

Bond Case Briefs

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Long Lives and Rocky Markets Have Some Pension Systems Recalibrating.

For decades, state and local pension systems thought of themselves as America's ultimate long-term investors.

Companies could go bankrupt by the thousand; corporate boards could show C.E.O.s the door. But the states and cities would be there forever. That meant their pension funds — and the local taxpayers who guarantee them — could invest aggressively, even if that meant taking more risk. In an infinite time frame, today's loss would always be offset by tomorrow's gain.

Or so the thinking went. Now, a long-living baby boom generation, rapidly fluctuating global markets and municipal bankruptcies are blowing holes in the notion that for public pension funds, time is infinite. It turns out that the short term matters too.

And it matters now more than ever. According to the National Association of State Retirement Administrators, virtually all public pension funds are in what is called a "cash-flow negative" state. That means that every year, they pay more in benefits to retirees than they receive in contributions. And that signals, for some at least, an urgent need to reconsider traditional investment strategies.

The trustees of California's giant pension system, known as Calstrs, are among them.

"It's really very simple," said Allan Emkin, co-founder of Pension Consulting Alliance, in a recent presentation to the board of the organization, officially the California State Teachers' Retirement System.

"The actuary is saying that you're going to get 7.5 percent every year," he said, referring to the grail-like investment assumption that virtually all public pension boards factor into their decisions, which affect millions of people and trillions of dollars.

"And that may well be your average," he said. "But getting to that average, if you take a really big hit in the early periods, you may not be able to recover."

He paused to let the heresy sink in: It is possible to hit your long-term actuarial target and still go insolvent. And the long term will not matter if you run out of money in the short. Think Central Falls, R.I., or Prichard, Ala. Think Puerto Rico.

It is possible for two funds, each starting with the same balance, and with the same average return over 20 years, to have vastly differing performances over the period. In the two cases below, the annual returns are the same, but occur in the opposite chronological order. When losses happen in the early years, as for Fund B below, the balance can be wiped out well before the 20 years are up.

Mr. Emkin was helping Calstrs's trustees with an asset-allocation review, a monthslong process in which the board was examining its investment approach in detail and considering changes. The board is scheduled to vote on a proposed new approach, called Risk Mitigating Strategies, this

month. The general idea is to cut back on stocks and increase investments that are expected to rise when the stock market falls.

It was necessary, Mr. Emkin said, because reducing the \$194 billion pension fund's exposure to another stock-market rout is "the single most important decision you'll make on the investment side."

Indeed, cutting back on stocks means backing away from the approach that virtually all public pension funds have taken for decades. Some of the trustees seemed concerned that none of their peers were going this way, but Mr. Emkin told them that company pension funds had been moving away from stocks for years.

Public pension funds have "matured," and that means doing things differently, he urged. Plans that were young in the 1950s or 1960s now have lots of retirees, who are living longer, healthier lives than their actuaries assumed they would. Assuming shorter life spans meant setting aside less money, and this is one reason so many state and local pension funds have shortfalls today.

This is not a death knell, but it means investment losses have outsize impact.

"When you've got negative cash flow, the math gets wicked bad," said Sean McShea, president of Ryan Labs Asset Management, an investment management firm that specializes in bonds. "Poor performance gets amplified."

Since annual contributions do not cover the payouts, pension funds with negative cash flow generally rely on investment income to close each year's gap. They need every year to be a good year, but they tend to invest heavily in equities, and the stock market can, of course, fall. A couple of back-to-back bad years — like 2001 and 2002, or 2008 and 2009 — can wreak havoc.

"If the pension fund has a bad sequence of returns, all of a sudden it's, 'How are you going to pay this?'" Mr. McShea said. "You can't grow your way out. It's almost mathematically impossible to close the gap."

The crash of 2008 showed what can happen. Public pension funds in growing, relatively prosperous places could fall back on their local taxpayers to fill the giant holes that opened. But not all "mature" pension funds are sponsored by wealthy states or cities. In many places, the obligations that workers and retirees have earned now dwarf the jurisdictions that sponsor them.

Many of the roughly 1,700 California school districts paying in to Calstrs are like that. And there is an added complication: The annual pension contributions are set by state lawmakers in Sacramento, not by Calstrs.

From Wall Street to Washington and in the towers of academia, people are buzzing about what some say is the pernicious focus in corporate America on short-term profits.

For years, lawmakers set Calstrs's rates far too low to cover what its promised benefits cost. Time passed, the system matured, cash flow went negative and then came the crash of 2008.

Calstrs lost \$54 billion and could not bounce back. By 2014, it was paying out \$12 billion to roughly 270,000 retired teachers and surviving spouses, and taking in only \$6 billion a year in contributions. By conservative measures, it had an \$80 billion shortfall. Even if it achieved its long-term investment-return assumption of 7.5 percent, its actuary said, it would probably run out of money around 2047. And if it missed its target, it would run out of money even sooner.

In 2014, Gov. Jerry Brown signed a law to substantially increase the money going to Calstrs every year, starting at \$450 million a year and rising to \$4.5 billion. The biggest increase, about \$3.2 billion, is to come from California's school districts, community colleges and other local governments. Additional amounts are to come from the state, and from Calstrs's 480,000 teachers and other school employees.

If everyone does their share, Calstrs projects it will close the gap in about 30 years as long as the invested money returns an average 7.5 percent per year over the long term. It is not going to be easy. Fitch Ratings has warned that less affluent school districts may have a hard time keeping up as the amounts rise. Until 2014, they were expected to contribute 8.25 percent of each payroll to Calstrs; by 2021 it will be 19.1 percent.

And for the state, a temporary tax increase that helps cover the increase will expire in 2019.

It was hard to get the promised billions, and the last thing Calstrs wants is to put the money into stocks, then see it vanish in another stock crash.

Calstrs still aspires to 7.5 percent average annual returns — otherwise everybody would have to kick in even more — but it now wants to “reduce downside risk” at the same time. The idea behind Risk Mitigating Strategies is to attempt that by selling off as much as \$20 billion of its equities and placing the money instead in Treasury securities, two types of hedge funds and possibly infrastructure projects.

Specifics were deferred until later. Much of the board meeting was devoted to comparing the results of modeling various hypothetical portfolios. Calstrs's current portfolio was shown to have about a 30 percent chance of another big fall by 2019 — the year, ominously, when the state tax increase is scheduled to expire.

Other modeled portfolios seemed to have a lower probability of a crash in the near term.

“I’m putting on my skeptic’s hat,” said one trustee, Paul Rosenstiel. “This sounds too good to be true, that we have figured out a way to eliminate downside risk, without sacrificing return, but no one else has.”

But Mr. Emkin quickly countered: “We’re not talking about eliminating risk. We’re talking about reducing it at the margin,” he said. “What we’re trying to do here is to minimize potential for there to be increased costs to the employer, or the employee, going forward. That’s the goal.”

THE NEW YORK TIMES

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NOV. 4, 2015