Municipal Market Comments

ASCENT Investment Partners

October 17, 2013

from Montage Investments

Moody's Approach to Pension Analysis Highlights New Risks for Investors

On Sept. 26, Moody's released a new analysis of the pension liabilities of the 50 largest local governments in the U.S. (as measured by the amount of Moody's-rated debt outstanding). The report is an extension of Moody's new approach to analyzing pensions, first introduced in April 2013. Moody's analysis suggests that by a variety of measures, the City of Chicago and Cook County, IL have the greatest unfunded pension burden among large, rated U.S. local governments. It is this pension overhang that has driven the downgrades of both issuers this year (Chicago to A3 from Aa3 and Cook County to A1 from Aa3).

There is a great deal of debate in financial markets over how to properly measure the long-term liabilities of public pension programs. Moody's approach is to recalculate the long-term value of pension liabilities using adjusted discount rates (rather than rates of investment returns used by the municipalities) that it believes better reflect more realistic assumptions for future investment returns in these issuers' pension funds. As the table below illustrates, adjusting the portfolio assumptions can make a tremendous difference in the balance of assets and liabilities that an issuer can project to have available many years in the future. Whether these adjustments are a better reflection of future financial liability is not the point. The point is they are now the basis for Moody's analysis and have direct impacts on credit ratings and market values.

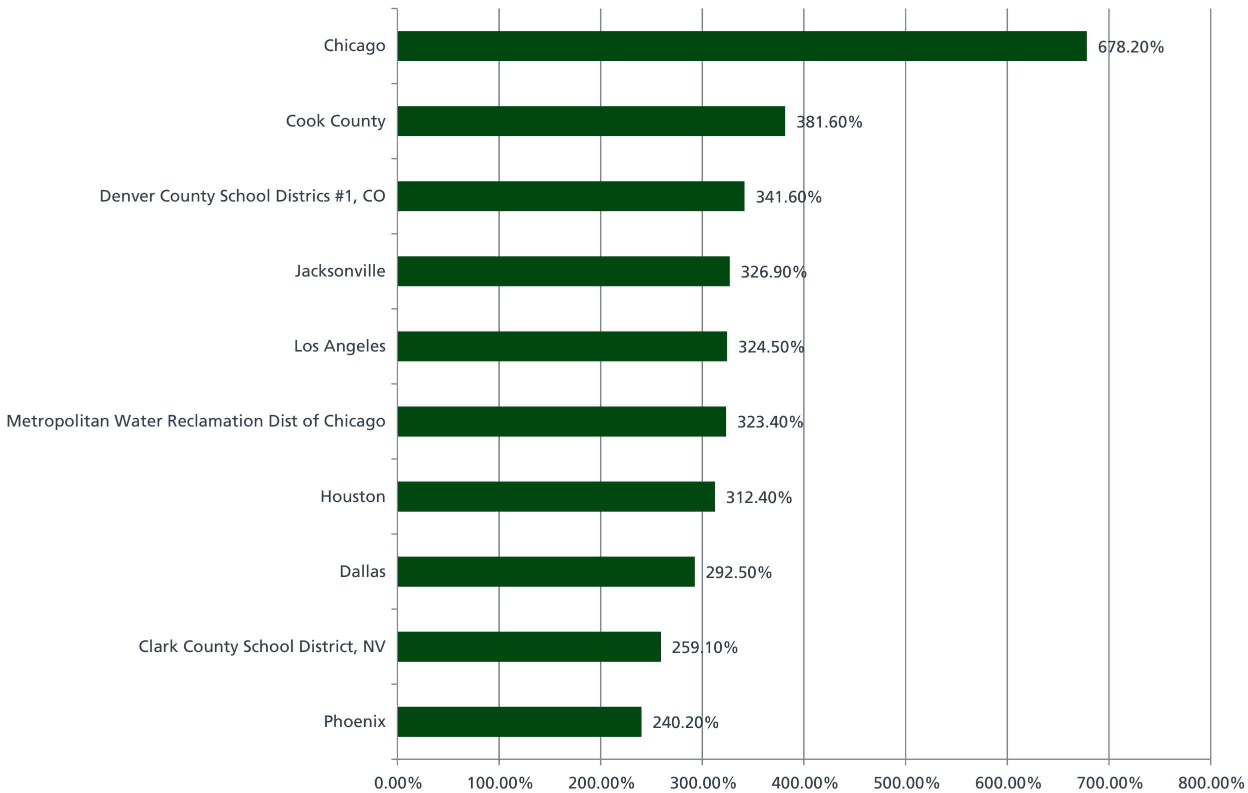
Moody's Adjusted Net Pension Liability Rankings
(most recent actuarial value, $ billions)

Rank	Issuer	State	Aggregate Unfunded Liability*	Moody's Adjusted Net Liability	Moody's G.O. Bond Rating
1	New York City	NY	$38.745	$68.992	Aa2
2	Chicago	IL	16.299	28.461	A3
3	Los Angeles County	CA	7.807	18.951	Aa2
4	Los Angeles	CA	7.812	14.621	Aa2
5	Chicago Public Schools	IL	5.373	10.593	A3
6	Cook County	IL	4.731	10.566	A1
7	Los Angeles Unified School Dist.	CA	4.591	9.68	Aa2
8	Fairfax County	VA	3.812	7.396	Aaa
9	Philadelphia	PA	4.936	7.333	A2
10	Houston	TX	2.286	6.084	Aa2

* Unfunded Actuarial Accrued Liability (UAAL) as reported in the issuer's most recent actuarial pension study.
Source: Moody's Investors Service

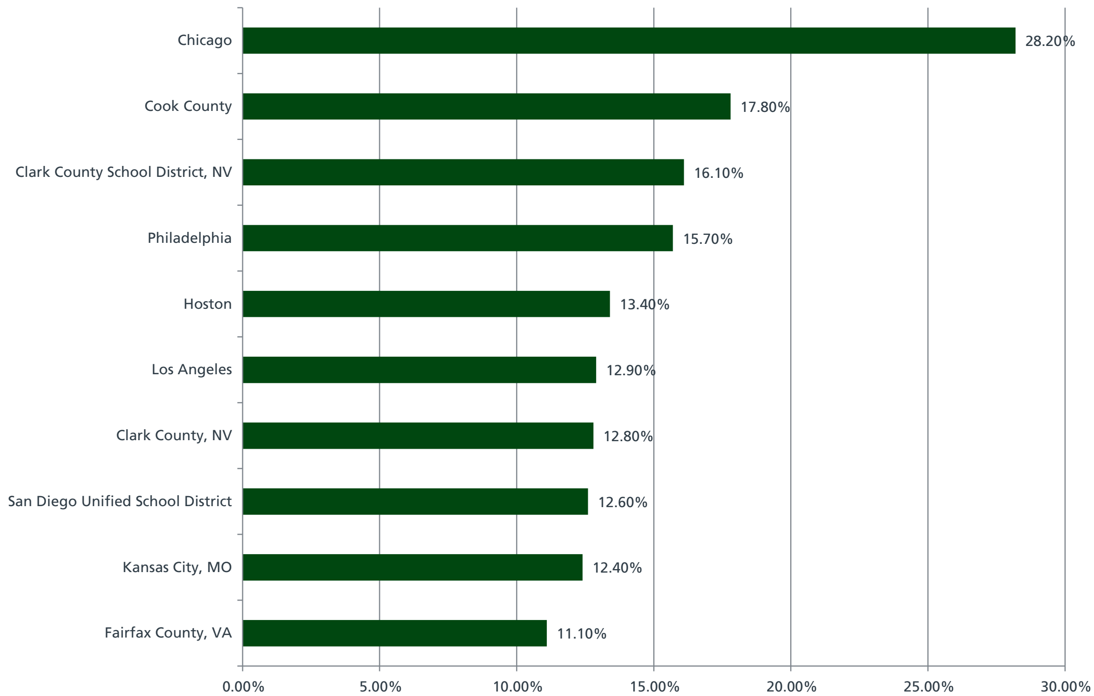
Pensions and pension funding have been an increasing area of focus for investors and the rating agencies for several years. As we have discussed in past research notes (most recently in the April 29th Municipal Market Comments), municipal balance sheets have been materially affected over the past five years due to changes in pension obligation accounting policies and the effects of the financial crisis and recession on investment portfolios. The resulting growth in annual budget costs to fund pension gaps has begun pressuring ratings. In many of the recent cases of Chapter 9 bankruptcy (Stockton, San Bernardino, Detroit, etc.), unmanageable pension obligations were one of the key liabilities that the municipalities cited when claiming insolvency.

10 Largest Adjusted Net Pension Liability Relative to Revenues



Source: Moody's Investors Service

10 Largest Annual Required Pension Contributions Relative to Revenues



Source: Moody's Investors Service

For investors, it is important to understand that pension funding is a growing factor in how rating agencies and markets view credit quality and market value. Consequently, differences in pension management approaches and funding levels should be a material factor when selecting credits for portfolios. We continue to believe that municipalities' approach to pension funding is at least as important as the absolute levels of funding. Governments that take a responsible long-term approach to retiree benefit structuring and investment management may show some year-to-year variability of investment returns, but will largely remain stable over time. Likewise, issuers with pension funding shortfalls that show a responsible approach to improving long-term funding levels, or to changing unsustainable pension systems, should not see significant credit or market deterioration. We believe such issuers will get the benefit of the doubt from rating agencies and buyers.

In some states, state constitutions or statutes severely limit the extent to which municipalities can make changes to pension systems. In other circumstances, local governments lack the political will to make the hard choices necessary to place retiree benefit systems on a stable long-term footing. We expect that issuers like this – the State of Illinois and the City of Chicago are prime examples – will get increasing harsher treatment from the rating agencies and the bond markets, reflecting rising investor fear that pensions can be a driver of municipal insolvency.

Ultimately, we expect the vast majority of issuers will take the steps needed to stabilize their pensions long-term and will maintain solid investment-grade ratings. We will continue to monitor developments in the analysis of pension obligations and their application to ratings. We continue to incorporate our own pension analysis into our assessment of every bond we place into investors' portfolios.

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