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Fitch Ratings: Higher Risk Not Translating to Similar Returns for U.S. Pensions

Link to Fitch Ratings' Report(s): U.S. State and Local Pension Investments (Concerns Grow with Riskier Allocations, Lower Returns)

Fitch Ratings-New York-06 May 2019: U.S. state and local pensions have taken on riskier asset allocations in recent years, though the rate of return is paling compared with the higher risk according to Fitch Ratings in a new report.

State and local pension plans have steadily increased their allocations to equities and alternatives such as real estate, private equity, hedge funds and commodities over the last several years. Asset allocation to both equities and alternative investments rose to 77% in 2017 from 67% in 2001. In contrast, asset allocation to fixed income investments and cash fell to 23% in 2017 from 33% in 2001. However, median average returns for major state and local systems were 6.2% between 2008 and 2017 compared with 6.4% between 2001 and 2017.

The falling rate of return is particularly notable for seven states (New Hampshire, Arizona, Rhode Island, Connecticut, Maryland, Hawaii and New Jersey), which showed average underperformance of 2% and higher. This is a performance gap that over time could have a material impact on how some pension plans are funded according to Olu Sonola, Group Credit Officer of U.S. Public Finance at Fitch. 'Persistent shortfalls in investment performance eventually necessitate future increases in employer contributions, which could be especially problematic for states with already elevated pension liabilities,' said Sonola.

Arizona's 86% allocation to equities and alternatives is the highest among U.S. states. Conversely, states like South Dakota (66% allocation to equities and alternatives as of 2017) and Indiana (48% allocation to alternative investments) are clearly making a hard turn away from riskier assets.

These developments will be critical in determining the overall picture of unfunded pension liabilities, which eclipsed $1 trillion two years ago. The increase in unfunded liabilities largely reflects lower than expected investment returns, shortfalls in actuarially determined contributions and steady increases in projected future benefits.

'U.S. State and Local Pensions – The Changing Risk-Return Landscape' is available at 'www.fitchratings.com' or by clicking on the above link.

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