Short-Term Market Volatility and Public Pension Plans

April 2025

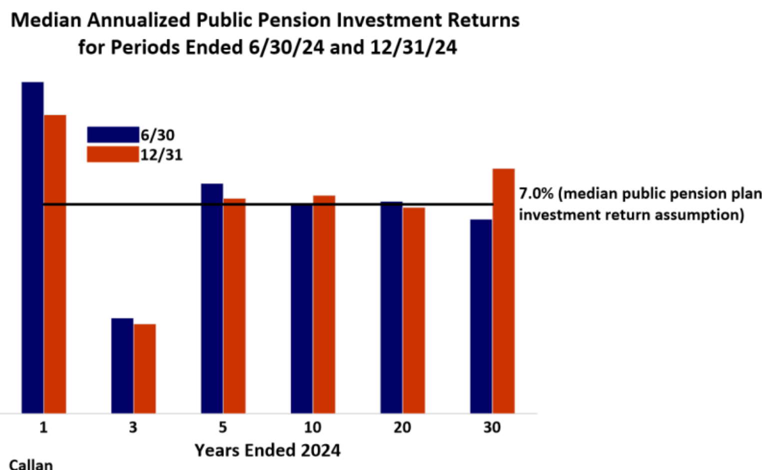
Short-term market volatility can raise concerns among public pension plan stakeholders and observers. Although headlines may focus on daily or weekly fluctuations, short-term declines should be viewed in the context of public pension funds' long-term, disciplined approach to investing.

Key Findings

- Public pension funds are managed by long-term, professional investors focused on meeting obligations that span decades. These investors avoid reacting to short-term market swings, instead relying on strategic asset allocation and investment policies to maintain resilience.
- Public pension fund portfolios are highly diversified, which reduces risk and mitigates the impact of market volatility.
- Most public pension plans diminish the effects of market fluctuations through strategies like asset smoothing, which spreads recognition of gains and losses over several years, promoting stability in funding requirements.

Public Pension Funds are Long-Term, Disciplined Investors

Public pension funds have long investment horizons, typically stretching decades into the future. They are not investing for the next quarter, but rather, to meet obligations that will come due over decades. This long-term perspective allows public funds to be patient and strategic, avoiding hasty decisions that could lock in losses or forego future gains. Investment decisions are made by experienced professionals following prudent investment policies, with a focus on sustainability and resilience. These policies include target asset allocations; metrics of portfolio risk; and periodic rebalancing of the portfolio to ensure that the plan's investments continue to align with its long-term strategic asset allocation, risk tolerance, liquidity needs, and return objectives.



As the chart above illustrates, over periods of five years and greater, median public pension fund returns are closely aligned with long-term return expectations.

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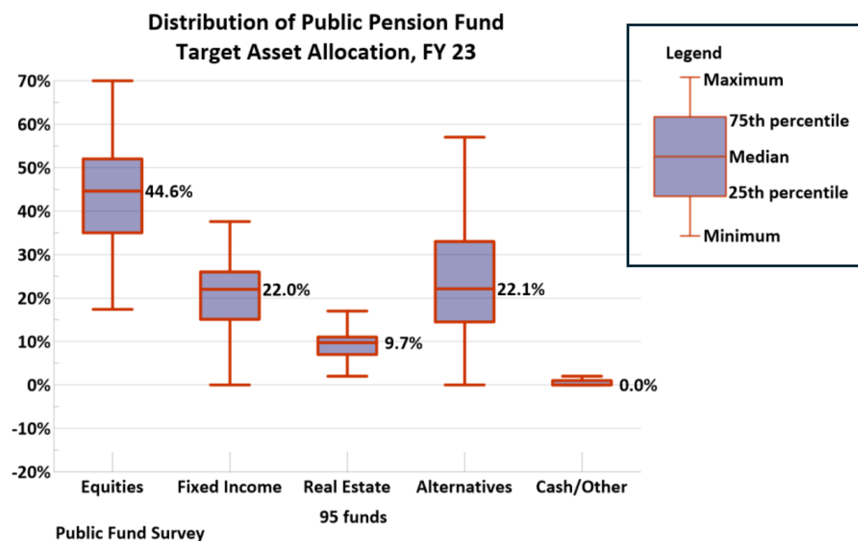
Public pension funds account for short-term market volatility in their asset allocation, investment strategy, and funding policy. Although volatility is something to be monitored, public pension funds are uniquely positioned—due to their diversification, long-term investment horizon, and disciplined management—to weather these periods and remain focused on generating returns to defray the cost of providing secure retirement benefits over generations.

Public Pension Funds are Invested in Diversified Portfolios

As illustrated in the accompanying chart, public pension fund assets are allocated across a broad range of asset classes, geography, and strategies. This diversification reduces total portfolio risk by insulating the portfolio from volatility in any one area: while one asset class, such as public equities, may experience sharp swings in value, others, such as bonds, real estate, and private equity, behave differently. Diversification helps maximize returns while reducing risk by spreading the risk across different asset classes, providing a buffer against isolated areas of market volatility. The chart shows that there is diversity not only among the asset classes public pension funds are invested in, but also across funds in terms of their specific allocations to broad asset classes.



Public Pension Plan Funding Policies Mitigate Short-term Volatility

Market fluctuation is a natural and expected outcome of investing. Short-term declines, even sharp ones, are not unusual and have occurred frequently, including during recent years. Just as markets go down, they also recover—sometimes quickly. Reacting to short-term market fluctuations can be far more damaging than simply staying the course through a temporary downturn. Public pension fund investment horizons extend beyond the next quarter, or even the next few years, and most public pension plan funding policies specifically account for short-term volatility by smoothing their actuarial (or funding) value of assets, typically over a five-year period.

As the chart below shows, as of 4/14/25, despite significant volatility, the S&P 500 is currently higher by over 73 percent relative to 7/1/20, which is the beginning of FY 2021 for plans with a 6/30 fiscal year end date.

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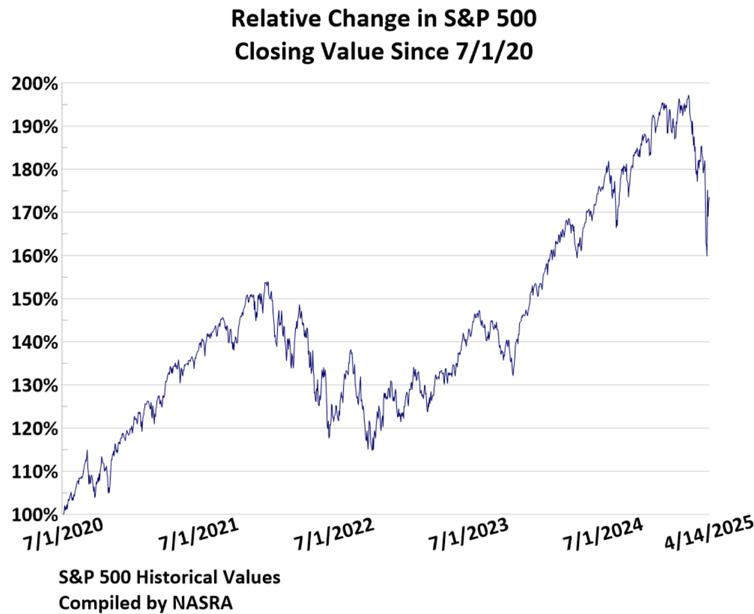
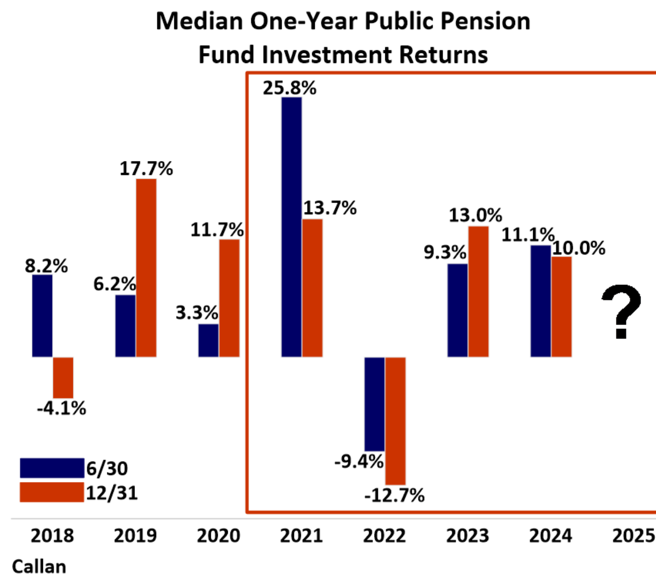


To promote stable funding requirements, most public pension plans don't immediately recognize investment gains and losses. Instead, most plans phase the recognition of investment gains and losses over a period of time, most commonly five years. This practice, known as asset smoothing, reduces volatility in the funding value of assets and results in greater stability of required costs.

The chart below plots median investment returns for public pension funds for the two most common fiscal year end dates of 6/30 and 12/31. Most public pension plans smooth their investment gains and losses over five years: each year the plan recognizes 20 percent of the gain or loss for the most recent five fiscal years. As a new year's experience is added, the oldest in the rolling five-year window is displaced. For example, fiscal year 2025 will replace FY 2020, just as FY 2024 replaced FY 2019. As a result, even amid periods of significant volatility, a pension plan's funding level and required cost can remain relatively stable.



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Conclusion

Public pension funds are built on a foundation of long-term strategy, diversified portfolios, and disciplined investment policies that account for the ups and downs of financial markets. Tools such as asset smoothing, strategic asset allocation, and periodic portfolio rebalancing help public pension plans maintain funding stability and meet long-term obligations. While short-term market movements can draw attention, they are not a reliable measure of a fund's overall health or trajectory. By staying focused on their long-term goals and maintaining a steady hand during periods of volatility, public pension plans are positioned to continue providing secure retirement benefits for generations to come.

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