

# **Bond Case Briefs**

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## **Pension Crisis Too Big for Markets to Ignore.**

In late 2006, Aaron Krowne, a computer scientist and mathematician, started a website that documented the real-time destruction of the subprime mortgage lending industry. The Mortgage Lender Implode-O-Meter caught on like wildfire with financial market voyeurs, regularly reaching 100,000 visitors. West Coast lenders, some may recall, were the first to fall in what eventually totaled 388 casualties.

A year earlier, to much less fanfare, Jack Dean launched another website in anticipation of the different kind of wave washing up on the California coastline. Called the Pension Tsunami, the website was originally conceived to provide Golden State taxpayers with a one-stop resource to track news stories on the state's mammoth and numerous underfunded public pensions.

Dean came about his inspiration honestly: "I started tracking this issue in 2004 after the Orange County Board of Supervisors gave a retroactive pension formula increase of 62 percent to county employees," he said. "I was stunned. It's the main reason Orange County has a \$4.5 billion underfunded liability today."

As the years have passed, though, the site has become a font of information for states and municipalities nationwide as well as corporate pensions. In all, over 40,000 headlines have been posted to the website to date. On a recent Friday, Dean posted multiple stories on the California Public Employees' Retirement System, the country's largest pension program, as well as a budget cliff facing San Francisco, six Los Angeles public safety officers who collected over \$1 million apiece last year in pensions, and eight cities that could face bankruptcy when the next recession hits. But the day's headlines also included the latest on the fiasco unfolding in Dallas, an update on Houston's less awful situation and features on states that have become the site's other usual suspects — Connecticut, Illinois and New Jersey. And that was a slow news day.

The question is why haven't the headlines presaged pension implosions? As was the case with the subprime crisis, the writing appears to be on the wall. And yet calamity has yet to strike. How so? Call it the triumvirate of conspirators – the actuaries, accountants and their accomplices in office. Throw in the law of big numbers, very big numbers, and you get to a disaster in a seemingly permanent state of making. Unfunded pension obligations have risen to \$1.9 trillion from \$292 billion since 2007.

Credit rating firms have begun downgrading states and municipalities whose pensions risk overwhelming their budgets. New Jersey and the cities of Chicago, Houston and Dallas are some of the issuers in the crosshairs. Morgan Stanley says municipal bond issuance is down this year in part because of borrowers are wary of running up new debts to effectively service pensions.

Federal Reserve data show that in 1952, the average public pension had 96 percent of its portfolio invested in bonds and cash equivalents. Assets matched future liabilities. But a loosening of state laws in the 1980s opened the door to riskier investments. In 1992, fixed income and cash had fallen to an average of 47 percent of holdings. By 2016, these safe investments had declined to 27 percent.

It's no coincidence that pensions' flight from safety has coincided with the drop in interest rates. That said, unlike their private peers, public pensions discount their liabilities using the rate of returns they assume their overall portfolio will generate. In fiscal 2016, which ended June 30th, the average return for public pensions was somewhere in the neighborhood of 1.5 percent.

Corporations' accounting rules dictate the use of more realistic bond yields to discount their pensions' future liabilities. Put differently, companies have been forced to set aside something closer to what it will really cost to service their obligations as opposed to the fantasy figures allowed among public pensions.

So why not just flip the switch and require truth and honesty in public pension math? Too many cities and potentially states would buckle under the weight of more realistic assumed rates of return. By some estimates, unfunded liabilities would triple to upwards of \$6 trillion if the prevailing yields on Treasuries were used. That would translate into much steeper funding requirements at a time when budgets are already severely constrained. Pockets of the country would face essential public service budgets being slashed to dangerous levels.

What's a pension to do? Increasingly, the answer is swing for the fences. Forget the fact that just under half of pension assets are in the second-most overvalued stock market in history. Even as Fed officials publicly fret about commercial real estate valuations, pensions have socked away eight percent of their portfolios into this less than liquid asset class. Even further out on the risk and liquidity spectrum is the 10 percent that pensions have allocated to private equity and limited partnerships. For the better part of a decade, New Albion Partners Chief Market Strategist Brian Reynolds has tracked pensions' allocations to these so-called alternative investments, and the total is approaching \$350 billion.

The working assumption is that the Pension Tsunami will never make land fall, but the next time you take comfort in the sanctity of pensions given they have yet to self-destruct, ask yourself instead how they are hedged in the event of a correction. Will it be their bond, stock, real estate or private equity holdings that shield their portfolios? Or will it be none of the above?

## **Bloomberg Prophets**

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Professionals offering actionable insights on markets, the economy and monetary policy. Contributors may have a stake in the areas they write about.

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