

Opinion: Calif. should pay down its CalPERS obligation

By John Moorlach

Gov. Jerry Brown wants to prepay the California Public Employees Retirement System (CalPERS) with \$6 billion beyond what most had expected.

The source of the funds is the Surplus Money Investment Fund. Don't ask me why a state with a \$169 billion unrestricted net deficit has some \$50 billion in a low interest bearing account with such an odd title. Perhaps the University of California chancellor can explain how her system and the state can better pull these things off?

Also, don't ask me why the timing is so odd. The Legislature just approved an annual \$5.2 billion gas and auto tax increase, and now the governor has \$6 billion for non-road repair expenditures?

Despite these concerns and anxieties, I like the proposal. It's about time that the governor got serious about the state's spiraling unfunded defined benefit liabilities, but, I would postulate that this proposal needs a little more sizzle to make it an even more interesting opportunity.

Let's address the cash flow components of this idea. The state currently has funds that are earning less than 1 percent per year. Paying down a 7.5 percent loan would provide a bigger bang for the buck. The spread of more than 6.5 percent will provide significant savings to the state's general fund.

It's true that whatever is deposited into a defined benefit pension plan by a plan sponsor is irretrievable. That is, it's not a loan to CalPERS, it's a payment. Once it goes in, the state cannot ask for it back. But, this will be a prepayment.

Consequently, should the state have a cash flow emergency, it could simply stop making the regularly scheduled payments into CalPERS and slowly accumulate back this advancement.

The upside? The state gets to pay down its liabilities sooner, which will have the potential of reducing the annual required contributions in future years. The state obtains the 6.5 percent spread in savings. CalPERS can allocate the funding to meet its own cash flow needs and reduce transaction costs by doing it in bulk. The state wins. The taxpayers will win. And CalPERS wins.

What could go wrong? For the answer to this question, you should ask former New Jersey Gov. Christine Todd Whitman. In 1997, she issued \$3.4 billion in pension obligation bonds. This is a risky technique that converts a soft debt to the pension system into a hard debt to bondholders.

The idea is similar to Brown's proposal, in that the cost of the money is cheaper than the current 7.5 percent investment assumption rate of the plan. In the late 1990s, this may have been a brilliant move. But, when the dot com boom turned to bust, pension plans lost a significant amount of plan funds invested in the internet-related industries.

The big risk the governor will have to face is the possibility that the investment markets may tank after making the contribution prepayment. Remember, if you lose 50 percent on your investments this year, you have to earn 100 percent next year just to break even on your principal. Will Rogers put it best, "I am not so much concerned with the return on capital as I am with the return of capital."

It's not a good idea to time the market. It's better to dollar-cost average, which means investing the same amount at regular intervals over time.

We cannot see the future. It's obvious that CalPERS cannot, based on their recent repositioning out of certain equity

markets last September, which has cost it more than \$900 million in lost appreciation. It makes one wonder if they were concerned about Hillary Clinton winning the November election. Had they assumed that Donald Trump was going to win, and held firm, they would have earned nearly 17 percent on equities since the presidential election.

Had Brown recommended this prepayment move last year, he would be a hero right now. So, he has to determine how serious he is about claiming a recession is around the corner.

To make the proposal more interesting, Brown should ask the board of CalPERS what type of incentive they will give the state for the prepayment. CalPERS will benefit from the large influx and should provide at least a 3.75 percent reduction on the actuarially calculated required contribution. This would provide a \$225 million savings to the state, using the \$6 billion figure, thus providing some sizzle.

Investing is not difficult, but it is also not for the faint of heart. You have to live with your decisions. Trust me, I managed a \$7 billion portfolio and sat on the board of one of the nation's largest public employee pension systems.

While serving as the treasurer of Orange County, I assisted in constructing a prepayment vehicle for the pension system. Instead of 26 regular payments during the year on biweekly pay days, the county paid the full amount up front, less the negotiated incentive. The county borrowed the funds, at an interest rate lower than the investment assumption rate of the retirement system and has realized about \$100 million in net present value savings over the last 11 years.

How did the county do with its investments over this time period, with the change in the regular payment intervals? It actually outperformed what would have occurred under the normal protocol.

We should always remember that past performance is not an

assurance that future performance will be the same or better. But, prepaying CalPERS's massive obligations is something that should be strongly encouraged. Pension plan debt is an expensive liability in the current low-interest rate environment. Consequently, public employee retirement stakeholders should enter into a good debate on this proposal.

I see nearly \$400 million in opportunity savings by taking low to no earning funds and paying down a 7.5 percent loan. I see the plan more efficiently investing the \$6 billion. And I see lower plan contributions as the unfunded actuarial accrued liability is reduced. Those are strong arguments.

I would encourage the governor to move forward with his proposal. But, I would also tell him to get more sizzle to the deal by negotiating with the CalPERS board before writing the check. And, if he is concerned about market volatility, he may want to encourage the board to consider allocating the funds toward fixed income investments that provide income commensurate with the investment assumption rate.

If the governor is really serious about the state's pension plan liabilities, he would figure out how to increase the annual contributions to CalPERS by \$6 billion every year, even if it has to come out of the general fund. Doing anything else is only deluding everyone about the seriousness of this rapidly growing and all-consuming obligation.

Thanks for thinking outside the box, governor. Now, take it to the next level.

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