,169,930 Sanofi ..... 1.7 1,692 1,791 43,203,775 Southwest Airlines Co. ..... 7.0 1,757 2,153 101,859,335 U.S. Bancorp ..... 6.0 3,239 5,233 26,620,184 United Continental Holdings Inc. ..... 8.4 1,477 1,940 43,387,980 USG Corp. ..... 29.7 836 1,253 500,000,000 Wells Fargo &

Company ..... 10.0 12,730 27,555 Others ..... 10,697 17,560 Total Common Stocks Carried at Market .... $ 65,828 $ 122,032 * Excludes shares held by pension funds of Berkshire subsidiaries. ** This is our actual purchase price and also our tax basis; GAAP “cost” differs in a few cases because of write-downs that have been required under GAAP rules. Some of the stocks in the table are the responsibility of either Todd Combs or Ted Weschler, who work with me in managing Berkshire’s investments. Each, independently, manages more than $10 billion; I usually learn about decisions they have made by looking at monthly trade sheets.

Included in the $21 billion that the two manage is about $7.6 billion of pension trust assets of certain Berkshire subsidiaries. As noted, pension investments are not included in the preceding tabulation of Berkshire holdings. ********** Excluded from the table – but important – is our ownership of $5 billion of preferred stock issued by Bank of America. This stock, which pays us $300 million per year, also carries with it a valuable warrant allowing Berkshire to purchase 700 million common shares of Bank of America for $5 billion at any time before September 2, 2021.

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My regular recommendation has been a low-cost S&P 500 index fund. To their credit, my friends who possess only modest means have usually followed my suggestion. 24 I believe, however, that none of the mega-rich individuals, institutions or pension funds has followed that same advice when I’ve given it to them. Instead, these investors politely thank me for my thoughts and depart to listen to the siren song of a high-fee manager or, in the case of many institutions, to seek out another breed of hyper-helper called a consultant.

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In many aspects of life, indeed, wealth does command top-grade products or services. For that reason, the financial “elites” – wealthy individuals, pension funds, college endowments and the like – have great trouble meekly signing up for a financial product or service that is available as well to people investing only a few thousand dollars. This reluctance of the rich normally prevails even though the product at issue is –on an expectancy basis – clearly the best choice.

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But I believe my calculation of the aggregate shortfall is conservative. Much of the financial damage befell pension funds for public employees. Many of these funds are woefully underfunded, in part because they have suffered a double whammy: poor investment performance accompanied by huge fees.

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Human behavior won’t change. Wealthy individuals, pension funds, endowments and the like will continue to feel they deserve something “extra” in investment advice. Those advisors who cleverly play to this expectation will get very rich.

Source: Warren E. Buffett, Letters to Berkshire Hathaway Shareholders: 2007, 2016 (berkshirehathaway.com/letters). Excerpts © Berkshire Hathaway Inc., all rights reserved; reproduced in part for non-commercial teaching. “…” marks skipped text. The summary is original course material by Jaeyoon Yu; not affiliated with or endorsed by Berkshire Hathaway Inc.