Bond Case Briefs

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Why Investors Shouldn't Buy Pension Obligation Muni Bonds.

For years there have been voices writing, speaking and worrying about U.S. unfunded pension liabilities. I, for one, included. Never should investors ever buy pension obligation municipal bonds. Cities, states and counties issue POBs because their pensions are grotesquely under water and they cannot meet their liabilities. The reasons are long, but pretty simple: Poor investment results; demographic shifts due to people living longer; mismanagement; devastating union-negotiated wage and benefit increases; low retirement age; and unrealistic assumed rates of return on assets.

The numbers in many circumstances are unconscionable. California State Teachers Retirement System returned 1.4% in fiscal year end June 30. Their target was actually 7.50%. Springfield, Illinois owes $21 million to pay police and firefighter pensions. That doesn't sound too bad until you realize the $21 million represents 98% of all property tax revenues. According to Standard & Poor's, the city of Houston, Texas has racked up pension costs from 2012 to 2015 that rose 48%. What will they do? Issue $1 billion in POBs—a hail Mary pass if ever there was one.

You are probably wondering why pension funds don't reduce their assumed rates of return to something realistic. Like taking their 7.50% fantasy returns to a more logical 4% to 5% return. The reason is simple. Such target rate of return reductions require real cash infusions to make up the difference.

So we find ourselves at the tail end of an equity bull market that began in March 2009 and a 30-plus year bond bull market. And yet pensions remain woefully underfunded.

The best objective source of research comes from PEW Research. Google PEW Research, unfunded pension liabilities. You'll find analyses on states and city funding gaps, states in the worst and best shape, data on the 50 state trends, and retiree health care trends. It all adds up to dismal funding for many cities that made promises to pensioners they simply cannot keep.

So why the rant? As the problem gets worse and being we are at the tail end of this credit cycle, general obligation municipal bonds issued by these same states, cities and counties will be severely downgraded. More nails in the coffin that GOs should no longer be the darlings of your municipal bond portfolio .

Connect the dots. As pension funding takes more and more revenue from their general funds, more GO bonds will have to be issued for essential services—schools, roads, welfare, the homeless. All will create a giant revenue sucking sound while essential services deteriorate. The reasons are precisely why revenue bonds—specific revenue bonds—are more desirable than GOs.

Invest in senior airport revenue bonds from major U.S. airports—no local mini airports. Names like Atlanta Hartsfield, Los Angeles International, Dallas Fort Worth, JFK and San Francisco. Major city senior airport revenue bonds are my top pick now.

If you are seeking more yield than airport revenue bonds, then selectively buy hospital revenue bonds. Not your local hospital, but major institutional teaching hospitals like Stanford, Mayo Clinic, Mount Sinai, Cedars-Sinai, University of Colorado Hospital, to name a few.

The weather report declares an unfunded pension tsunami. Please prepare so your portfolio doesn't drown.

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