Pension Crisis in America…Heads Up Everybody!

By Charles "Skip" Fish, CEO and CIO

Recent actions on the part of the State of New Jersey* have prompted us to remind our clients and colleagues that it is easy for investors to understand that what New York City did in 1974/75 (issuing long-term debt in order to pay for current operating expenses) was wrong on many levels. Not only is it inappropriate for a municipality to put a long-term burden (borrowing) on future generations just so they don't have to cut current expenses, it is thankfully no longer an option for them to issue bonds to do so.

The problem is that even though the vast majority agree that one cannot and should not borrow for current expenses, many people do not appreciate that failing to make a contribution to fund a pension liability is doing exactly that! Creating a long-term liability that a future generation will be required to honor because you are unable to budget the portion you currently owe (aka "kicking the can down the road") is irresponsible at best. I don't think this correlation has been sufficiently exposed so that the average citizen can stop and think about what municipalities are doing when continuing to promise benefits while allowing pensions to operate underfunded. Quite frankly, this is unfortunately something that too many politicians have tried to sweep under the rug. Our goal here is to shed light on the subject and encourage candid discussion in order to, at the very least, understand the implications of the sometimes short-sighted actions being taken today.

Why should muni buyers care? Assessing an entity's "willingness to pay" is one of the three pillars of prudent credit analysis. Identifying which states and municipalities are making strides to stay current versus which are seeking ways to defer payments is a critical aspect of issuer due diligence. Additionally, pension woes, if not adequately addressed, may also impact the economy and interest rate environment as a whole.

How does your state compare? For an excellent interactive table detailing pension plan funded ratios state by state, check out The Wall Street Journal article discussing challenges facing the State of Connecticut. South Dakota, Wisconsin and the District of Columbia are fully funded; Illinois and Kentucky are the most underfunded… how does your state stack up? **http://on.wsj.com/1RpQ3oQ**

(If you have any difficulties accessing this article, please give us a call.)

**For a more detailed review of factors impacting pension plans, including a brief summary of the recent actions by New Jersey, see Betsy's Credit Corner starting on page three.*

In This Issue

Our Mission

CFI is dedicated to the task of securing for each individual account the best possible after-tax performance net of fees. We accomplish this by actively managing tailored portfolios in strict adherence to the strategic objectives of each client. It is our responsibility to employ the most suitable fixed income assets and strategies in a manner most effective for every account. It is our duty to devote the resources, intensity and vigilance necessary to insure all clients consistent superior results.

"It is not fair to ask of others what you are not willing to do yourself."

–Eleanor Roosevelt

October 11, 1884 - November 7, 1962

FISH SCALES

		Scales for California names only					
NATIONAL AAA RATED**	AUG	AA G.O.	A-rated COPs	Pre-Refunded	Non - Rated*	USTN	AA Txbl Muni
0.23	2016	0.24	0.52	0.28	0.65	0.32	+48
0.54	2017	0.53	0.88	0.55	1.23	0.73	+50
0.76	2018	0.77	1.16	0.76	1.61	1.03	+59
0.95	2019	0.99	1.42	0.92	1.94	1.35	+74
1.17	**2020**	**1.22**	**1.68**	**1.16**	**2.25**	**1.52**	**+82**
1.38	2021	1.43	1.94		2.49	1.76	+96
1.58	2022	1.65	2.20		2.73	1.89	+104
1.78	2023	1.89	2.42		2.94	1.97	+117
1.92	2024	2.07	2.62		3.06	2.09	+124
2.04	**2025**	**2.23**	**2.75**		**3.22**	**2.15**	**+132**
2.16	2026	2.40	2.91		3.36		
2.27	2027	2.55	3.07		3.50		
2.36	2028	2.68	3.23		3.61		
2.45	2029	2.80	3.34		3.72		
2.54	**2030**	**2.89**	**3.47**		**3.83**	**2.40**	**+161**
2.82	**2035**	**3.22**	**3.62**		**4.13**	**2.58**	**+182**
3.00	**2040**	**3.42**	**3.75**		**4.23**	**2.83**	**+182**
3.07	**2045**	**3.46**	**3.84**		**4.32**	**2.92**	**+179**

** National Scales from MMD*
***Proxy for Non-Rated Paper*

October 30, 2015

AS OF DATE

Credit Corner

By Betsy Shelton, Director of Research / Sr. Portfolio Manager.

Pension Challenges

Failing to make one's mortgage payment is never a good idea. Clearly the folks in such a boat lack the funds to do so and, unfortunately, it is rarely possible to solve the problem in one month's time. So before they know it, the next payment comes due and the hole becomes deeper and grows increasingly larger with each passing month. The same is true for states (and local municipalities) that fail to adequately fund over time the pension benefits they have promised their employees. As state legislators struggle to balance ever increasing budget demands, the vicious cycle of underfunding pension liabilities in years past is once again rearing its ugly head. It is the biggest challenge facing the municipal market today. Just ask the governors and legislators in Pennsylvania, Ohio, Illinois and Kansas, to name a few. In this article we will be limiting our discussion to the pension liability challenges at the state level but clearly the problems are present at the local level as well.

To understand how states got into such a pickle, one needs to understand the importance of a strong "funded ratio" and the elements comprising this ratio. It is really quite simple. Assets divided by the actuarial accrued liabilities equals the funded ratio. At 100 % a system has sufficient assets to pay all the benefits earned to date by all its members. A funded ratio of 80% or higher indicates that a pension system is in sound fiscal condition. The mean funding level for states in 2013 and 2014 was 71.5%. While still below its 2007 high of 84.7%, this is off the 2012 low of 68.9%. However, numbers can be deceiving because they usually don't reflect the entire picture. For example, while there are at least eight states with funded ratios below 60%, many states have recently been proactive in increasing their ratios. Washington D.C., South Dakota and Wisconsin, for example, are fully funded, while five others stand at 90% and another eighteen are at 80%. (For details on all states, refer to The Wall Street Journal article highlighted on page one.)

Historically, states have largely relied on returns earned on assets under management to meet future liabilities. But we now know that the earning power of assets alone, even assuming above market rates of return, is neither sufficient to meet the increasing liabilities faced by state plans nor to eliminate the accrued liabilities from prior years. To erase these shortfalls requires that a state make an annual required contribution (ARC) in order to cover the plan's actuarially determined level (ADC) of funding. Not making all or most of one's ARC is akin to not making one's mortgage payment. A missed payment here and there is not catastrophic, but the consequences of falling behind can easily spiral out of control. Unfortunately there is no remedy, such as foreclosure, to stop the bleeding when it comes to underfunding one's pension obligations. The hole only grows deeper over time until the state finds itself drowning in red ink.

Such is the case with states like New Jersey and Illinois. For a number of years, tech bubble gains and smoothing techniques (no longer allowed) kept New Jersey's funded ratio at over 100% through 2002. In addition, issuance of pension obligation bonds "provided political cover for successive administrations to underfund annual contributions…while in some cases, increasing benefits."[1] Enter the Great Recession of 2009-10, which produced unprecedented budgetary pressure, and it is easy to see how some states have fallen behind in their funding requirements. Add a slower than expected recovery, higher federal mandates, increasing competition for funding dollars, and years of ignoring one's pension obligations and you have the perfect set up for today's pension funding woes.

Conventional wisdom says that a state's ARC should be equal to the annual cost of the pension plan. Many governments trimmed their ARC during and after the recession in order to alleviate budgetary pressures. Fortunately, with the slow albeit sluggish improvement in the economy such pressures have begun to abate and many states, concerned about their eroding funded ratio, have begun to increase their ARC. Also, with the help of plan changes such as increases in employee contributions, extended minimum retirement age, and reduced COLA (Cost of Living Adjustment) payments, states are more or less able to cover both the newly earned benefits and, if willing, can make some headway in amortizing past underfunding (commonly referred to as the UAAL). That is why Governor Christie's budgetary elimination of New Jersey's ARC is all the more troublesome because it highlights just how unaffordable the state's pension liability has become. This is in spite of issuing pension obligation

[1] Diver by Lumesis, Weekly Commentary, March 2, 2015

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bonds in prior years, which were meant to eliminate or at least lighten the burden of the state's UAAL at that time. *"New Jersey's path to its current predicament reflects just how poorly pension bond issuance can be when used to improve one's funded ratio"* [2] without solid reforms to the elements that got you there in the first place.

Pension plans use a discount rate to determine both the present value of their UAAL as well as to establish the assumed rate of return on investments within the plan. This assumed rate of return is composed of the expected real rate of return on assets as well as the expected inflation rate. With inflation at near zero there is a greater reliability on real returns to support the higher-than-market average assumed discount rate of 7.5% to 8% employed by most plans. Even with the prospect for potentially higher interest rates in the near future, such assumptions are simply unsustainable. The lower discount rates now being assumed by many plans reflect a more conservative outlook in future market performance, which in turn also causes liabilities to rise. Similar to the inverse relationship between interest rates and bond prices, a lower discount rate raises the plan's ADC level, necessitating a higher ARC. According to Loop Capital, the GASB 67 requirement to use a lower discount rate once a depletion date[3] occurs has been the main driver behind the decrease in New Jersey's funded ratio. This requirement is just another whammy for states already struggling to improve their funded ratios.

Heretofore pension plans have had substantial leeway in what assumptions they employed in the amortization of their UAAL and in their choice of an assumed discount rate. However with the adoption and implementation of GASB 67 and GASB 68 this flexibility has been replaced by more stringent reporting standards. No longer can a plan "smooth" their returns over several years nor can they use actuarial assumption when valuing their assets. Now the new Fiduciary Net Position (FNP) to Total Pension Liability (TPL) must be used when reporting a plan's funded ratio. Although the use of market values will present a more realistic picture of a plan's assets, one should expect the funded ratio to be more volatile. Nevertheless, the older funding valuation methodology, according to Fitch, *"remains critical to pension management because it determines how a system intends to amortize its UAAL over time"* . [4]

On the positive side, GASB 68 sets forth new regulations for those states that have a cost-sharing multiple-employer (CSME) retirement system. All participating employers must recognize as a liability and disclose their proportionate share of the net pension liability of the overall system. Nearly 80% of all major state retirement systems are defined as a CSME plan. This is good news for investors as they will now be able to see both the state's liability as well as that of the local municipalities participating in the plan. It will now be easier to assess the risks attributed to each party. California has already begun to release information on this new allocations requirement. It recently disclosed that its share of CalSTRS liability was nearly 38% of the overall system liability. Previously one could only estimate the amount but not before spending a great deal of time sorting out the data. We welcome this change in reporting requirements because it will allow for a more thorough assessment of credit risks at both the state and local levels.

In the end, however, neither the ARC nor the ADC are perfect yardsticks when it comes to measuring the sufficiency of a system's efforts to reduce its outstanding unfunded liability. Eroding demographics continue to be a driving force behind rising pension liabilities. The ratio of active employees to retirees is shrinking. In 2014 this ratio was 1.45:1, down from 1.85: 1 in 2008. Not only are there fewer current employees contributing to the funding of retiree benefits, those benefit payment obligations are now being made for a longer period of time than previously anticipated. According to Loop Capital, the economic debt metric, which assesses the long-term health of a government, indicates that for most states the UAAL accounts for over 50% of the state's total economic debt (defined as the collective total of UAAL, bonded debt, and OPEB liability). [5] This metric is one of several measurements used by the credit analysts and has been a key driver behind recent rating agency downgrades.

It is always easy to focus on the negative but we would be remiss if we did not close with some positive news as well.

[2] Ibid.
[3] "The depletion date is the estimated year in which assets of a plan will no longer cover the projected benefit payments. For New Jersey these dates range from 2021 to 2027, depending upon the plan. New Jersey must now use a 4.29% discount rate versus the generally used 7.75%." Loop Capital, Thirteen Public Pension Funding Review.

[5] Loop Capital, Thirteen Public Pension Funding Review
[4] Fitch Ratings 2015 State Pension Update Special Report, October 15, 2015.

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While much work lies ahead in the area of pension reform and contentious discussions are sure to follow, many states have taken action to reduce their liabilities. Between 2009 and 2011, twenty-eight states increased or implemented employee contributions with twenty-one of those states applying new requirements to current employees in addition to new hires. Many plans have increased age and service requirements. Alabama, Florida, Rhode Island and South Carolina have all benefited from reduced ARC payments as a result of pension reform. Maine, Tennessee, and New Hampshire have successfully implemented reforms that have withstood court challenges and now have become the poster children for other state initiatives.[6] Only time will tell just how successful future reform measures will be, how well states will continue to improve their ARC record, or how impactful GASB 68 will be in helping investors assess the true nature of the pension status of a given municipality.

With so many "moving parts" affecting a variety of factors, it is and will continue to be challenging to navigate one's way through this quagmire. However, despite the uncertainties, there are two things investors can be certain about; 1) state and local governments will continue to grapple with how to fund their rising UAAL and 2) investors should anticipate more negative headlines, especially when it comes to proposed reform measures. We continue to monitor pension related matters and will endeavor to keep you apprised of such developments in the days and months ahead.

As questions arise in the meantime, please don't hesitate to contact us. If you are having trouble keeping track of the acronyms (i.e. ARCs versus FNPs versus UAALs) visit the News page of our website for a cheat sheet http://charlesfishinvestments.com/news.html .

[6] Ibid.

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