



## **The Riskiest Pension Assets (and the Implications for Muni Bonds)**

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State finances are in trouble, and unfunded pension liabilities are largely to blame. To assess the depth of those problems, look no further than what is likely the riskiest component of states' pension assets – their exposure to alternative investments and, in particular, to private equity.

As I will discuss, private equity is likely to cause some states that are currently without problems to face unfunded liabilities over the next decade. Yesterday's winners will be tomorrow's losers, as future returns from private equity are likely to fall far short of targeted performance.

For advisors, the larger question is whether unfunded liabilities, especially in high-profile states like California and Illinois, foreshadow a wave of municipal bond defaults.

That fear, at least over the short term, is unjustified. State pension finances will impede economic growth over the long term, but municipal bond investors should expect the timely payment of interest and principal on their bonds.

### **Pensions and private equity**

State pension plans, on average, had 7.4% of their assets in private equity in 2009, according to the latest data from the consulting firm Wilshire Associates. That is up from 5.6% the year before, and up from just 3.0% in 2000. Increased allocations to private equity reflect that asset class' expected outperformance of. Wilshire expects 10.0% annualized returns from private equity, higher than any other major asset class.

Wilshire, however, also acknowledged that private equity is the riskiest asset class held by pension funds. It projects a 26% standard deviation for returns; by contrast, US equities are projected to return 7.5% with 16% standard deviation, and non-US equities project a 7.5% return with 17% standard deviation.

Those performance estimates are likely to be overly optimistic. James Montier, a member of GMO's asset allocation team, provided a compelling argument in a paper he published in May, *I Want to Break Free*. Essentially, Montier concludes, too much money has flowed into the hands of private equity investors to offer attractive returns for all investors. Ten years ago, approximately \$50 billion in new money went into private equity funds. That rose for several years thereafter and peaked at nearly \$250 billion in 2007, before dropping off a bit in the last two years.



As a result, in the last few years private equity investors have paid increasingly higher prices to acquire companies. The ratio of enterprise value to EBITDA has risen from less than 6.0 in 2001 to nearly 12.0 last year. As expected, annualized returns for private equity buyouts fell from over 20% in 2001 to -20% in 2007.

Much of the published data, though, suggests that private equity has generated substantial outperformance over the long term. This, however, is probably the result of idiosyncrasies in the way the private equity industry reports performance, as is explained by Ludovic Phalippou in a CFA article, *Private Equity: Performance, Risk, and Fund Selection*, to be published in September. The industry calculates performance, according to Phalippou, by calculating an internal rate-of-return, using beginning and ending asset values and intermediate cash flows. As Phalippou demonstrates, a fund consisting of projects that earn 15% can report annualized performance of 20%. Reported performance for the private equity industry should not be trusted, Phalippou wrote.

As private equity investments have grown, its risks are becoming clearer. As with mutual funds, some claim that superior-performing funds persist in their outperformance, and that such funds can be readily identified. As Phalippou shows, that is not the case. Of 440 funds in a recent study, only one firm with a fund in the top performance decile was in the top decile with its next two funds. "It is difficult to conclude that performance persistence exists in private equity funds," Phalippou wrote.

At a more basic level, it is incredibly difficult for public pension investors to understand the underlying risks in private equity investments. They must rely on consultants for due diligence and manager selection, and those consultants are largely guided by past performance, which, as Phalippou has shown, is unreliable. Understanding the risks of a private equity investment requires an intimate knowledge of the financial condition of portfolio companies, their competitive strengths and weaknesses, the potential for a successful exit opportunity, and the details of the financing used to purchase those companies. Those factors may be well understood by the private equity fund managers, but they are certainly less known to consultants, and even lesser known to pension investors.

The increased size and complexity of the private equity industry alone – not to mention the resulting difficulties for pension investors who seek to understand the risks of investing – argues for diminished risk-adjusted returns in the future.

As Montier writes, the flight to private equity over the last decade was fueled by a desire among institutional investors to "look like Yale" in their commitment to alternative investments (Yale had a 20.2% allocation to private equity in its most recent annual report). States have embraced this trend to varying degrees. Some, like the state of Washington, which had a 21.2% allocation to over 100 private equity fund managers as of its 2009 annual report, have truly outsized commitments to private equity.



Washington is also notable because it has virtually no unfunded pension liabilities, an impressive feat that is partially attributable to successful private equity investments over the last decade. If Montier and others are correct, though, such success will be impossible to replicate over the next decade. Private equity has all the signs of a “hot” asset class that now has far too much capital invested to replicate whatever historical outperformance it may have delivered.

The best-case scenario is that disappointing private equity returns will cause pension funds like Washington’s to fail to achieve their targeted performance levels (Washington’s overall target is approximately 8.0% annual performance). The worst case is that truly dismal private equity performance, which could result from a lack of exit opportunities through initial public offerings, will result in “cash calls” from funds. Normally, cash calls are offset by successful exits, allowing investors to keep a constant allocation. A lackluster IPO market, however, would force pensions to increase their allocation well beyond targeted levels.

Either way, pensions with substantial private equity allocations will face more unfunded liabilities.

### **Implications for municipal bond investors**

To understand the implications of private equity allocations and, more broadly, pension assets as a whole on the municipal bond market, I spoke with Matt Fabian, a managing director with Concord, MA-based Municipal Market Advisors (MMA). MMA is one of the leading strategy, research and advice firms in the municipal markets.

Within the municipal market, the primary exposure to pension obligations is in state-issued general obligation (GO) bonds. To a smaller degree, locally-issued GO bonds may also be affected, where cities and utilities manage their own pensions.

MMA published a report on the potential impact of state pensions in January, and Fabian said that its findings have not changed since then. He did not question published reports that put unfunded liabilities between \$1 and \$2 trillion across all 50 states. Nonetheless, he said that those liabilities are an “oblique threat to debt service,” for several reasons.

Most states have adopted the guidelines of the Government Accounting Standards Board (GASB), which is a recommended practice for states. Unlike private corporations, which must amortize unfunded liabilities over seven years, GASB allows amortization over 30 years. As a result, states can draw on existing pension assets to serve current benefit needs and hope that economic growth and investment performance over the ensuing-30 year period will combine to eliminate any unfunded liabilities. “As long as states’ current cash flow is sufficient to meet their pension needs,” Fabian said, “they can squeak by.”



Fabian cited a 2010 study by Robert Nory-Marx of the University of Chicago and Joshua Rauh of Northwestern University, [Public Pension Promises: How Big are They and What are They Worth?](#), which said that states now pay \$150 billion annually to current retirees. Those costs will double over the next 20 years, but currently they are relatively small compared to state budget deficits, which are estimated to be \$215 billion for 2009 and 2010. Those operating deficits were closed, albeit through measures that may not be sustainable (stimulus payments, employer payment holidays, and other accounting gimmicks).

States face much larger problems in their operating budgets than they do though unfunded pension liabilities. As long as states continue to find ways to meet their short-term operating needs, Fabian expects pension problems to remain in the background.

Fabian expects that states will reform their labor agreements to make pension obligations to not-yet-hired employees more manageable.

While investors should not be concerned with the possibility of municipal defaults, ratings downgrades are another story, according to Fabian. Some states will suffer downgrades because of their financing strategies. Illinois, for example, has chosen to continually borrow in the public debt market to fund both immediate and long-term pension costs, and it has scheduled dramatic increases in state contributions based on projected economic growth. That has placed strains on its operating budget. "While the risk of Illinois actually defaulting on a bonded obligation is remote," MMD said in its report, "its continual replacement of flexible with inflexible obligations is surely moving in the wrong direction."

Pension liabilities will affect other stakeholders, according to Fabian. Tax rates will go up, there will be less infrastructure investment, and citizens should expect cutbacks in education, welfare, prisons and other social services. "The country as a whole will see slower economic growth, as tax revenues are used to meet pension obligations," he said. Municipal bondholders, though, will get paid before other fiscal measures are taken.

Unfunded liabilities will continue to make bold and ominous headlines. Many states, like Washington, which have thus far avoided scrutiny, will face problems because of their excessive private equity allocations. For municipal bond investors, though, pension obligations will not lead to defaults in GO bonds.

Fabian recommends disregarding the comments from "market observers" who point at pension issues as a reason to worry over municipal defaults. "Any source making this connection has a limited grasp over what, exactly, they are talking about," he said.

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