Retirement News Highlights
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Pension Funds Make Riskier Bets

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U.S. public pension funds don't have nearly enough money to pay for all their obligations to future retirees. A growing number are adopting a risky solution: investing borrowed money.

As both stock and bond markets struggle, it's a precarious gamble. More than 100 state, city, county and other governments borrowed for their pension funds last year, twice the highest number that did so in any prior year, according to a Municipal Market Analytics analysis of Bloomberg data. Nearly $13 billion of these pension obligation bonds were sold last year, which is more than in the prior five years combined.

The Teacher Retirement System of Texas, the U.S.'s fifth-largest public pension fund, began leveraging its investment portfolio in 2019. Next month, the largest U.S. public-worker fund, the roughly $440 billion California Public Employees' Retirement System, known as Calpers, will add leverage for the first time in its 90-year history.

While most pension funds still avoid investing borrowed money, the use of leverage is spreading faster than ever. Just four years ago, none of the five largest pension funds used leverage.

Investing with borrowed money can juice returns when markets are rising, but make losses more severe in a down market. This year's steep slump in financial markets will test the funds' strategy.

It's too soon to tell how the magnified bets are playing out in the current market, as funds won't report second-quarter returns until later in the summer. In the first quarter, public pension funds as a whole returned a median minus 4%, according to data from the Wilshire Trust Universe Comparison Service released last month. A portfolio of 60% stocks and 40% bonds—not what funds use— returned minus 5.55% in the quarter, Wilshire said.

While leverage could pay off if markets rebound, the losses it risks could affect not just the pension funds but also the state and local governments that stand behind them—and ordinary citizens. When public pension funds' investment returns fall short, governments are primarily responsible for taking up the slack, pressuring them to find money by cutting other spending or by raising revenue from steps such as raising taxes.

Public pension funds are "operating more like hedge funds in some cases," said Joseph Brusuelas, chief economist at accounting firm RSM. "They're treading on very risky footing."

Pension funds historically invested very conservatively, favoring relatively low-yielding fixed-income investments. Calpers had all its money in bonds until 1967.

Funds suffered significant losses in the 2000-02 dot-com bust and the 2008 financial crisis. Those setbacks, coupled with years of insufficiently funded benefit promises, left the funds as a whole well over a trillion dollars short of the asset level they ought to have. The level is dictated by a formula that includes their obligations and their targeted investment returns.

In some cases, workers' unions have secured sizable payouts for retirees that can keep pension funds paying out full or significant benefits to their members for many years.

Public-sector retirement plans tend to carry higher and more unpredictable costs because they offer defined benefits. While private employers have generally shifted to defined- contribution plans with payouts based on market returns, state and local governments still largely offer their employees pension checks calculated based on salaries and years of service.

Even the longest equity bull market in history—a roughly 11-year run through early 2020 —didn't close the gap between pension funds' obligations and assets. In 2021, public pension plans had an average of just $0.75 for every dollar they expected to owe retirees in future benefits, according to data from the nonprofit Center for Retirement Research at Boston College.

The funds can try to fill the gap by the politically difficult task of demanding more in yearly contributions from governments and from workers themselves, a move that often meets with pushback from public-employee unions. Or they can adopt a potentially higher-yielding—but riskier— investment strategy.

To access leverage, large funds sometimes purchase complex derivatives such as futures contracts linked to U.S. Treasury bonds, betting the value will rise or fall. The effect is to bet on assets without actually buying them, thereby increasing the amount of money being invested without holding additional assets.

A city, state or county might also sell municipal bonds and deposit the proceeds into its pension fund to be invested alongside other assets there.

The use of leverage by the $200 billion Teacher Retirement System of Texas— through repurchase agreements, futures and other derivatives—added 1.43% to its returns over two years coming into 2022, according to a presentation by the fund.

Jase Auby, its chief investment officer, said using leverage allowed the fund to diversify its asset mix in a way that relies less on stocks but is still projected to hit the fund's return targets. "A carefully considered use of leverage is a way to add balance to the portfolio, i.e., reduce the reliance of the portfolio on the equity markets," Mr. Auby said.

The board of Calpers voted last November to add up to 5% leverage beginning in July. The fund could turn to a derivatives- based approach, according to people familiar with the matter. The Calpers staff pitched the leverage plan as a way to meet its return target with a little less money in stocks and more in bonds than needed if it didn't use leverage.

With leverage, the fund could hit a 6.8% target return and allocate 2 percentage points less to stocks and seven points more to bonds than in an unleveraged portfolio projected to hit the same target, according to projections by Calpers staff. Compared to an unleveraged portfolio, the leveraged one that is projected to earn 6.8% would carry a lower the risk of losses in certain scenarios, such as if stocks crashed and bonds rallied, Calpers staff found. "With the use of leverage, we can reduce the equity exposure just a smidge and increase the fixed-income exposure," Calpers' managing investment director Sterling Gunn told the board in November.

Still, a staff presentation noted that the use of leverage "could result in higher losses in certain market conditions."

One large fund, the Pennsylvania Public School Employees' Retirement System, adopted leverage well ahead of others, in 2012. Leverage has often increased its gains in periods when returns were positive. But when Covid-19 shut down much of the economy in early 2020, the fund's use of leverage worsened its first-quarter return to minus 8.21% from what otherwise would have been minus 7.03%, according to a review by Aon PLC, which consults on risk and employee benefits in addition to its insurance business.

The fund's five-year annualized return at the end of 2020—5.6%—trailed the 6.9% national average for major state and local government pensions, according to Center for Retirement Research data.

Its preliminary investment return for the 2022 first quarter was 1.14% and significantly outperformed the average of large public pension funds, which Aon said was mainly due to its use of alternative investments such as private equity, not to leverage.

Staff at the Pennsylvania fund have said leverage helps them earn higher returns with less reliance on stocks.

Some pension funds that embrace leverage point to its widespread use in Canada. There, retirement plans borrow amounts equivalent to 15% to 20% of their assets, according to Jason Mercer, a senior analyst with Moody's Investors Service.

In recent decades, some pension funds also have reduced their holdings of both government and investment-grade corporate bonds, which historically hold or even gain value during stock downturns.

Funds have dipped more heavily into private-market investments. They have ramped up alternative investments, such as hedge funds, real estate, private-debt funds that make unrated loans, and private-equity funds that buy, overhaul and sell companies.

State and local pension funds now have about a quarter of their roughly $5 trillion of holdings parked in such assets, according to Center for Retirement Research and Federal Reserve data. A record $480 billion in public-worker retirement money is invested in private equity, up 60% from 2018, according to an analysis of data from the Fed and analytics company Preqin.

Alternative investments such as private equity tend to carry substantially higher fees and sink alongside stocks in times of market distress. Private- equity funds also typically lock up money for a decade, so gains and losses are hard to gauge in real time.

Meanwhile, U.S. public pension funds reduced their fixed-income holdings to 22% of assets in 2021 from 29% in 2009 —and 33% in 2002—according to the Center for Retirement Research.

On the whole, funds plan to continue dialing up risk. A survey of institutional asset managers by investment bank and data provider Natixis found that more than two-thirds plan to use investments such as private equity, private debt and hedge funds as a replacement for fixed income to "generate yield." In 2017, just over half said they planned to.

Even absent any leveraged bets, the ramp-up in alternative investments is increasing the potential for higher market losses at pension funds in a given year, according to a 2021 report by Moody's. For some cities and school districts, losses in a single year could potentially amount to a quarter of revenue, Moody's found.

Courts tend to protect pension promises, prohibiting cuts to retirees' checks and often barring changes to the rules on how much current workers must set aside toward their eventual pensions. That throws the burden of filling pension-fund gaps primarily on state, city and local governments, some of which have already endured years of spending cuts to cover pension payments.

The risks of leverage especially worry one Calpers pensioner. In 33 years working for the city of Pasadena, Calif., Steve Mermell has watched its budget squeezed by rising amounts it has had to contribute to Calpers.

When the Calpers board began discussing a plan to use leverage two years ago, Mr. Mermell met with officials of the fund and wrote a letter imploring it to reconsider because of the risks. The plan moved forward.

Mr. Mermell retired as Pasadena's city manager last year and knows better than most how borrowing to juice returns can backfire. Pasadena has struggled for decades with costs from a local pension plan it once offered to its police and firefighters.

In 1999, to manage the rising cost of that plan's inflation- linked benefits, Pasadena borrowed $102 million through municipal bonds and put the proceeds toward its pension obligations. The idea was that the pension fund could start earning market returns on a larger amount of money immediately, while the city gradually paid off the bond debt.

Instead, the Sept. 11 attacks and dot-com collapse triggered big stock losses in 2001 and 2002, obliterating some of the borrowed money. Mean-while, the city faced bond payments at initial interest rates above 6%.

To plug the hole, Pasadena issued another pension-obligation bond in 2004, for $40 million. Four years later, the stock market cratered again.

The local police and fire pension plan has been closed for nearly 50 years. Pension recipients have dwindled to fewer than 180. But the city still owes about $135 million in bond debt on the plan. Payments on it are expected to be about $6 million in 2022.

"It's like going to the ATM in Vegas and then going to the roulette wheel and it comes up red and you go back to the ATM," Mr. Mermell said.

The types of leverage employed by the Texas teacher fund and likely to be used by Calpers are simpler to terminate than a 30-year municipal bond. But they carry the same kind of risk: In a down market, losses can be larger than if the fund had stuck to investing money it had on hand.

Ever since Pasadena closed its local pension plan, all of its public workers' pensions have been managed by Calpers. The city's annual contributions to Calpers have doubled since 2015, to about $70 million last year, more than the city spends on transportation.

"With pensions, you either pay now or pay more later," Mr. Mermell said. "If you take on a strategy of increasing your risk exposure but you bet the wrong way, you're really going to get hurt."

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