

Warren Buffett: The Grim and The Gruesome

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.

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.

This means that the remaining 72% of assets - which are mostly in equities, either held directly or through vehicles such as hedge funds or private-equity investments - must earn 9.2% in order for the fund overall to achieve the postulated 8%.

And that return must be delivered after all fees, which are now far higher than they have ever been.

How realistic is this expectation? Let's revisit some data I mentioned two years ago: During the 20th Century, the Dow advanced from 66 to 11,497. This gain, though it appears huge, shrinks to 5.3% when compounded annually. An investor who owned the Dow throughout the century would also have received generous dividends for much of the period, but only about 2% or so in the final years. It was a wonderful century.

Think now about this century. For investors to merely match that 5.3% market-value gain, the Dow - recently below 13,000 - would need to close at about 2,000,000 on December 31, 2099. We are now eight years into this century, and we have racked up less than 2,000 of the 1,988,000 Dow points the market needed to travel in this hundred years to equal the 5.3% of the last.

It's amusing that commentators regularly hyperventilate at the prospect of the Dow crossing an even number of thousands, such as 14,000 or 15,000. If they keep reacting that way, a 5.3% annual gain for the century will mean they experience at least 1,986 seizures during the next 92 years. While anything is possible, does anyone really believe this is the most likely outcome?

Dividends continue to run about 2%. Even if stocks were to average the 5.3% annual appreciation of the 1900s, the equity portion of plan assets -allowing for expenses of .5% - would produce no more than 7% or so. And .5% may well understate costs, given the presence of layers of consultants and high priced managers ("helpers").

Naturally, everyone expects to be above average. And those helpers - bless their hearts - will certainly encourage their clients in this belief. But, as a class, the helper-aided group must be below average.

Found at: http://groups.google.com/group/aiii/browse_thread/thread/f42625644a9c9395/662908b0e93d1feb

The reason is simple: 1) Investors, overall, will necessarily earn an average return, minus costs they incur; 2) Passive and index investors, through their very inactivity, will earn that average minus costs that are very low; 3) With that group earning average returns, so must the remaining group - the active investors.

But this group will incur high transaction, management, and advisory costs. Therefore, the active investors will have their returns diminished by a far greater percentage than will their inactive brethren. That means that the passive group - the "know-nothings" - must win.

I should mention that people who expect to earn 10% annually from equities during this century - envisioning that 2% of that will come from dividends and 8% from price appreciation - are implicitly forecasting a level of about 24,000,000 on the Dow by 2100.

If your adviser talks to you about doubledigit returns from equities, explain this math to him - not that it will faze him. 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 their 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. But the auditors and actuaries who are charged with vetting the return assumptions seem to have no problem with it.

What is no puzzle, however, is why CEOs opt for a high investment assumption: It lets them report higher earnings. And if they are wrong, as I believe they are, the chickens won't come home to roost until long after they retire.

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 for 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 the 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. Promises involving very early retirement - sometimes to those in their low 40s - and generous cost-of-living adjustments are easy for these officials to make. In a world where people are living longer and inflation is certain, those promises are going to come unfulfilled.

The U.S. dollar weakened further in 2007 against major currencies, and it's no mystery why:

Americans like buying products made elsewhere more than the rest of the world likes buying products made in the U.S. Inevitably, that causes America to ship about \$2 billion of IOUs and assets daily to the rest of the world. And over time, that puts pressure on the dollar.

When the dollar falls, it both makes our products cheaper for foreigners to buy and their products more expensive for U.S. citizens. That's why a falling currency is supposed to cure a trade deficit. Indeed, the U.S. deficit has undoubtedly been tempered by the large drop in the dollar. But ponder this: In 2002 when the Euro averaged 94.6¢, our trade deficit with Germany (the fifth largest of our trading partners) was \$36 billion, whereas in 2007, with the Euro averaging \$1.37, our deficit with Germany was up to \$45 billion.

Similarly, the Canadian dollar averaged 64¢ in 2002 and 93¢ in 2007. Yet our trade deficit with Canada rose as well, from \$50 billion in 2002 to \$64 billion in 2007. So far, at least, a plunging dollar has not done much to bring our trade activity into balance.

There's been much talk recently of sovereign wealth funds and how they are buying large pieces of American businesses. This is our doing, not some nefarious plot by foreign governments. Our trade equation guarantees massive foreign investment in the U.S. When we force-feed \$2 billion daily to the rest of the world, they must invest in something here. Why should we complain when they choose stocks over bonds?

Our country's weakening currency is not the fault of OPEC, China, etc. Other developed countries rely on imported oil and compete against Chinese imports just as we do. In developing a sensible trade policy, the U.S. should not single out countries to punish or industries to protect. Nor should we take actions likely to evoke retaliatory behavior that will reduce America's exports, true trade that benefits both our country and the rest of the world.

Our legislators should recognize, however, that the current imbalances are unsustainable and should therefore adopt policies that will materially reduce them sooner rather than later. Otherwise our \$2

billion daily of force-fed dollars to the rest of the world may produce global indigestion of an unpleasant sort.

Fanciful Figures - How Public Companies Juice Earnings

Former Senator Alan Simpson famously said: "Those who travel the high road in Washington need not fear heavy traffic." If he had sought truly deserted streets, however, the Senator should have looked to Corporate America's accounting.

An important referendum on which road businesses prefer occurred in 1994. America's CEOs had just strong-armed the U.S. Senate into ordering the Financial Accounting Standards Board to shut up, by a vote that was 88-9. Before that rebuke the FASB had shown the audacity - by unanimous agreement, no less - to tell corporate chieftains that the stock options they were being awarded represented a form of compensation and that their value should be recorded as an expense.

After the senators voted, the FASB - now educated on accounting principles by the Senate's 88 closet CPAs - decreed that companies could choose between two methods of reporting on options. The preferred treatment would be to expense their value, but it would also be allowable for companies to ignore the expense as long as their options were issued at market value.

A moment of truth had now arrived for America's CEOs, and their reaction was not a pretty sight. During the next six years, exactly two of the 500 companies in the S&P chose the preferred route.

CEOs of the rest opted for the low road, thereby ignoring a large and obvious expense in order to report higher "earnings." I'm sure some of them also felt that if they opted for expensing, their directors might in future years think twice before approving the mega-grants the managers longed for.

It turned out that for many CEOs even the low road wasn't good enough. Under the weakened rule, there remained earnings consequences if options were issued with a strike price below market value.

No problem. To avoid that bothersome rule, a number 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 companies continue to choose an assumption that allows them to report less-than-solid "earnings."