[Bond Case Briefs]

Municipal Finance Law Since 1971

[Markets Provide a Reality Check for the Risky Bet of Pension Obligation Bonds.]

The scary stock market that we've seen since mid-August is a classic example of how reality keeps intruding on theory. And it shows how there really is no such thing as free money on Wall Street, no matter how beguiling the sales pitch.

The case in point: pension obligation bonds — a supposedly magic solution to the problem of underfunded government pensions. The idea is that governments with badly underfunded plans can borrow money at historically low rates, invest the borrowed cash in the stock market, and earn much more on stocks than the bonds cost in interest.

I wrote a [skeptical article] about these bonds in July, with Cezary Podkul of ProPublica as co-author. "Governments can borrow cheaply these days — but the risks of investing pension bond proceeds are unusually high," we said. Recent weeks have proved us right.

We warned that potential pension bond issuers such as Colorado and Pennsylvania would be taking a huge chance by selling billions of dollars of bonds at seemingly low rates and investing the cash in the then-stable stock market.

The idea, as presented by investment banks (which get fees for doing deals), is that pension bonds can be a magic elixir. For two groups in particular, they profess, it's just the thing: employee unions worried that underfunded pension plans could lead to benefit cuts, and public officials who want to improve pension-funding ratios without raising taxes or cutting benefits.

After all, the argument goes, you can't go wrong selling bonds at about 5 percent interest to raise money to buy stocks, which have historically produced returns exceeding 10 percent.

Oops. Timing is everything. Had a government sold pension bonds on July 10, the day our article appeared, it would have suffered a double whammy. The Standard & Poor's 500-stock index has dropped 6 percent since then, and interest rates on the kind of municipal bonds that make up a large piece of pension issues have fallen.

Had Colorado sold its proposed maximum of $12 billion in pension bonds on July 10 and put the proceeds into the S&P 500 that day, its portfolio would be about $700 million underwater. What's more, its bonds would probably be carrying a somewhat-higher-than-current-market interest rate.

That's because the rate on 30-year AA-rated taxable muni bonds, a major component of pension bond issues, was 4.74 percent Thursday, according to Bloomberg, down from 5 percent on July 10. Rates on the 20-year version of the bond, another major pension bond component, were down slightly, to 4.46 percent from 4.49 percent.

So Colorado — which fortunately for its taxpayers deferred the pension bond issue after state legislators got nervous — would have had a large paper loss and would be paying what at least for now is an above-market rate on much of the borrowing.

“Recent market behavior has reminded us that markets have volatility and uncertainty and may not provide the returns we want, no matter how badly we need them,” said Ben Valore-Caplan, a Denver-based adviser to institutional investors who quit as vice chairman of the Colorado Public Employees’ Retirement Association board rather than be involved in a pension bond issue.

“Markets don’t care that a pension is underfunded,” he told me. “Pensions don’t get secret access to higher returns or lower risk. When they forget their place, the markets sooner or later will remind them.”

The S&P 500 has produced an average of 10.6 percent in price increases and reinvested dividends over the past 45 years. But that doesn’t mean you are guaranteed a double-digit return if you invest on a particular day. It’s about statistics: You can drown in a pond that’s an average of one foot deep if you happen to step into a 10-foot-deep part.

It’s one thing to invest in stocks over the long term. But investing gradually, over time, is a lot different than hocking yourself to the eyeballs and putting the borrowings into the market in one shot.

No, I’m not saying that stocks won’t recover and go on to new highs. What I am saying is that any government — or any retail investor — borrowing a ton of money and putting it all in the stock market at once is taking an enormous risk. It’s not a risk I would take myself. As recent weeks have shown, it’s not a risk that governments should take, either.

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By Allan Sloan

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Research for this column was provided by Cezary Podkul of ProPublica.