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Public Pension Funds Will Put More Money Into Stocks: Joe Mysak

New York, May 23 (Bloomberg) -- States and municipalities are going to put more money to work in the stock market.

That's good news for the stock market, certainly, and may translate into good news for the economy. Whether it's good news for retirees is another matter.

Public pension funds saw their assets decline by an average of 9.3 percent from 2001 to 2002, compared with a 14.6 percent drop for corporate pension funds, according to a survey of 199 public pension funds by Greenwich Associates, a research firm. The survey was released in April.

Why didn't public funds lose as much as private? "A key reason may well be their heavier degree of investment in fixed income," says the survey.

That emphasis on fixed income is about to become history, as municipalities sell bonds to raise more money for their pension plans. Proceeds from the bond issues will be plowed into stocks, rather than into low-yielding fixed income investments.

In 2002, 32.6 percent of public pension funds were invested in fixed-income securities and 44.1 percent in domestic equities. Corporate funds put 52.5 percent of their money into domestic equities and 22.3 percent in fixed income.

Keep that in mind as states and municipalities prepare to sell bonds to replenish their pension funds. Selling bonds converts a public pension fund's so-called soft obligations -- what it may have to pay retirees -- into hard ones, what it will definitely have to pay bondholders.

The state of Illinois this week said it expects to sell \$4 billion to \$6 billion of taxable general obligation pension bonds during the week of June 2.

Bear Bites

Public pension funds have been increasing the amount of money they put into the stock market for years. In 1982, according to Greenwich Associates, public pension funds put 22 percent of their assets into domestic stocks.

That changed in the 1990s, some would say for the better. By the end of the decade, public pensions were almost 100 percent funded -- that is, assets matched the actuarial liabilities almost precisely.

What a difference a bear stock market makes! A record 79 percent of U.S. public pension funds are underfunded now, according to Wilshire Associates of Santa Monica, California. That's why so many states and localities are considering the sale of pension obligation bonds.

Terrific Pressure

The pressure on states and localities to sell such bonds is going to be irresistible.

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For one thing, there's the whole impetus to do a deal. When bankers and politicians decide that selling bonds is the thing to do, woe to the critic who gets in the way. He gets steamrolled. This applies to all bond issues, not just pension obligation bonds.

More importantly, selling pension-obligation bonds now can give a municipality at least a couple of years of budgetary relief. The issuer sells the bonds and decreases or defers the amount of money it has to set aside for retirees.

Is selling a pension-obligation bond issue the way to go? To be sure, the interest rates are attractive. Municipal bond yields are at their lowest level since 1968. States and localities can sell taxable debt at levels just above where they can sell tax- exempt debt.

Billions of dollars will be invested in stocks and other riskier assets because municipalities will have to invest the bond proceeds in everything except fixed income in hopes of making back at least what they have to pay.

The funny thing about pension-obligation bonds is that they didn't really become popular until the mid-1990s. That's when rating companies began emphasizing unfunded pension liability as a factor in credit ratings. The unfunded portion of pension liabilities was smaller than it is now, yet issuers, at least some of them, became positively obsessed with it.

Railroad Tracks

The even funnier thing about pension-obligation bonds and those who advocate them is their sense of certainty. Sell the bonds now and you can resolve your pension liabilities forever, for the next 30 years, you name it.

Of course, you can do no such thing, any more than you can predict the winner of the World Series in 2006. Actuarial assumptions change, payroll count goes up or down, benefits are increased or even, as we are seeing now, cut back. Pension funds and their liabilities, a banker told me shortly after New Jersey sold its pension bonds in 1997, are like railroad tracks. They may look like they meet in the distance. They do not.

Several issuers sold pension-obligation bonds in the 1990s -- New Jersey, the city of Philadelphia, several big California counties. Stock prices shot up, and those unfunded liabilities in public pension funds (even for those municipalities which hadn't bothered selling bonds to top up their pension funds) disappeared.

Now, after the bubble burst, those unfunded pension liabilities are back. So is the idea of selling bonds to resolve those liabilities. The money raised is going to go back into stocks because the issuers can't afford to buy bonds.

Maybe it will work this time.

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