A member of
Deutsche Bank Group

The Muni Opinion

October 2010: Will pensions sink the states?

Many state workers have been promised generous retirement benefits. At the same time, pensions have put some states on a trajectory toward fiscal ruin. Muni bond investors need to incorporate pension policy into their analysis — because something has to give.

For many municipalities, huge pension and retirement health care obligations represent a huge problem. Today we'll focus on pensions, because they are beginning to scare muni bond investors like ghouls on Halloween night.

The core concept is simple: State and local governments reward their retired workers by sending them monthly pension checks, which are paid for by government pension funds. Pension funds come from taxing the private sector. And that's the root of the problem — the private sector is struggling.

AUTHORS

- Philip G. Condon, head of municipal bond portfolio management, DWS Investments
- Carol L. Flynn, CFA, head of municipal bond research, DWS Investments
- Ashton P. Goodfield, CFA, head of municipal bond trading, DWS Investments
- Anthony Parish, fixed-income product specialist, DWS Investments

From the private sector's perspective, the retirement benefits enjoyed by public sector workers seem disproportionately generous.

As California Governor Arnold Schwarzenegger ("The Governator") said in an August 27, 2010, *Wall Street Journal* op-ed piece, "Few Californians in the private sector have $1 million in savings, but that's effectively the retirement account they guarantee to public employees who opt to retire at the age of 55 and are entitled to a monthly inflation-protected check for $3,000 for the rest of their lives."

Regardless of whether you believe public pension benefits are appropriate, we believe they are unsustainable on their current trajectory. Pensions represent a significant and growing threat to the long-term financial health of muni bond issuers for the reasons stated on the following page. (Note to muni bond investors: You may want to hide all sharp objects and/or steady your nerves with a strong beverage before proceeding.)

DWS
INVESTMENTS
Deutsche Bank Group

- The average state's pension is just 76% funded, according to data compiled for the Bloomberg Cities and Debt Briefing. Illinois is barely 50% funded. Funding for the pensions of Oklahoma, Kentucky, New Hampshire and Louisiana is 60% or lower. Twenty other states are below 80% funded.[1]

- Many state pensions utilize what many analysts view as unrealistic actuarial assumptions. Typically, states estimate their pension investments can reliably generate an average investment return of 7% to 8%.[2] Many outsiders believe a more realistic assumption would be around 5%. If pension accountants assumed a lower return on investments, their funding gaps would be even larger.

- Actual performance of pension assets in recent years has been even lower. According to Wilshire Associates, the estimated five-year average annual return for the largest public pension portfolios (those with assets above $5 billion) was around 3%, well below the 7% to 8% bogey many states use as their benchmark.[3]

- At least 14 states paid out more than 10% of their pension assets last year in the form of benefits.[4] At that rate, they will burn through the bulk of their pension assets in a few years.

- While only about 5% to 7% of a state's annual budget goes to debt service (that is, the proportion of their budgets used to make interest and principal payments on their debt), annual retirement contributions average close to 10% but vary widely.[5] And while debt service charges are relatively stable, retirement expenses are scheduled to grow dramatically. In many states, retirement costs are rising faster than state revenues.

The list goes on and on, but suffice it to say these retirement obligations are among the states' biggest and fastest-growing problems.

PRESSURE TO REFORM

Not surprisingly, state treasurers, governors and legislators are now facing severe and growing pressure to reform their pension fundamentals. The problem is, they can't just walk into their offices one morning and erase those promises. Pension obligations are contractual obligations. Plain and simple. Black and white. Difficult to revise.

But something has to give. Many state officials are now saying, essentially, "We cannot continue like this; the state will become insolvent. We need to renegotiate the terms of the pension obligations."

They are reopening negotiations like a major league baseball general manager with players' contracts. And this time their negotiating position is strengthened by the severity of their budget problems. This tactic would have been unthinkable a couple of years ago. It appears the threat of employee cutbacks seems to be making unions more willing to renegotiate pensions.

[1] Bloomberg, "Municipal Finance," September 15, 2010

[2] Pew Center on the States, "The Trillion Dollar Gap: Underfunded State Retirement Systems and the Road to Reform," 2/10

[3] Bloomberg, Municipal Finance, September 15, 2010 (quoting an August 2010 study by Wilshire Associates)

[4] Bloomberg, "Municipal Finance," September 15, 2010

[5] DeAM and Pew Center on the States, "The Trillion Dollar Gap: Underfunded State Retirement Systems and the Road to Reform," 2/10

They are also working with legislators to change existing laws or write new ones. For example, some states are doing away with the practice known as "spiking." This practice—perfectly legal and very common—allows public workers to build up their income in the final year before retirement by working overtime, carrying over sick days from previous years and opting out of vacation time. This creates an inflated benchmark for future pension benefits.

Additional measures include extending the retirement age, migrating from defined benefit programs to defined contribution programs (similar to 401(k)s) and reducing the public work force. Chris Christie, the governor of New Jersey, recently introduced legislation to change pension rules for existing employees, changing the retirement age from 60 to 65, lengthening from three years to five years the period used to determine retirement benefits and rescinding the pension bonus granted in 2001 because the state's pension plan was, at that time, over funded. Minnesota is attempting to change the cost-of-living formula for retirees.

From a bondholder's perspective, these changes are positive, and they do make a difference. However, the changes need to be made at all levels, not just in a few isolated cases.

As an aside, in the 1970s, corporate pensions were massively underfunded, a condition that largely resulted from sustained underperformance in the capital markets. (Sound familiar?) This ultimately resulted in pension reform and, over time, a shift away from pensions as the primary vehicle for retirement benefits.

Although none of the measures mentioned above will make a significant impact on their own, in aggregate, over the long term, their impact could be substantial.

SHIFTING FUNDAMENTALS

From our perspective as muni bond analysts and investors, we look very closely at how issuers are responding to their pension problems. This includes, among other things, their projected obligations, their funded status and the measures they are taking to address their funding shortfalls. These are all important elements to determine whether we can trust a municipality enough to buy its debt.

For example, we recently opted to pass on a municipal bond deal that came our way from a regional art museum. Why? Because we did not believe the issuer's revenues—almost entirely driven by museum ticket sales—could support the pension obligations over the long term.

The current pressure on legislators to enact pension reform is necessary and good. It is demonstrating that elected officials have choices, and how they respond to those choices will determine whether we—and the market at large—view them as responsible borrowers. Public-service unions have been a powerful force in determining pension and benefits. However, in this time of stressed budgets, voters and, therefore, politicians have little patience with expenses that are seen as excessive.

For the municipalities that make the necessary changes to get their financial houses in order, the markets will reward them in the form of lower borrowing costs. For municipalities that don't, the market will penalize them, and their problems will likely get worse.

The epicenter of the pension debate is the state of Illinois. This year the state received a credit downgrade due to its deteriorating fundamentals,

the most notable being its growing pension problems. Will Illinois address its pension problems head on? Do the politicians have the political will? Can they afford to wait any longer? Will they lean on the federal government for support?

These are all important questions that will have to be answered sooner or later. From our perspective, the sooner the better.

Importantly, the solution for states' pension problems is generally NOT for municipalities to default on their debt. In most cases, that wouldn't free up enough capital to solve their pension problems. As we have said in previous editions of "The Muni Opinion," defaulting would almost certainly handicap their access to the capital markets — something they need to fund their ongoing operations.

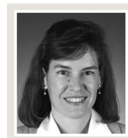
Given the choice, we would rather be municipal bond investors than taxpayers reliant on the states for services. We believe public entitlement programs and social services are likely more vulnerable to cuts than payments to bond holders. Although we take some comfort with the senior lien that debt enjoys over pension obligations, we recognize that failure to address pension costs (as well as health care costs) could potentially lead to insolvency. After years of watching the unfunded obligation of municipalities, we are finally seeing an environment where reform is possible.

In the end, we expect to see a number of reforms take place in the coming years that will help municipalities to get their pension obligations under control. These reforms will take time to have a significant impact on municipal budgets. But their impact will be significant.

We are confident that unless the economy recovers at a much quicker pace than most people expect, public pension reform will likely be substantial.

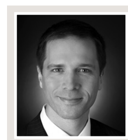
Why? Because municipalities really have no other choice.

Philip G. Condon
Head of municipal bond portfolio management



Ashton Goodfield, CFA
Head of municipal bond trading

Carol L. Flynn, CFA
Head of municipal bond research



Anthony Parish
Fixed-income product specialist

This article is not intended to provide tax or legal advice and should not be relied upon as such. Any specific tax or legal questions concerning the matters described in this article should be discussed with a tax or legal advisor. DWS Investments, including its subsidiaries and affiliates, does not give tax or legal advice. The opinions and forecasts expressed herein are those of the authors, do not necessarily reflect DWS Investments, are as of 9/27/10 and may not come to pass. This information is subject to change at any time, is based on market and other conditions, and should not be construed as a recommendation of any specific security.

IMPORTANT RISK INFORMATION

Bond investments are subject to interest-rate and credit risks. When interest rates rise, bond prices generally fall. Credit risk refers to the ability of an issuer to make timely payments of principal and interest. Although municipal bond funds seek income that is federally tax-free, a portion of the their distributions may be subject to federal, state and local taxes, including the alternative minimum tax. Credit quality is a measure of a bond issuer's ability to repay interest and principal on time. Rating agencies assign letter designation such as AAA and AA. The lower the rating, the higher the probability of default. Credit quality does not remove market risk. See the prospectus for details.

OBTAIN A PROSPECTUS

To obtain a summary prospectus, if available, or prospectus, download one from www.dws-investments.com, talk to your financial representative or call (800) 621-1048. We advise you to carefully consider the product's objectives, risks, charges and expenses before investing. The summary prospectus and prospectus contain this and other important information about the investment product. Please read the prospectus carefully before you invest.

NOT FDIC/NCUA INSURED MAY LOSE VALUE NO BANK GUARANTEE NOT A DEPOSIT NOT INSURED BY ANY FEDERAL GOVERNMENT AGENCY

DWS Investments is part of Deutsche Bank's Asset Management division and, within the US, represents the retail asset management activities of Deutsche Bank AG, Deutsche Bank Trust Company Americas, Deutsche Investment Management Americas Inc. and DWS Trust Company.

DWS Investments Distributors, Inc.
222 South Riverside Plaza Chicago, IL 60606-5808
www.dws-investments.com inquiry.info@dws.com
Tel (800) 621-1148

© 2010 DWS Investments Distributors, Inc. All rights reserved. PM102953 (10/10) R-18340-3 MUNI-OPIN