Bond Case Briefs

Municipal Finance Law Since 1971

The $4 Trillion Pension Problem.

Retirement funds raise more contributions that have to go somewhere.

A California retirement system just provided a sobering reality check for the U.S. public pension industry. But there's a potential opportunity for credit traders, at least in the short term.

Earlier this month, the $20.2 billion Los Angeles Fire and Police Pension System lowered its assumed rate of return by a quarter of a percentage point to 7.25 percent. This seems like a fairly minor and obvious move. It's no secret that future returns will be harder to come by given the current historically low bond yields and high stock valuations.

But the fund's relatively minor adjustment will probably cost taxpayers $27 million in additional contributions to help make up the shortfall in fiscal year 2018 alone, according to estimates that New Albion Partners Chief Market Strategist Brian Reynolds put in a note on Tuesday.

Reynolds expects that a considerable chunk of that money will go toward buying credit, adding new fuel to a seemingly interminable debt rally and keeping yields at their uncomfortably low levels for longer.

Taking a step back, it's important to recognize just how troubled U.S. public pensions are. Even if pensions' investments deliver a 25 percent return from 2017 through 2019, which is a best-case scenario, that won't be enough to fortify these pensions' budgets. The gap between how much state and local governments are projected to pay retirees and the amount they've set aside has risen to more than $4 trillion, Bloomberg's Kristy Westgard reported in an article on Tuesday, citing a Moody's Investors Service report.

Taxpayers have been contributing more money into these plans in recent years, giving pension funds new cash to pile into long-term Treasuries, corporate and private debt, among other investments. This has helped suppress bond yields, which are near all-time lows as central banks globally have sought to stimulate their economies by dropping short-term rates to zero (or below) and buying trillions of dollars of assets.

Of course, most of these investments won't go all that far toward meeting the investment returns most pensions have. U.S. public pensions are broadly assuming a 7.58 percent average rate of return as of 2015, according to Public Plans Data. That compares with a mere 2.7 percent yield on 30-year Treasuries and 5.48 percent for U.S. junk bonds. A decade ago, the yields on both types of debt were substantially higher and could be counted on to deliver a safe stream of money to hit annual returns. The low yields are also pushing pension funds into riskier investments like hedge funds and private equity, which have the potential to juice returns but can go the other direction in a hurry as well.

All this adds up to bigger estimated budget gaps for pensions, requiring even more taxpayer contributions. This is incredibly unpopular politically and will have negative social ramifications. It will probably crimp salaries of public employees and constrain the size of municipal staffs as a greater proportion of public money goes toward supporting the pensions.

Pension funds will need to chase returns somehow, and bonds will play a big role even with their stunted yields. Credit traders will be waiting.

Bloomberg Businessweek

By Lisa Abramowicz

June 21, 2017, 11:00 AM PDT From

This column does not necessarily reflect the opinion of Bloomberg LP and its owners.