Gurtin Municipal Bond Management

Municipal Credit Update

Investment Returns are Just One Piece of the Pension Puzzle

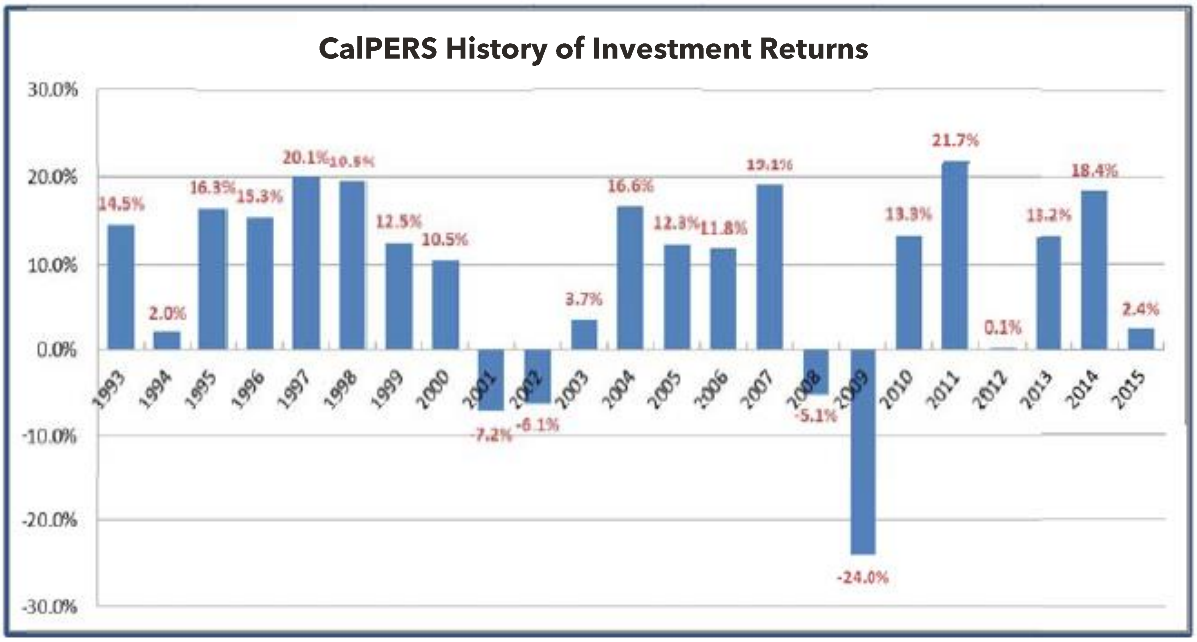
September 2015

State pension plans largely underperformed in fiscal 2015, seeing investment returns come in at levels well below expected rates of return. A review by Governing magazine found that not one single reporting plan met its investment target for the fiscal year, which ended June 30th.[1] Despite the negative headline, we believe the news is unsurprising given that pension returns typically mirror domestic equity markets and do not believe that one year's weak performance is indicative of anything other than one year's weak performance. Reading too much into the pessimistic headlines surrounding missed investment targets is no way to assess the true fiscal health of a pension fund or any resultant credit risk to high quality obligors. Pension funds have long-term horizons and their investment composition is designed to perform through the ebbs and flows of capital markets. In fact, a year of underperformance is often preceded by several years of strong performance, with these cyclical returns normalizing to near targeted levels over an extended period of time.

For instance, the California Public Employees' Retirement System (CalPERS) preliminarily reported 2.4% returns for 2015, falling well short off their 7.5% target and generating questions about the fiscal health of the fund. However, as shown below, in 2014 and 2013, the fund's returns far exceeded the target at 18.4% and 13.2%, respectively, and its 20-year investment return stands at 7.76%. What is notable is that included within this 20-year horizon CalPERS experienced tremendously poor years, with several years of negative returns and a nearly 25% decline in assets in 2009, yet it still managed to exceed the current return target of 7.5% when averaged over the long-term period. One caveat to this number, however, is that the significant gains after the financial crisis were generated on a substantially weakened asset value. While meeting the plan's investment target over the long-term is certainly a favorable indicator of a fund's management and performance, it is just one metric and in isolation does not convey the full scope of a pension fund's fiscal health.

Interestingly, the negative news and heightened scrutiny of public pension plans are now driving many plans to reconsider their assumptions. Over the last several years, as a result of weakened performance through the economic downturn, several states have shifted investment return targets downward. Figure 2, compiled by the National Association of State Retirement Administrators (NASRA), exhibits this shift to more conservative investment return assumptions. Prior to The Great Recession the majority of funds anticipated returns in excess of 8%.

[1] Farmer, Liz. *After a Few Years Afloat, Pension Plans Start Sinking Again*. Governing. August 4, 2015. Retrieved from http://www.governing.com.

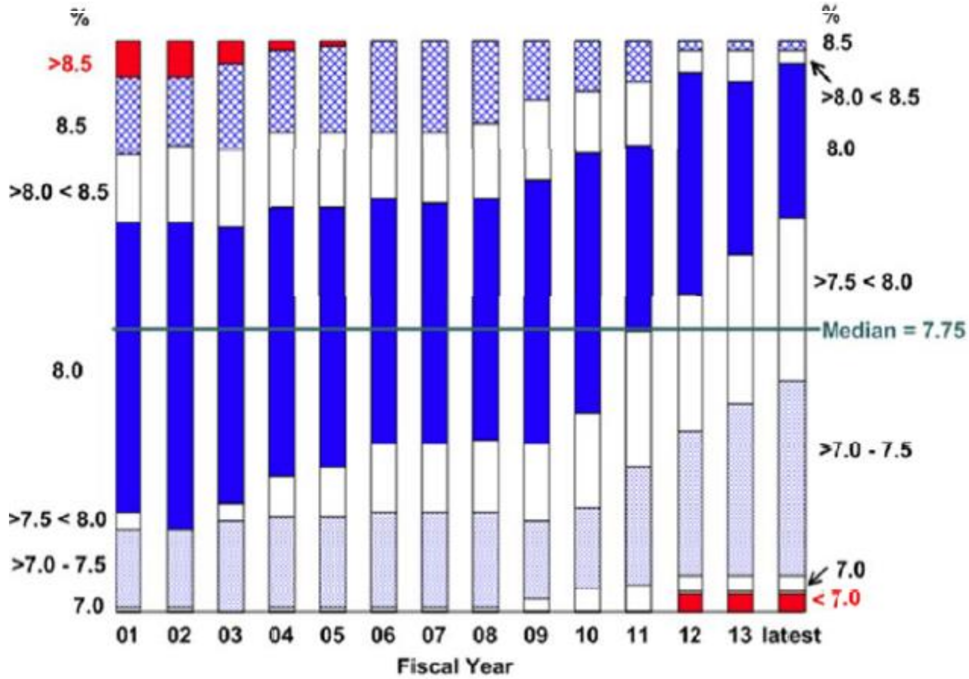


Source: CalPERS State Actuarial Valuation Report

Now, 7% to 7.5% is not uncommon, and some plans have even adopted expected rates of return below 7%. Although these changes may seem subtle, we believe the incremental moves will have a significant impact over time. For solidly funded plans tied to high quality obligors that make their annual contributions, we believe there will be positive long-term effects as the plans are better able to weather bad years and base annual contribution amounts on more realistic return assumptions. However, for poorly funded plans, the downward move in return assumptions may further strain already weak obligors as they are asked to contribute even higher annual amounts. Lowering the expected rate of return has a direct impact on the annual contributions that governments are expected to make to their pension plans, as actuaries use this rate when calculating the pension fund's liabilities. A lower expected rate of return will yield higher annual contributions. It is not a coincidence that some of the highest expected rates of return are found among some of the lowest funded pension plans. Illinois uses an 8% return for its Teachers' Retirement System (40.6% funded ratio in 2014) and 7.75% for its State Employees' Retirement System (33.7% funded ratio). In contrast, CalPERS, a much stronger plan with estimated 77% funded levels in 2014, has on various occasions revised targeted return levels downward to set more realistic expectations and manage to current and projected economic conditions.

We believe that public pensions will continue to attract significant media attention and likely generate anxiety in the municipal market for the foreseeable future. However, we continue to hold that our robust research efforts focused on the long-term trajectory of pensions and their potential effect on individual obligor's budgets will protect our clients. Our analysis of pensions relies on a variety of metrics examined over a multi-year period, as opposed too merely focusing on the latest headline or a single measurement of a pension plan's relative health. We have seen the negative impact that a strained pension

Figure 2: Change in distribution of public pension investment return assumptions, fiscal year 2001 through May 2015



Source: Compiled by NASRA based on Public Fund Survey

fund can have on a State's ability to successfully navigate difficult fiscal landscapes, with high-profile examples such as Illinois and New Jersey currently unable to implement sustainable solutions to long-festering pension funding dilemmas and consequently attempting to determine how to improve their pensions' health without significant tax increases or highly unpopular budget cuts in other areas of state spending. However, it is imperative to recognize that it was not a single year or even multiple years of poor investment performance that generated those states' pension woes, but rather a prolonged track record of skipping or materially shorting required annual contributions to their pensions. Again, by relying on an array of pension related metrics, we were able to exit our positions in both states and have protected our clients from the growing concerns surrounding each state's future.

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