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Moody's: Investment Risk Grows as U.S. Public Pensions Continue Pursuing High Returns.

New York, July 25, 2016 — The ability of US state and local governments to absorb adverse market performance by their pension funds has been constrained by rising costs associated with past unfunded liabilities, Moody's Investors Service says. At the same time, high return seeking by public pension funds increases risk of investment losses in any given year.

Over the long term, most public pension portfolios are designed to attain annual returns over 7% to offset rising employee retirement costs. To achieve these targets, state and local government pension funds must invest in potentially volatile assets. For example, public pension funds generally allocate close to 50% of assets to public equities, although allocations can vary substantially by plan.

"US public pension assets declined in six separate years from 2000-2015, and even governments with comparatively well-funded pensions can face budget risk if returns do not match expectations" Thomas Aaron, a Moody's Vice President — Senior Analyst says in "State and Local Governments — US: Even Comparatively Well-Funded Public Pensions Carry Risk of Volatile Investments."

Moody's says this was illustrated when the largest US public pension fund, the California Public Employees' Retirement System (CalPERS, Aa2 stable), experienced investment losses in four separate fiscal years from 2000 to 2015, with a 24% loss in 2009 representing its most dramatic single-year drop.

"Exposure to pension investment volatility is a credit risk because governments must be able to withstand the downside when short-term asset risk materializes, while still delivering public services and repaying debt. Government budgets are already under increasing strain because of the unfunded liabilities that have materialized over roughly the last 15 years," Aaron says.

While governments can shift pension asset allocations to lower investment risk, this translates to higher government pension contribution requirements, because discount rates are linked to assumed asset performance. It also translates to higher reported liabilities under GASB rules. CalPERS notably opted to begin de-risking its pension portfolio last year, but at a very gradual rate in order to avoid cost spikes.

The report is available to Moody's subscribers at

https://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBM_1028742.

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