# Rodney's Take

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## California Pension Fund Chooses Leverage…What Could Go Wrong?

By its own measure, the California Public Employees Retirement System (CalPERS) is on the path to failure. Granted, it won't happen soon, but the fund's 2020 internal calculations estimate that it has about $440 billion in assets and owes retirees $600 billion, which results in $160 billion in unfunded liabilities. Those numbers certainly improved during 2021, but not nearly enough to close the gap.

CalPERS uses a discount rate of 6.8% per year, which is down from 7% last year, but with its current investment strategy, the fund expects to earn just 6.2%. Now the CalPERS board of trustees has come up with a plan to close the gap. They will use leverage to supercharge their results.

Using leverage to increase investment returns is nothing new. Closed-end funds do this all the time, and at HS Dent, we consistently invest in them. But the process is not without risk; it amplifies the investment results both directions. Typically, funds borrow money in the short-term lending market and use the extra cash to invest for long-term gains or income. As long as the gains or income outpace the cost of the short-term capital, then it all works out. If a fund that would have earned 7% uses 20% leverage, then it will earn 120% of 7%, or 8.4%, less the cost of capital. In today's market, short-term capital cost around 1%, so the example fund would net 7.4%, which is still better than its unleveraged 7% return.

But it can go the other way. If the example fund had a bad year and lost 7%, then with leverage it would lose 8.4% and still be on the hook for the 1% cost of capital, which would mean a negative 9.4% return.

CalPERS is starting out small by adding just 5% leverage. But the fund is increasing its allocation to alternative investments from 8% to 13% and adding 5% in private debt. If everything works out, the higher allocations to the risky asset classes will boost the overall portfolio returns enough to reach their 6.8% long-term target. Unfortunately, if borrowing money to invest in high-risk assets goes against them, then the fund not only will suffer investment losses, but also it will be on the hook for the borrowing costs.

There's a simpler but obviously unpalatable solution. CalPERS, along with almost every other underfunded state pension plan, could set payments that realistically reflect what pension contributions and earnings will support. The problem is that many states contractually set payments, or outflows, even though inflows are variable because they include investment returns. If inflows are variable, then outflows should also be variable, but that's a situation that pension beneficiaries would never accept.

Annuity companies have dealt with this for as long as they've existed. They address the problem by setting benefits low enough to be paid by conservative investments, which is something else that most public pensions aren't likely to do, but there are some exceptions. My county is part of a tri-county organization that doesn't offer pensions. Instead, the counties annually fund deferred annuities for employees. That way, the benefits travel with the employees and the counties do not have long-term responsibility for the program. The benefits are less generous than those offered by other counties, but they're also better funded, and the annuity companies don't need to take on added risk to make good on their contractual obligations.

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*Got a question or comment? You can contact us at* info@hsdent.com.