



## **PAPERS Conference Pittsburgh**

### **Pension Obligation Bonds:**

### **Friend or Foe?**



**RYAN LABS  
ASSET MANAGEMENT**

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- I. Public Pension Plans
- II. Pension Obligation Bonds Defined
- III. The Math (Actuarially vs. Economics)
- IV. Risks
- V. Recommendation

## **Why do we accumulate Assets in Pension Trusts?**

1. Ensure we meet our obligations when they come due
2. Equitable to the current and future taxpayer
3. Meet or outgrow liabilities

# Understanding The Three Pension Levers:

## Three Levers in Pension Plans

1. Asset Allocation
2. Contribution Strategy
3. Benefit Management

## Pension Obligation Bonds: Profile of a POB Issuer

### **What is the appeal of a POB?**

Governments facing falling revenues

Governments use POBs for budget relief

Governments need to reduce pension under funding

Governments expect they will earn actuarial arbitrage

Governments avoid making the hard decisions

# Pension Obligation Bonds (POBs): Defined

## What are POBs?

Taxable general obligation bonds

Municipality sells bonds

Municipality puts the money into its pension trust fund

Municipality adds debt to balance sheet

Municipality adds assets to pension trust

On an enterprise basis, nothing has changed

# Pension Obligation Bonds: How POBs are sold to municipalities . . .

## Actuarial Alchemy | Place your bets

Actuarial Expected Return on Assets = 8%

POB Bond Yield (Financing) = 5%

Expected Cost Savings = 3%

*POBs historically are priced ~100 bps to 200 bps over the US Treasury Yield Curve*



## Pension Obligation Bonds: How would an Economist Explain the POB?

Government Employer pays direct and deferred income

Direct compensation is paid as a salary

Deferred compensation is borrowed from the worker

Annuity is paid at a latter date

Annuity is a high quality cash flow

Annuity should be priced at the Treasury Yield Curve

POB is a negative arbitrage and may impact future taxpayer

# Pension Obligation Bonds: Negative Arbitrage impacting the future taxpayer

## POB in an economic framework

Pension Obligation Bond Yield = 5.0%

Pension Liability Yield at Treasury Yield = 3.5%

**Negative Arbitrage** = 1.5%

*POB refinanced at a higher cost*

## Pension Obligation Bonds: Rating Agency Perspective

### Pension (soft) Debt is converted to bonded (hard) Debt

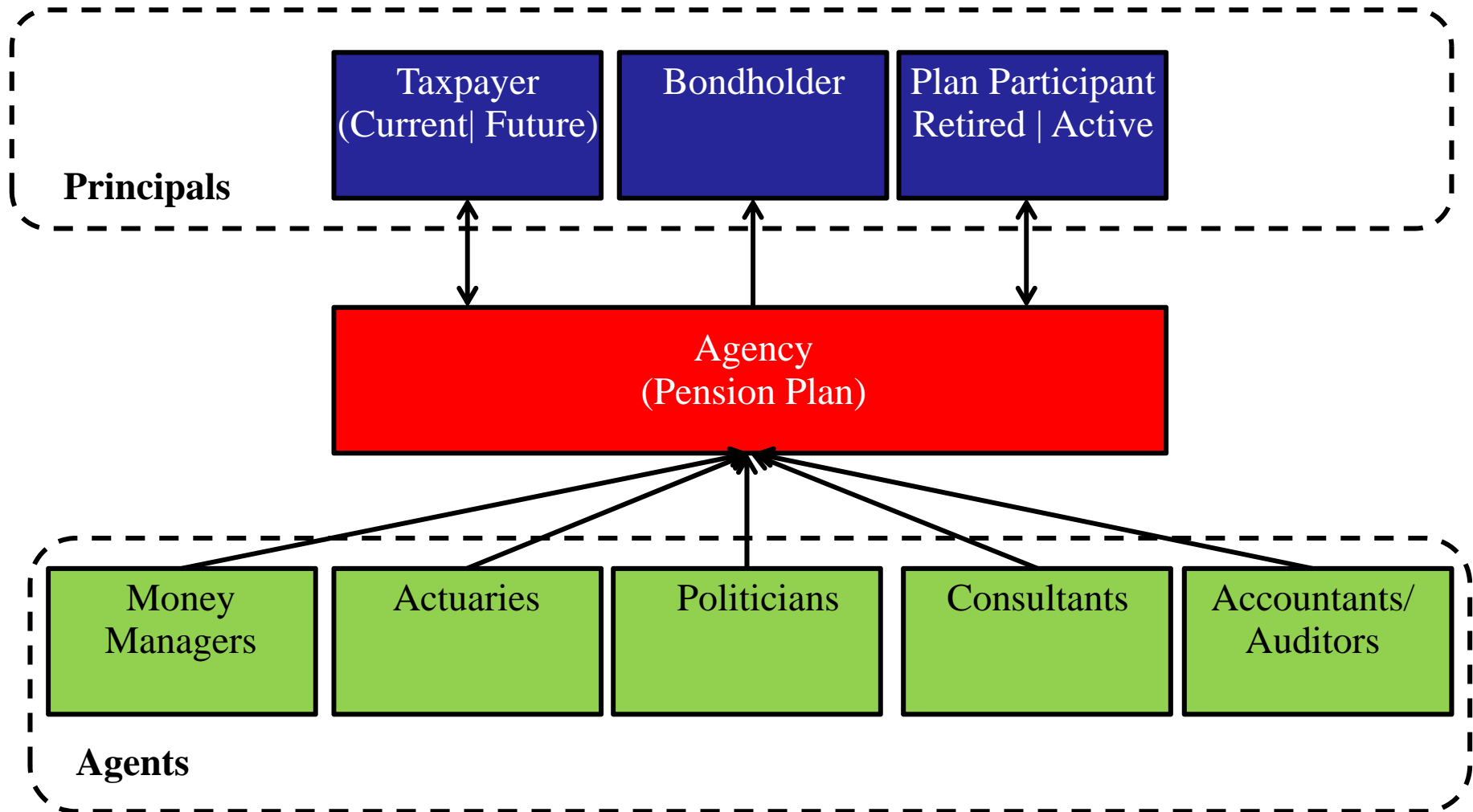
1. Budgetary risk from un realized budget savings
2. Default risk – missed coupon on the POB is different than a missed payment on the ARC
3. Loss of flexibility in contributions
4. Deficit borrowing is view as a credit negative

## Pension Obligation Bonds: NYC Actuary

**Robert C. North**, chief actuary for New York City's employee pension plans, says the only ones who benefit from these deals are the investment bankers (agents). The risk is too high to justify the benefits, he says, particularly when there are other alternatives available.

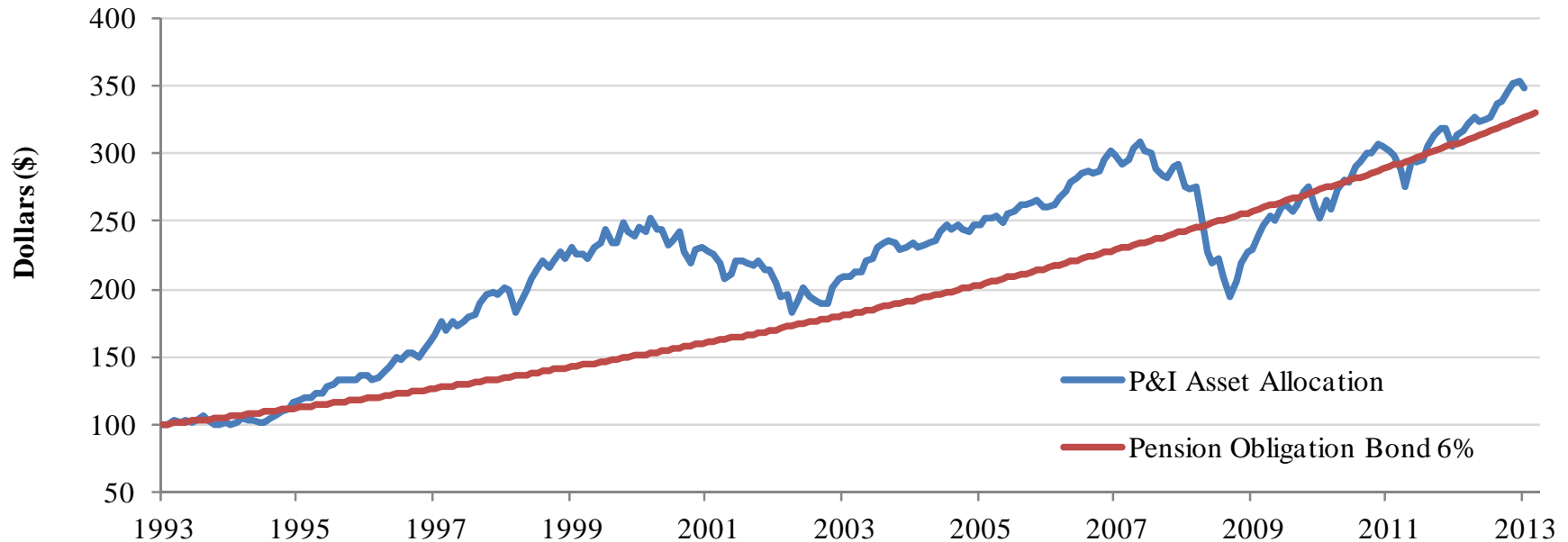
December 22, 2003

# Pension Obligation Bonds: Principals vs. Agents Tension



# Pension Obligation Bonds: P&I Asset Allocation vs. POB yield

**20 Year Return of \$100 (as of 06/30/13)**



	Last 12 months	Last 3 Years	Last 5 Years	Last 10 Years	Last 20 Years
	6/2012-6/2013	6/2010-6/2013	6/2008-6/2013	6/2003-6/2013	6/1993-6/2013
P&I Assets	111	138	126	166	348
POB @6%	106	119	134	181	326
Difference	5	18	-8	-14	22

## **Whitman Administration in January 1997**

Avoided hard decisions (higher taxes and spending cuts)

Sold \$2.8 billion in POBs

Raided POB to create two years of budget relief

Strategy collapsed in 2001 when the equity markets fell

Most POB issuers are worse off (pay benefits + financing)

Gov. Corzine said POBs are the dumbest idea ever (2012)

## City Of Philadelphia

Mayer Rendell sold \$1.29 billion in 1999

Equity market in 2001 (-10.21%) and 2002 (-19.82%)

Success of POB highly sensitive to entry points and market timing.



## **Application for a bank loan**

Visit your local banker

Explain to the banker what you would like to do . . .

Apply for a \$100 loan at 5%

Take the loan and invest it in the S&P 500

Will your banker make the unsecured loan to you?

## **Avoid issuing Pension Obligation Bonds (POB)**

POBs are actually refinancing at higher cost

POBs are like a second mortgage on a house

POBs represent pure leverage

POBs coupon is paid by future stakeholders

POBs may negatively impact a municipality's credit rating

Most POB issuers are worse off (pay benefits + financing)

# Understanding The Three Pension Levers: Focus on the hard decisions

## Three Levers in Pension Plans

1. Asset Allocation
2. Contribution Strategy
3. Benefit Management

# Disclosures

The information contained herein employs proprietary projections of expected returns of assets and liabilities, as well as estimates of their future volatility. The relative relationships and forecasts contained herein are based upon proprietary research and are developed through analysis of historical data and capital markets theory. These estimates have certain inherent limitations, and unlike an actual performance record, they do not reflect actual trading, liquidity constraints, fees and other costs. References to future returns are not promises or even estimates of actual returns a client portfolio may achieve. The forecasts contained herein are for illustrative purposes only and are not to be relied upon as advice or interpreted as a recommendation. Performance results represent the investment performance record for a size-weighted composite of similarly managed, unconstrained discretionary accounts.

Performance results are gross of investment management fees. The deduction of an advisory fee reduces an investor's return. Actual account performance will vary depending on individual portfolio security selection and the applicable fee schedule. Past performance is not a guarantee of comparable future results. Fees are described in Part II of the Advisor's ADV which is available upon request.

The following is an example of the effect of compounded advisory fees over a period of time on the value of a client's portfolio: A portfolio with a beginning value of \$100 million, gaining an annual return of 10% per annum would grow to \$259 million after 10 years, assuming no fees have been paid out. Conversely, a portfolio with a beginning value of \$100 million, gaining an annual return of 10% per annum, but paying a fee of 1% per annum, would only grow to \$235 million after 10 years. The annualized returns over the 10 year time period are 10.00% (gross of fees) and 8.91% (net of fees). If the fee in the above example was 0.25% per annum, the portfolio would grow to \$253 million after 10 years and return 9.73% net of fees. The fees were calculated on a monthly basis, which shows the maximum effect of compounding. The investment strategy described in this presentation is managed by Ryan Labs Asset Management's opinions and estimates offered constitute our judgment and are subject to change without notice, as are statements of financial market trends, which are based on current market conditions.

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