

HEADLINE: Bond Funds Gone Wild? A Pension-Plan Dilemma

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BODY:

For years now, pension funds have faced a dilemma: The interest rates on their bond assets have fallen to historic lows, while liabilities -- the pensions they pay out to retirees -- have ballooned. As a result, many funds have taken on more risk to boost returns.

In this long-running bull market, adding riskier assets to a portfolio has paid off, but some critics fear pension managers may have gone too far. Chriss Street, treasurer-tax collector of Orange County, Calif., is one such critic, and the object of his concern is his own county's pension fund.

Street was elected treasurer last fall, and joined the board of the Orange County Employees Retirement System in December. For the past six months, he has been trying to convince OCERS that the county's pension plan, which is only 74% funded, has taken on too much risk. OCERS, he charges, has granted bond-fund behemoth Pimco, of Newport Beach, Calif., too much latitude in investing the fund's core bond portfolio, while its allocations to alternative assets such as hedge funds and commodities have grown too large.

"Orange County is in no position to invest in high-risk investments," says Street. "We should be conservative, because we're not playing with the house's money."

OCERS executives disagree, noting in a statement to Barron's that "OCERS is not taking additional risk to boost returns...and is willing to forfeit return for risk control . . . In reviewing the risk-adjusted returns, the portfolio is ranked in the top quartile of the Callan universe [an industry ranking] over the last three-, five-, seven- and 10-year time periods ending March 31, 2007."

Some in the county paint Street as a politician using scare tactics to score points with an electorate that remembers Orange County's notorious bankruptcy in 1994.

Yet, Street raises interesting issues that face many struggling pension plans across the country.

In a recent report, William Wechsler of Greenwich Associates (a Greenwich, Conn.-based financial-research firm) writes: "Public-plan sponsors understand that local governments can't tax their way out of this [under-funding] situation because the numbers are too big. "Instead," he continues, "they are trying to invest their way out of it with more sophisticated strategies. If they are able to generate returns that bring them close to where they need to be today, then the upcoming battles about how to fund their obligations will be later rather than sooner, and less harsh."

Orange County's pension portfolio, which returned 14% last year and 9% in 2005, is about 41% invested in domestic and international stocks, and 35% in fixed-income assets, including foreign bonds and TIPS (Treasury inflation-protected securities). Almost 25% of the fund is in alternative assets -- well above the average public-pension fund's 10.6% stake. Street is concerned about what theoretically is the safest portion of the county's bond allocation, a \$532 million account managed by Pimco.

A core bond portfolio typically invests in dollar-denominated corporate and mortgage-backed bonds and Treasuries, and is measured against the Lehman Brothers U.S. Aggregate Index, which holds only dollar-denominated, investment-grade bonds. Core bond-plus funds, which have grown more popular in the past decade, often invest a portion of their assets in high-yield and emerging-market bonds, and/or derivatives.

OCERS has given Pimco a core bond-plus mandate for more than 15 years, and in December broadened it to allow Pimco to invest in a wider range of securities including currencies, options and credit-default swaps -- although it set limits on the proportion of such assets the portfolio could hold. The fund yielded 5.3% as of March 31, and average credit quality was double-A-plus.

The potential problem with core bond-plus funds, critics say, is that the emphasis may be shifting to the "plus." In general, "the level of risk in core bond portfolios has increased over time," says Richard Ennis, chairman of Ennis Knupp + Associates, a consultant to institutional investors and editor of the Financial Analysts Journal. "They're increasing their exposure to areas that are opaque, and there's leverage involved. There is no way [for an outsider] to measure the risk being taken."

OCERS executives explain in an e-mail to Barron's that their updated guidelines "reflect the changes in the fixed-income markets and provide clarity as to the investable universe. For example, interest-rate swaps were approved, as the swap market, in many cases, is more liquid than the U.S. Treasury market."

It added that the pension board "has received education on derivatives" from various parties, and that "OCERS has confidence in Pimco's experience in the fixed-income markets and its conservative and disciplined investment process."

As of March 31, the OCERS core bond-plus portfolio had \$275 million invested in short-term securities such as commercial paper and CDs. Another \$241 million was in long-term debt, mostly triple-A-rated mortgage-backed securities. The portfolio had relatively few corporate bonds or cash Treasury bonds. Instead, it had futures positions in various short-term markets around the world, in an apparent bet that rates would fall worldwide.

The largest of these positions was in Eurodollar futures, with a notional value of \$4.9 billion. The fund also had sold short \$88 million worth of two-, 10- and 30-year Treasury futures. Other positions included swaps, options and investments in currencies such as the Brazilian real and the Polish zloty.

"[It is] predominantly an arbitrage portfolio that is tremendously involved with swaps, options and futures," alleges Street. "You've converted a core bond portfolio into something entirely different."

In a statement, Pimco says that it has had "a 25-year relationship" with OCERS to manage pension assets, and has used derivatives in its fixed-income portfolio "for approximately 20 of the 25 years." The firm notes that it employs derivatives in the OCERS portfolio "for substitution, hedging and overall yield-curve and duration management; our use of derivatives does not create economic leverage."

Pimco says portfolio volatility has been commensurate with the Lehman Aggregate since it began working with OCERS, while "tracking error" has been near 1%. "We will continue to manage these fixed-income assets prudently and consistent with OCERS' approved investment guidelines," it adds.

Pimco is known for using the futures market to get interest-rate exposure in lieu of simply buying Treasury bonds -- an approach that requires little cash but creates leverage. In the case of OCERS, the firm may be using Eurodollar futures to create the equivalent, or synthetic, of a two-year Treasury note. Investing in Eurodollar futures requires only a minimal deposit: about 0.5% of notional value, or in this case, about \$25 million.

The Eurodollar position contributes about two years of duration to the portfolio's 5.8-year duration. (Duration is a measure of a bond's interest-rate sensitivity.) To create the same amount of duration with a two-year Treasury note, the portfolio would have to buy \$500 million of notes. Using Pimco's approach, it still can have \$475 million remaining with which to buy other securities.

Eurodollars are considered among the most liquid and least risky derivatives. A one-percentage-point move in the Eurodollar futures could mean a gain or a loss of about \$12 million, or 2%, in the overall portfolio. On most days, Eurodollar futures move by only 0.01 to 0.10 of a percentage point. Every night the position is settled, and either cash comes into the account to reflect the gain or OCERS ponies up cash to compensate for the loss.

The problem with this arrangement lies in the possibility that OCERS could be left holding not an actual Treasury bond but an obligation to the Chicago Mercantile Exchange in the event that the markets seize up. While Street, the county's Treasurer, acknowledges that the failure of an exchange is a remote possibility, some large U.S. bond investors with whom we spoke cast the issue more

philosophically. They believe that having exposure to financial exchanges in the case of Eurodollar futures, or banks and brokerage firms as counterparties in the case of interest-rate swaps, may be inappropriate for a so-called core bond portfolio, particularly one managed for the benefit of public pensioners.

"The core bond portfolio should [act as] an anchor for the entire pension fund," says Street, adding that it should not be so complex as to require a "model" to understand.

"Even the best models can fail," he says. "Wall Street is a graveyard of geniuses."

Street also takes issue with a \$507 million TIPS portfolio Pimco manages for OCERS. It holds more than \$1 billion of Eurodollar futures, as well as numerous swap contracts, corporate bonds, mortgages and a dash of foreign currencies. These instruments, he argues, "don't reflect the stated purpose of the asset allocation."

OCERS executives note that the fund must have at least 80% of its exposure from TIPS and can invest the remainder in other assets, depending on market conditions.

At Street's urging, the Orange County Board of Supervisors hired Strategic Investment Solutions, a pension-consulting firm, to review and report on OCERS' asset allocations, investment policies and procedures, and investment-manager selection and monitoring. The firm is expected to deliver its assessment in about three months.

Given the historically robust performance of the county's pension fund, it is hard to argue that Orange County has been hurt by liberalizing Pimco's mandate and taking on more risk. If markets turn, however, some pension funds that have embraced riskier assets may long for the good, old days of plain-vanilla bonds.