

Underfunded public funds...it can stop here!

By Charles Dushek, *president, Capital Management Associates*

Public sector defined benefit funds have been suffering underfunded net asset conditions for nearly a decade. Currently, underfunding 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 50% 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 only 3% dividend yields greatly limit annual 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.

Are pension boards therefore condemned to investment underperformance and massive fund deficits? 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 bailout public funds. The solution to underfunded public funds must come from modifying state investment pension codes and/or improving pension board investment practices.

Stop here & shift forward 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.

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 visiting the S&P website at <http://www2.standardandpoors.com/spf/pdf/media/QualityRankingWhitePaperFinal.pdf>

When held in a diversified portfolio of at least 100 of the higher common stock dividend issuers, these common equities can add the final compliment 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.

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