

Underfunded Public Funds ...

It Can Stop Here!

A Special Report by

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The Problem: A Ticking Time Bomb

Public sector defined benefit funds have been suffering underfunded net asset conditions for nearly a decade.

Currently, under-funding is at its worst ever status, with many funds 30%, 40% and 50% underfunded. The culprit is a perfect storm combining record low U.S. government securities interest rates, with the five-year Treasury averaging just 3.75% over past 10 years, and the worst equity market losses in 30 years... the S&P 500 index is down 35% since its year 2000 high.

Typical 7% annual hurdle return rates needed by funds to be actuarially sound are nearly impossible to hit under many state-mandated investment pension code limitations.

Required asset allocations to U.S. government securities of short duration that have very low interest rates, and using S&P 500-type common growth equities that average less than 3% dividend yields greatly limit annual fund return yields. For public funds, after deducting investment consultant, adviser and custody fees, the net annual portfolio income may only be a little over 2%, which is 5% short of 7% annual hurdle return rates needed.

Also, with the current U.S. recession, lower state income tax and sales tax collections are producing large state fiscal deficits. There is virtually no room for states to financially bail out public funds.

Are pension boards therefore condemned to investment underperformance and massive fund deficits?

The solution to under-funded public funds must come from modifying state investment pension codes and/or improving pension board investment practices.

"Solutions"--Those Workable and Those Not!

Current discussion going on around the country by states and municipalities are offering many potential solutions such as raising state sales tax rates to increase revenue for fund contributions, or issuing "pension obligation bonds" that creates new debt to fund a debt, which just "kicks the can down the road."

It does not solve the problem at all.

On the liability side, states are thinking about terminating existing defined benefit plans and converting to "defined contribution" alternatives, where the public employees shoulder their own saving & investing responsibilities. Then, there are the proponents of simply having annual percentage of employee earnings contributions raised a little or a lot based on how bad off the pension fund is.

There are many ideas tendered, but no agreeable consensus because: Many options proposed have natural adversity between taxpayers having to give more, which they don't have in this recession, and public employees not very willing to make higher employee contributions or cut back on entitlement public pension benefits they are or will be receiving.

I've staked out my own solution proposal, whereas a good part of the under-funded pension cure can be had by improving fund investment performance, by applying more investment focus on attaining substantially higher annual income returns. This utilizes more non-government bond securities and equities that have much higher annual interest & dividend yields than are typically used in fund portfolios today.

Please read on for more solution-oriented ideas in high income investing for public pension funds. Without either higher annual income returns or new massive contributions, the under-funded problems can lead to fund bankruptcy—a disaster waiting to happen.

A Plan to Hit Hurdle Return Rates

There *are* investment options pension boards can utilize to hit 7% annual income hurdle return rates.

Funds can use more guaranteed securities with high income streams, such as corporate bonds of long duration that match pension duration payout liabilities. Corporate bonds have the express guarantee of each issuer to fully repay principal at maturity and interest through their life until maturity. Long-term corporate yield spreads are currently 2% to 6% over Treasuries at the investment grade threshold of BBB and higher. This provides greater than 7% current interest yields that can be locked in for the long term until maturity.

Another asset class to promote higher predictable income yields are preferred stocks, inclusive of the Trust Originated Preferreds. Even before the credit crisis of 2008, these preferreds have consistently yielded nearly 3% above long term Treasuries – on banks, insurance, utilities, industrial and REIT issuers. The durations, dividend yields and non-cyclical industry setting of most preferred share issuers make these nearly ideal fixed income securities for public pension funds to match long-term pension payout liabilities and dividend rates above 7% hurdle rate needs.

An added attribute is that preferred dividend payments are cumulative, so if a payment is ever skipped by the issuer, it must be made up in the future.

What about Asset Value Growth?

Yet in considering just bonds and preferreds as pension portfolio assets, it may beg the question: “Where is the asset value growth?” Bonds and preferreds have virtually none, unless they are bought at substantial secondary market price discounts to par values.

The answer rests in using high dividend common equities of public companies, REITs, master limited partnerships (MLPs) and

income trusts *along with* bonds and preferreds. From this universe of hundreds of corporate common stock issuers, diversified portfolios of commons can be created that produce weighted average annual dividend income in a 6% to 8% average yield range. This asset class of common equities provides three great attributes:

- 1.) High current dividend income of 6%-8%
- 2.) Growth of the income, and
- 3) Rising capital values of the shares.

Reliable annual dividend payments and future dividend growth really matter toward earning high, predictable annual dividend income. Standard & Poor's Corp. has been doing a quality ranking system on a universe of common equities for nearly 50 years covering a 4,000 issuer database. Their ranking range is from A+ to B- to gauge the issuing corporation's financial strength and dividend reliability over the long term.

The stronger issuers are in the quality category of A+, A, A-, B+ and B, and this strata of quality ranked companies outperforms the S&P 500 index on growth of corporate revenue, earnings, dividend growth, and durability against adverse economic and financial cycles. All Rankings of B and higher represent the upper 50% of high quality companies in the S&P 500 index.

One can easily review the S&P Quality Ranking process by getting [this document from the S&P website](#).

When held in a diversified portfolio of at least 100 of the higher common stock dividend issuers, these common equities can add the final complement to achieve 7% annual hurdle rate returns on public pension fund assets.

So, stop the under-funding here, and shift forward in evaluating your pension fund investment policy for higher annual return options!

Charles Dushek is President of Capital Management Associates of Lisle, Illinois Registered Investment Advisory firm started in 1995, that manages portfolios in fixed income allocations for individuals, qualified plans and funds. The company's specialty is "high income common & preferred equities, REITs and corporate bond" portfolios.

Chuck is a 40-year veteran of the investment management and financial services industry. He entered finance in 1969 at Harris Bank as a Corporate Financial Consultant in the International Banking Group, then joined Merrill Lynch in 1973 to head its Financial Futures Group helping businesses and institutions hedge risks in interest rates and foreign currency exposures. He has managed money for wealthy individuals and Soros Fund during the 1970s and 80s, and in the early 1990s managed money for upper net worth families. He is a graduate of North Central College in Naperville IL and obtained his Masters degree from Roosevelt University.

Chuck invites you to visit www.pensionfundrescue.com, a blog that keeps you up to date on news and developments concerning pension funds and pension fund management.

If you would like to discuss some of the pension fund investment options proposed here, feel free to contact Chuck at 630-963-4235, ext. 1 or chuckdushek@cmaadvisors.com.