Investment Insights
Navigating Underfunded Pensions

BESSEMER TRUST

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Highlights

- The underfunding of municipal pensions accelerated with the 2008 to 2009 financial crisis; multiple factors have exacerbated the issue
- Underfunding will likely be the leading cause of municipal credit downgrades in 2016
- Many municipalities have taken steps to ease their pension burdens and retain credit quality
- Our research indicates there are good investment opportunities available in fiscally disciplined municipalities

It became a perfect storm of sorts: trouble with municipal pensions accelerated during the financial crisis of 2008 when money reserved to fund retirement obligations was heavily invested in the stock market, which suffered steep losses. As pension funding levels subsequently deteriorated, an economic downturn caused municipal tax revenues to decline. Confronted with large budget gaps, many municipal policymakers opted to limit new pension contributions at a time when funding was already low. If these misfortunes weren't enough, the first wave of Baby Boomers started to retire and a longer-term demographic trend began to take shape — fewer earners would support more retirees who were likely to live longer and become a more powerful voting bloc.

Putting the retirement shortfall in context, collective municipal pension obligations grew at an annual compounded rate of seven percent between 2005 and 2014. At the same time, municipality revenues increased at a relatively low 3.4%. Analysts currently estimate that the national unfunded municipal pension liability totals approximately $1.4 trillion. In our view, this issue will be the leading cause of municipal credit downgrades in 2016.

Some Measures of Reform

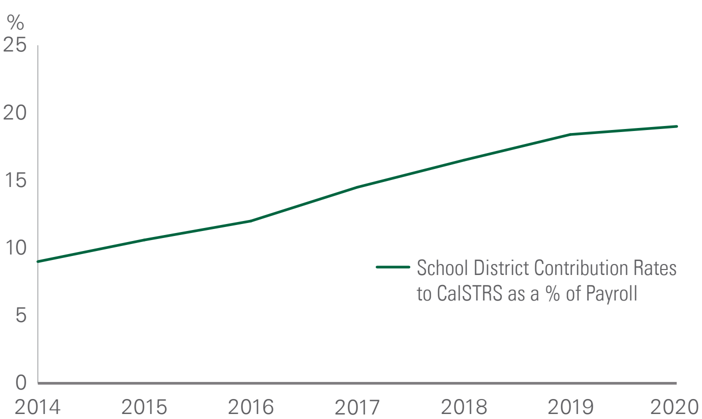
One bit of good news: not all municipalities followed the same path throughout this period. Granted, there were many decisions to underfund actuarial requirements. Too often the shortsighted political mindset was, "Why pay for something today when it only benefits another politician in the future?" Thankfully, there was another school of thought. Some municipal governments properly tended to their pension needs and increased contributions to meet actuarial requirements. Some state plans reduced their benefit obligations by providing less generous packages. In addition, many municipalities chose to restructure their retirement plans and switched from programs that paid a defined benefit to a defined-contribution 401(k)-type system that many corporations adopted years earlier. It is important to note that state constitutions played and continue to play a role in this shift as some states limit or prohibit change to plans while others provide wide latitude to restructure.

Viable Solutions?

Is there a solution for the underfunding problem? Underfunding in the past basically means future budgets will bear the burden. Higher taxes are one way to fix the problem — but raise the levy too much and another problem is created. There is an old adage that says, "Money goes where it is treated best." People and businesses have the option of voting with their feet and as such, an element of competition exists. People and businesses in heavily taxed states have the ability to move and increase either net pay or profit. Those staying behind are basically agreeing to become part of the solution. The solution will likely be a combination of higher taxes and a reduction in the same services those residents have come to expect. This adjustment is starting to become evident in California, where budget priorities will no doubt be adjusted for school districts whose pension costs are expected to double during the next five years (Exhibit 1).

Exhibit 1: California Adjusts to Higher Pension Costs

Key Takeaway: In California, school district contribution rates to the state pension plan, CalSTRS, are expected to double by 2020.



Source: CalSTRS (California State Teachers' Retirement System)

Finding Opportunities

At Bessemer, we review a number of factors when evaluating the impact that pensions have on municipal governments. We assess funding levels and look at the expected investment return (called a discount rate) that a municipal government expects to earn. For example, the probability of a plan achieving an 8% investment return is less likely than earning a 6.5% rate of return in a more conservative plan. Using a high discount rate is a little bit of a game to make the unfunded pension liability appear lower. We take this discounting tactic into consideration and make adjustments for a more accurate apples-to-apples comparison.

We also review impediments to change. States that make it constitutionally difficult to change their plans are penalized. Moreover, we recognize the balance between inherent risk and the amount of reward (or yield) necessary to compensate an investor for that risk. In some cases, there is not enough yield to overcome the weight of bad pension decisions. However, there are other situations that warrant review and possible investment. We evaluate a municipality's willingness and ability to change plan benefits or increase contributions. We also look at the unfunded level and judge capacity to achieve a more stable funded ratio. In the end, we regularly monitor the status of these liabilities and target a yield that provides compensation for the embedded risk we find.

Properly assessing risk/reward trade-offs entails a review of a number of factors before separating good from bad value. Based on our work, we believe there are some good values available; these are where we allocate capital. So while risks remain, opportunities exist to invest in municipalities that adhere to sound pension practices.

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