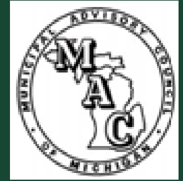
Mac Quarterly Newsletter
Municipal Advisory Council of Michigan

Buhl Building 535 Griswold, Suite 1850 Detroit, Michigan 48226
Phone: 313-963-0420 800-337-0696 FAX: 313-963-0943 Email: mac@macmi.com Internet: www.mi-macsite.com



SPRING 2014

SPRING CONFERENCE

Courtesy of
The MAC & Bond Club of Detroit
May 21, 2014 3:00-4:30pm

PERSPECTIVES ON DETROIT'S BANKRUPTCY:

What it means for Michigan Local Governments and their debt so far - with a Panel Discussion Featuring

Amanda Van Dusen, Principal and Leader at Public Law Group

Timothy Fusco, Principal, Bankruptcy and Work-Out Group at Miller Canfield, Michigan Counsel to City of Detroit

Jane Ridley, Senior Director and Analytical Manager, U.S. Public Finance, Standard and Poor's, Chicago

Register Today: 313-963-0420
Offered at VisTa Tech Center, Schoolcraft College
Livonia, Michigan

MAC Update from Director Jim Bickley

We all know that the new issue market has been a little weak, but the staff at the MAC has been busy improving data integrity, validating outstanding debt and developing new ways to display information.

Maintaining a system with nearly 9,000 debt issues spread among 2,800 issuers is a challenge to say the least. Making sure that we learn of new issues in a timely manner has also been a challenge. See *MAC* Page 9

National Pension Crisis - PFM Report

Psst. Did you hear? Pension financing is in a bit of a pickle at the state and local level. Add to it that most Americans have saved precious little to "fund" their own retirement and the issue is fast ballooning into something larger and if unstopped, will become a crisis, *too big* to ignore.

The PFM Group has studied state and local pensions and published a report late 2013. Asked about the impetus to write the report, John White, chairman and former chief executive of PFM said, "We do a lot of work for clients on these issues and decided to take what we know and look at the bigger issue in general terms, and consider how we might address pension shortfall concerns." See Next Page.

Hedge Funds

There are thousands of hedge fund investors. The market itself consists of $2.5 trillion in assets and twenty top investors hold 9% or $223 billion of the pie. The investment market dynamic has made a remarkable shift in the past 10 to 15 years. In the beginning, college endowments were the main participants, or perhaps a foundation or group of wealthy families. Today Abu Dhabi and China lead the top 20, with the Texas County & District Retirement bringing up the rear. Institutional holdings like Harvard Management, Massachusetts Pension Reserves and the Pennsylvania Public School Employees which appeared in a top-20 list in 2012 dropped out last year. See *Hedge Funds* Page 10.

The Great GASBs 67 & 68

Coming to a Municipality Near You

The Government Accounting Standards Board approved two statements aimed at improving the accounting and financial reporting of pensions by state and local governments and pension plans.

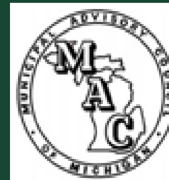
GASB Statement No. 67 Financial Reporting for Pension Plans addresses financial reporting for state and local government pension plans.

GASB Statement No. 68, Accounting and Financial Reporting for Pensions, sets up new accounting and financial reporting requirements for governments that provide their employees with pensions.

See *GASB* on Page 5

Mac Quarterly Newsletter
Municipal Advisory Council of Michigan

Buhl Building 535 Griswold, Suite 1850 Detroit, Michigan 48226
Phone: 313-963-0420 800-337-0696 FAX: 313-963-0943 Email: mac@macmi.com Internet: www.mi-macsite.com

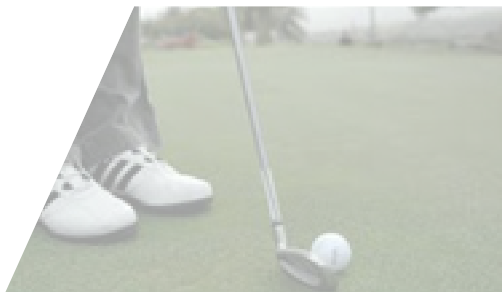


SPRING 2014

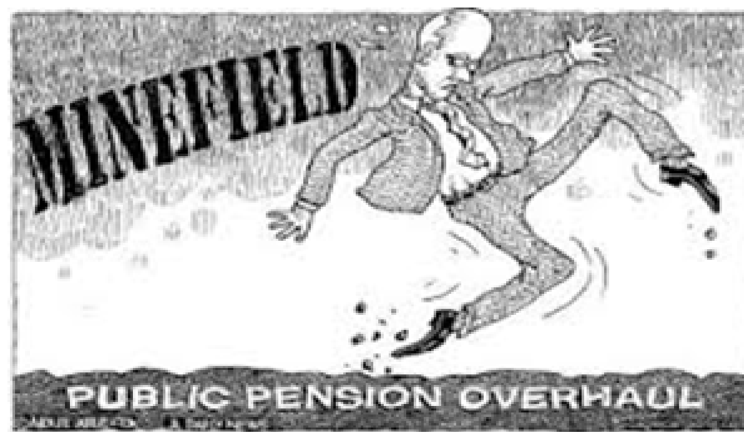
The report noted that retirees through spending really do help the economy. According to White, "Retirement spending is 5.3% of GNP and employs millions of people directly and far more indirectly. There is a tendency to think this is a problem that only affects government employees and state employees. But actually it is a society problem."

FACTS YOU NEED TO KNOW

There are a number of industries aimed at the retiree market: nursing homes, retirement, hotel and other travel industry businesses. Retirees spend money in these markets and if there is no money, there is no business going forward. Where retirees live and spend creates a ripple throughout the economy, a sizeable one.



The report said retirees hold $20.8 billion in invested capital. Some is in the form of pension funds, or 401(k) assets. What happens if it is not replaced as it is drawn down by retirees who need it in their golden years? Where will new capital for expanded growth come from? Pension funding is a source of capital for many new businesses. Ditto for the mortgage industry; it too gets capital from pension funding.



A three-legged stool has oft been used as the poster child of a happy retirement made up of: pension, savings and social security. The number of employees with pensions has declined significantly and simultaneously the prospect of living beyond 80 years of age is real. The statistics are scary: less than half of 55-64 year olds have any real retirement savings according to PFM and of those that do, the average is a mere $120,000.

"Of course, if you eliminate Social Security or Medicare the situation changes. Funding for these programs is under attack, with Medicare more precarious than Social Security. These programs are vital and must stay. They cannot be taken away unless retiree income is increased significantly," avows White.

And doing nothing is not the answer either. White said, "We need a balanced solution to the problem. Simply eliminating pensions is not the answer. A combination of reforms is required. State and local governments have unfunded pensions and that is doing a disservice to retirees." What's needed said White is to "promise to continue pension funding in exchange for reform in some other area," and then to make "the commitment to follow through on that promise, to uphold the bargain." It might take the form of a hybrid pension scheme: combining defined benefit and defined contribution, but whatever is promised must be upheld.

Rating agencies going forward are beginning to look at pension obligations as similar to other forms of debt and it will encourage mu-

Mac Quarterly Newsletter
Municipal Advisory Council of Michigan

Buhl Building 535 Griswold, Suite 1850 Detroit, Michigan 48226
Phone: 313-963-0420 800-337-0696 FAX: 313-963-0943 Email: mac@macmi.com Internet: www.mi-macsite.com

SPRING 2014

nicipalities to revamp how they fund worker retirement, sooner rather than later. “They will have to,” said White, “because at some point there will be no choice. Eventually it affects the cost of borrowing and ability to borrow.”

Some of the solutions the PFM report highlights border on the creative side: cost sharing strategies, monetizing assets and other methods are options. PFM tried to maintain balance in the report. “We really tried to state facts,” said White.

White suggested that one workable solution to pension shortfall issues might be a hybrid plan combining a defined benefit pension with a defined contribution component, where “everyone has skin in the game and makes a sacrifice. The problem with these types of solutions is that employees agree to it then the defined benefit portion ends up not being funded and a bigger problem surfaces.”

The PFM study considered 12 states: California, Connecticut, Florida, Georgia, Illinois, Maryland, Massachusetts, Ohio, Pennsylvania, Texas, Washington and Wisconsin. The experience seen by those states was extended to the larger more national concern. States selected had a large number of state employees, large populations, and “state funded capital spending on infrastructure and significant unfunded liabilities [unfunded accrued actuarial liabilities or UAAL],” said White. What those states experience, PFM believes applies to the broader nation as a whole—to other states. “We did not want to assign blame,” said White. “The study was meant to be educational.”

Some states have made improvements to their pension funding. For example, the report notes that between 2009 and 2012: 30 states increased employee contributions; 31 states increased age or service requirements for new hires; 21 states made changes to post-retirement cost of living adjustments and 15 states reduced benefit multipliers. In addition 11 states now offer a hybrid retirement plan combining defined benefit with defined contribution.

ENGINEER A PARTIAL “FINANCIAL” SOLUTION

Pension shortfalls cannot be fixed solely by pen or brilliant financial magic. But there are steps government can implement to offset pension underfunding to make its “holes” whole again. Any move will require diplomacy and willpower to carry through on promises in exchange for compromise. PFM’s report said, “A one-time action can be used effectively to reduce an accumulated deficit, but that reduction will only be truly meaningful if combined with systemic change to cure the root causes of the deficit.” To deem any proposed solution a success requires that once implemented, underfunding does not balloon further while maintaining promises to employees.

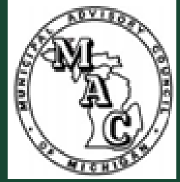
CREATIVE FINANCING: ASSET SALES

One solution discussed in PFM’s report involves the sale of public assets. They noted that governments with large pension deficits often have equity tied up in assets: buildings, utilities and parking garages. It is possible to privatize them which would free up proceeds to fund the pension deficit, particularly when benefits must be provided over a long term (i.e. pension funds). The private sector can often deliver efficient service at a lower price. But doing so necessitates a promise to maintain future funding levels.

“The City of Philadelphia’s Gas Works has an agreement of sale with a utility [UIL Holdings Corporation] to buy it,” said White. UIL’s purchase price is $1.86 billion and “the proceeds are to be put into the pension fund which is underfunded,” he added. It is expected that the proposed sale, which still awaits approval from City Council will put at least $424 million into

Mac Quarterly Newsletter
Municipal Advisory Council of Michigan

Buhl Building 535 Griswold, Suite 1850 Detroit, Michigan 48226
Phone: 313-963-0420 800-337-0696 FAX: 313-963-0943 Email: mac@macmi.com Internet: www.mi-macsite.com



SPRING 2014

the City's pension fund, which currently funded to less than 50% can use the added boost. The Pennsylvania Public Utility Commission must approve the sale before closing.

In another case, the city of Pittsburgh planned to sell parking garages and put the proceeds into the pension fund. Instead, after rejecting a $453 million bid to establish a 50-year lease, it took the annual parking garage revenue and put it toward the pension deficit. They hoped to achieve the same benefits expected from an outright sale; but no changes were ever made to the pension benefits. And today, the funded ratio continues to fall.

In yet another case, highlighted by PFM, "Allentown, Pennsylvania leased the water utility for 50 years to a public authority in return for $211.3 million, of which $160 million was used to reduce the unfunded pension liability. Future rate increases were limited and there was no initial cost to taxpayers. As a result, Standard & Poor's revised Allentown's ratings outlook from stable to positive." Done right, White said asset sales are a good way to go. "I'm a fan of using them to get equity," he said. Besides it is a tough climate to raise property taxes and many programs have already been cut. It gets political.

But, there are difficulties any time reforms are underway. "If you are renegotiating pensions that obtain long run savings, and you are going to sell an asset, do it all at the same time," advises White. Otherwise, he added, "You won't get the money from pension reforms that you expected. Instead it will be used elsewhere and the pension situation will never be righted." To get it right, a solution must be "sufficient, sustainable and affordable as written in the PFM report," said White.

"It seems to us at least that on both the employer and employee side, pension funding is not regarded as compensation and it should be. It really is part of a deal, a contract with employees. From the employer side, it's a case of, 'We give you X in wages and you can expect to receive Y in the form of a pension.' Employees only have the use of pension assets in the future, so they do not see them as current income," said White. There is an inherent attitude of disregard on "both sides of the labor management equation," he said. Pension funding has a cost associated with it and employers must regard and honor the compensation commitment.

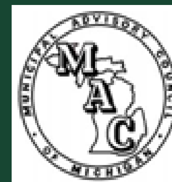
Depending on where you look, pension funding is a mixed bag. Some plans are solid, and funding as a whole is in good shape, while others are severely underfunded.

PFM operates in the middle, situated between government and finance as noted in their report. White said he believes best solutions will involve dialogue here, and compromises. "Everyone must have skin in the game." And he again drove home, "Any reform solution must be sufficient, sustainable and affordable." The PFM report suggested some policy recommendations to create sound pension funding:

- Base pension funding policy on an actuarially determined contribution.
- Build discipline into the policy.
- Maintain equity across generations to ensure that employee benefit costs are paid by the generation of taxpayers who receive services.
- Make employer cost a consistent percentage of the current and expected future payroll.
- Ensure transparency in reporting; make clear when pension plans will be fully funded.

Mac Quarterly Newsletter
Municipal Advisory Council of Michigan

Buhl Building 535 Griswold, Suite 1850 Detroit, Michigan 48226
Phone: 313-963-0420 800-337-0696 FAX: 313-963-0943 Email: mac@macmi.com Internet: www.mi-macsite.com



SPRING 2014

Why Nations Fail
A New Book
from Daron Acemoglu and James Robinson

Daron Acemoglu and James Robinson are brilliant authors. They offer a real look at how economies, built by people, by human capital, either succeed at becoming rich, or are left poor. They evaluate Korea (North and South) and other countries, including Great Britain and of course the United States.

The crux of the book is a look at world inequality and why some nations succeed at driving wealth and others do not. Great Britain and the US are rich. Why? Because power was overthrown and "rights" were then more broadly divided among citizens. Opportunities existed because government was made accountable; it had to answer the citizens. Doing so bore seeds of opportunity.

Schumpeter was a great economist who touted the notion of creative destruction and one of the tenets of **Why Nations Fail** is that those in power fear losing it to "creative destruction", the idea that innovation and capitalism can affect the power base and unseat it. In the end though, it is precisely those in power who prove more dangerous than a poster-wielding protester and his/her friends.

Two combinations that help nations succeed are: great leadership...and perhaps accidental success. When creativity and the destruction it sometimes brings is warmly welcomed, nations have opportunity to flourish. Those without both ingredients will find it harder to do so. The book illustrates the principle by example.

The book follows history including the 16th century African kindgom of the Congo where taxes were abritary...and also looks at border issues between the US and Mexico. The Roman Empire's demise along with that of the Mayan people is also laid out for would-be readers.

The best part: discussion of the Black Death in the 14th century in Europe. Huge amounts of the available labor supply vanished. Where did it lead? And how? History tells the story. Really, the book is about choice. Does society go left or right...or passively float? The decisions ultimately shape what comes next: growth or stagnation.

Admittedly the book is a bit over-the-top when it opines about the American dream. And in some other parts it falls short. Still if it makes you want to sing, "You're a grand ole flag..." or run out and buy a US flag, is that really a bad thing? You be the judge. Available at Amazon.

GASB from Page 1

IMPLEMENTATION DATES

GASB 67
•Effective for plan fiscal years beginning after June 15, 2013 (e.g., FYE June 30, 2014)

GASB 68
•Effective for employer's fiscal years beginning after June 15, 2014 (e.g., FYE June 30, 2015)

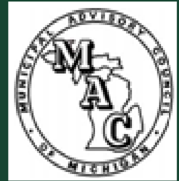
Source www.GASB.org

Michelle Watterworth CPA, in charge of the technical standards department for Plante Moran's governmental practice, and Stephen Blann director of governmental audit quality at Rehmann, discussed some of the details surrounding GASB 67 and 68.

Watterworth said, "The new standards represent significant changes in the way governments calculate and report the costs and obligations of

Mac Quarterly Newsletter
Municipal Advisory Council of Michigan

Buhl Building 535 Griswold, Suite 1850 Detroit, Michigan 48226
Phone: 313-963-0420 800-337-0696 FAX: 313-963-0943 Email: mac@macmi.com Internet: www.mi-macsite.com



SPRING 2014

their pension benefits. For the first time, the true impact offering pension benefits has on financial statements will be visible no matter what type of pension plan an employer offers. This was something not previously transparent, particularly when you looked at cost-sharing employer's financial statements." No matter what type of pension plan a governmental employer offers, they will now measure and record this pension liability. In the past depending on the type of pension offered, financial statements offered varying degrees of information. Now there will be "consistency among all employers in the measurement and disclosure of pension information," she said.

Blann said, "Rules before GASB 67 and 68 were different. But by and large, in Michigan, governments were already using the actuarial methods GASB now requires, so the message coming from actuaries who are actually doing the work has been somewhat consistent. In a sense, Michigan might be ahead of other states."

He added, "Prior to GASB 67 and 68, you could get some strange results." Under the old rules a government with a plan that is only sixty percent funded could still report an asset if it had paid even slightly more than the ARC. Conversely, a government with a 110% funded ratio could still report a liability if it paid less than the ARC. The old rules painted a false picture because they recognized a net pension asset or obligation based on whether the government paid more or less than the annual required contribution, and ignored funding status.

WHAT HAS CHANGED?

Compliance will require changes in how governments calculate and report costs associated with pensions. The purpose is to improve transparency and make reporting more consistent so data can be compared across multiple governments.

GASB 67 revises current standards of financial reporting for most pension plans. This Statement replaces the requirements of No. 25, Financial Reporting for Defined Benefit Pension Plans and Note Disclosures for Defined Contribution Plans, and No. 50, Pension Disclosures.

The primary objective of GASB 68 is to improve pension accounting and financial reporting by state and local governments. It also aims to improve information provided by state and local governmental employers about pension support, provided by other entities. It replaces requirements found in No. 27 and No. 50.

TYPES OF PENSION PLANS

In general, governments offer pensions through defined benefit plans that can be provided from a single employer, meaning pension benefits are provided to the employees of one employer or multiple employers, where the pension provides benefits to employees of more than one employer. There are other types—including cost-sharing plans which will not be discussed here.

The GASB 67 and 68 changes mark a distinct shift from a funding-based approach to an accounting-based approach as they relate to pensions.

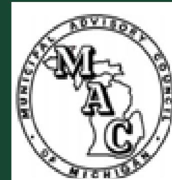
There are two types of compensation employees receive: salaries in the form of paychecks which is earned as work is performed; and deferred compensation in the form of pensions which requires employees meet certain age and years of service requirements before receipt is granted. The latter creates a future obligation to pay pension benefits. In these new standards, GASB has indicated that this future obligation should be recorded as a liability by governments *today* to the extent those benefits have been earned.

When an obligation to pay future benefits exists, and that benefit has already been earned by employees, it is called the total pension liability. If it is more than the related pension plan assets, then there's a net pension liability.

According to GASB, "Governments will now be required to report that amount as a liability in their accrual-based financial statements (for example, the government-wide statement of net position). The pension plan's net position available for paying benefits is to be measured using the same valuation methods that are used by the pension plan for purposes of preparing its financial statements, including measuring investments at fair value."

Mac Quarterly Newsletter
Municipal Advisory Council of Michigan

Buhl Building 535 Griswold, Suite 1850 Detroit, Michigan 48226
Phone: 313-963-0420 800-337-0696 FAX: 313-963-0943 Email: mac@macmi.com Internet: www.mi-macsite.com



SPRING 2014

The Municipal Employee Retirement System of Michigan wrote, "MERS will help members comply with these new financial standards by providing them with their net pension liability number each year in their annual actuarial valuation. With the addition of the NPL, this results in separate pension numbers for three areas: financial accounting statements, budgeting and bonds."

WHAT DOES THIS MEAN?

The change should illustrate a government's financial position (health) more clearly. And yes, in some cases the numbers will tell a different story than they did in years past: some governments will appear weaker. It does not mean their situation has changed; but the reporting has. The ultimate goal is to put pension liability at the same level of reporting with other long term obligations.

MEASURING THE PENSION LIABILITY

The methods of measuring the total pension liability, which is done by an actuary, include three major steps, which have not changed since implementation of the prior standards:

1. Projecting future benefit payments for current employees, former employees and beneficiaries.
2. Discounting payments to present value.
3. Allocating present value over past, present, and future periods of employee service.

Future employment events including age changes, years of service changes, and annual merit increases are included in the calculations. But, unplanned COLAs and other unplanned benefit changes won't be included unless there is data indicating that they are "regular" occurrences.

GASB: DISCOUNT RATE CHANGES

Governments assume a discount rate when performing pension liability calculations. Today, the rate used is equal to the long-term expected rate of return on the investments of the pension plan. With the GASB changes, this rate becomes the starting rather than ending point for calculations. It will only be applied to available pension plan assets expected to be invested using a strategy to achieve "that" return.

Assuming a pension plan's position and contributions (whether from existing or past employees) covers any projected benefit payments for those individuals, it will be deemed okay to use the long term return rate. But if things change and the "net" position employee contributions and investment earnings no longer will cover expected future benefit payments or administrative expenses based on calculations, then going forward a government must discount the projected benefit payments using a municipal borrowing rate—this is a tax-exempt 20-year rate, a rate much lower than the typical "discount rate" mentioned above.

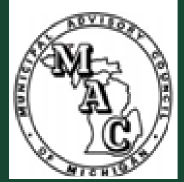
Watterworth explained, "You start with the long term expected rate of return on pension investments. However, that long-term expected rate of return will only be applied to the projected benefits to the extent that plan net assets continue to be available to fund those benefits. Essentially, the actuary creates a cash flow analysis showing what's in the pension today, its net position, then adds investment income, anticipated employer and employee contributions and subtracts investment expenses and expected benefit payments. If this analysis shows that plan net assets are projected to run out before the last retiree dies, the rate applied to present value those remaining benefits is the lower tax-exempt, high-quality 20 year general obligation bond index rate, not the 7.5% or eight percent most are currently using. Using this lower rate will result in a higher pension liability."

Watterworth explained further, "Those entities for which the cash flow calculations show that the plan cannot sustain itself in the long run will be forced to use the lower blended rate today to calculate their total pension liability."

The new standards are attempting "to make it so governments cannot fudge the discount rate. Studies show the discount rate, even under today's standards, is slowly trending a bit downward....[Today it] is closer to 7.75% which can have a big impact going forward. There's a renewed emphasis in looking at this discount rate more closely, particularly given what

Mac Quarterly Newsletter
Municipal Advisory Council of Michigan

Buhl Building 535 Griswold, Suite 1850 Detroit, Michigan 48226
Phone: 313-963-0420 800-337-0696 FAX: 313-963-0943 Email: mac@macmi.com Internet: www.mi-macsite.com



SPRING 2014

has happened over the past six or seven years," said Watterworth.

Blann said, "Michigan's pension funding is around 70% to 80% in round figures. So, we don't expect the blended rate to kick in very often as long as we continue to have decent funding methods." Still, he admits the return rate has declined a bit.

Benefit payments—discounted to their present value—are allocated to past, current and future periods. Something called an entry age actuarial cost method is used to allocate present value; the present value of projected benefits gets matched against the employees' expected periods of employment. It all starts when employees first begin to earn benefits.

Calculating Pension Expense

Net pension liability could significantly change every year, as it depends on what the plan earns, the mix of investments, changes in employee counts and compensation and pension liability interest along with several other factors.

The ARC

Prior standards seemed to focus on the annual required contribution (ARC) and the employers' contributions relative to ARC. A liability only appeared on the employer's balance sheet to the extent that a contribution of an amount equal to the ARC was not made by the employer. Under the new standards, plans that have a funding policy based on an actuarially determined ARC will continue to have to disclose the ARC, but it will not impact the accounting.

The only mention of ARC in the new standards, "is when it gets to disclosures," said Watterworth. "It is not relevant to the accounting aspect anymore," she said.

However, "In Michigan because of a constitutional requirement ARC is calculated and it stays," said Blann.

Many governments may end up having two actuarial calculations, one for funding purposes, to calculate the ARC and another for accounting and financial reporting purposes. For funding purposes, employers may end up staying with the old standards and calculating the ARC on that basis. In most cases Watterworth said using the new standards to compute the ARC will result in significantly higher contribution rates as "most governments will see lower funded ratios."

The lower funded ratios are mainly a result of the requirement to change the asset side of the equation to market value. "Under old standards, there could be differences between the actuarial smoothed asset value and the market values of assets. Some communities amortizing losses from 2008 had smoothed asset values which were higher than the market. This caused higher funded ratios," explained Watterworth.

With the new standards, pension expenses should be better matched with the period in which "benefits" are earned.

Pension Expense Calculations

There are changes in how pension expense is calculated. If changes in net pension liability occur, what caused the change will be reported in the period of occurrence. For example, if there are changes in benefit terms or changes in interest in the total pension liability, these must be reported in the period of occurrence.

When asked, a spokesperson for MERS wrote, "We are dedicated to helping our municipalities understand the changes that are going into effect and how it impacts them." One of the ways MERS is assisting municipalities, is through a resource page available on their website which includes information on unfunded accrued liability and GASB. "Educational sessions are [also] being developed for regional meetings and webinars, and our regional managers are available for employer questions and concerns," MERS added.

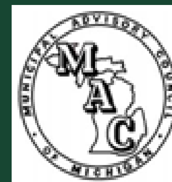
MERS does not take a stance regarding the new GASB statements. Their role is mainly to assist members with understanding and implementing the standards which they follow closely. "Our goal is to ensure our customers fully understand the changes, their impact and where they can find the information needed to satisfy these changes," noted MERS. And they work hard to provide the information and resources their customers need "to assist them in explaining their plan's status and options they have for long-term sustainability."

Mac Quarterly Newsletter

Municipal Advisory Council of Michigan

Buhl Building 535 Griswold, Suite 1850 Detroit, Michigan 48226

Phone: 313-963-0420 800-337-0696 FAX: 313-963-0943 Email: mac@macmi.com Internet: www.mi-macsite.com



SPRING 2014

Rating Agencies

Watterworth said rating agency Fitch does not expect a significant level of rating changes to occur in light of the new standards because they already accounted for pension risk in financial statements. New pension standards will give better information about pension funding and benefit levels going forward, said Watterworth.

Moody's has their own computation of this liability with the primary difference being that they look at the discount rate differently. Moody's believes the discount rate, even if blended, is too high. They use a long term taxable bond index rate which obviously results in a higher liability.

Around the Corner: A Teaser

In closing Watterworth said GASB is taking a close look at GASB 43 and 45, which covers other post-employment benefits (healthcare). Expect any new standards to look similar to No. 67 and No. 68. The aforementioned offers a cursory overview of standards requirements and is not exhaustive in detail. To learn more check out the following GASB links:

1. GOVERNMENTS IN SINGLE EMPLOYER DEFINED BENEFIT PENSION PLANS
2. GOVERNMENTS IN AGENT MULTIPLE-EMPLOYER DEFINED BENEFIT PENSION PLANS
3. GOVERNMENTS IN COST-SHARING MULTIPLE-EMPLOYER DEFINED BENEFIT PENSION PLANS
4. GOVERNMENTS IN DEFINED CONTRIBUTION PENSION PLANS
5. SPECIAL FUNDING SITUATIONS
6. PENSION PLAN REPORTING
7. COMMON MISPERCEPTIONS ABOUT THE NEW STATEMENTS

MAC Continued from Page 1

I'd like to highlight just a few things we've done to make the MAC System better—things that can really benefit you.

First, have you explored the County Debt Report? This report provides easy access to summary debt information for each county in Michigan. It also provides population and taxable value *and* it offers the ability to drill down to each municipality and school district within the county—yes, now all of the cities, townships, villages and school districts are displayed as a group. You can also compare direct and overlapping debt for communities and school districts on a per capita and percentage of taxable value. You will find the report under the "Report Tab"; once there select "County Debt Report" and highlight any county name. The detail for political subdivisions will be displayed.

We've changed the Home Page to let you know what new issues are on the calendar. Some basic information on the debt is presented. Select "MAC Report" to display the report. Also, you can view bid results for competitive deals in spreadsheet format for 15, 30, and even 60 days.

If you'd like to receive this information by email each Friday morning—let us know.

The MAC made a major press announcement last fall about the data sharing arrangement with Munetrix. Have you tried it using the MAC system for access? We think it is a big deal. Summary financial data is available for virtually any community or school district right from the MAC Issuer Page. Within the system, select the issuer you are interested in and the Munetrix logo will appear; next select the logo and you will be transferred to that issue on the Munetrix website.

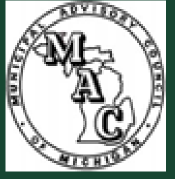
The reports and information are only as good as the data in the system. We have been hard at work reviewing financial audits and comparing the Long Term Debt Footnote to what is in the MAC System. All of the county debt reviews are complete and approximately two hundred of the municipalities with the highest amount of debt outstanding are complete. Additionally, all of the ISDs and school districts are complete.

Now don't think we've overlooked the municipalities. We currently provide about 200 overlapping debt reports and charge just $100. If members provide the reports to issuers they remit the $100 fee. We would like these municipalities to use the new MAC website: www.macmuni.com. In addition to overlapping debt reports (that can be run on demand as of a specific date), the issuer gains access to a listing of their direct debt, indirect debt, debt service reports and the MAC Newsletter. The fee to the municipality is just $100 for the year!

Mac Quarterly Newsletter
Municipal Advisory Council of Michigan

Buhl Building 535 Griswold, Suite 1850 Detroit, Michigan 48226

Phone: 313-963-0420 800-337-0696 FAX: 313-963-0943 Email: mac@macmi.com Internet: www.mi-macsite.com



SPRING 2014

Yes, all this for $100—for an entire year.

Our Director of IT, Sean Fulcher, has been busy installing a new server to ensure we can serve our members efficiently and reliably. In addition, all member reports have been rewritten to run faster.

In closing we'd like to ask you, our members, to please:

1. Provide MAC with new information as timely and completely as possible.

2. Let us know how we can improve and meet your needs.

Remember, the MAC is here for you—and will continue to work hard to meet your needs.

Sincerely,

Jim Bickley
MAC Director

To view the latest GFOA training schedule visit: **TRAINING**

HEDGE FUNDS FROM PAGE 1

Because sovereign wealth funds like Abu Dhabi are not managing other people's money—they can focus intently on specific complex investment strategies; and it makes them quite welcomed among hedge fund operators.

About Hedge Funds

Hedge funds do serve a purpose. They are an alternative investment vehicle used to improve retirement security and help build communities. They offer a "niche" way to balance risk and reward. And they are not regulated by the Securities and Exchange Commission.

Hedge funds purchase normal securities—stocks, bonds and real estate for example. But, unlike mutual funds, they also participate in the derivatives world, and use long-short strategies of buying and selling to optimize returns. Another tactic, employing leverage, investing with money borrowed, to offer potentially significant returns, which on the downside can (and sometimes does) result in significant losses. Their name, hedge, comes from the offsetting techniques they employ: gains against potential losses. It's all about managing risk.

Largest Hedge Fund Investors

Sovereign Wealth Fund
Abu Dhabi Investment Authority holds $627B in assets with $47B in hedge funds.

Public Pension – United States
Texas Teachers, Austin holds $117B in assets with $9.4B in hedge funds.

Endowment
University of Texas, Austin holds $30B in assets with $7.9B in hedge funds.
Source: Hedge Fund Alert November '13

While it's harder to sell asset shares of a hedge fund, they can indeed be sold after a lock-up phase, which is a set time period after purchase. Similar to mutual funds, a net asset value (NAV) based on the share price is calculated once per day; stock prices fluctuate throughout the day.

Hedge Funds vs. Mutual Funds

Hedge funds are pooled assets and hedge fund managers receive a management fee and a return percentage fee relative to net asset values calculated; usually the fund manager has skin in the game; his /her own assets are risked along with the investor assets. If they don't participate, it can be a bad sign. There's no limit to what fees can be charged either as the SEC does not regulate them. Mutual fund managers however are held to a fiduciary responsibility and the National Association of Securities Dealers Inc. sets forth strict guidelines regarding disclosures and limits on compensation. Some investors like the structure of hedge fund management, because compensation is based on performance.

Mac Quarterly Newsletter
Municipal Advisory Council of Michigan

Buhl Building 535 Griswold, Suite 1850 Detroit, Michigan 48226
Phone: 313-963-0420 800-337-0696 FAX: 313-963-0943 Email: mac@macmi.com Internet: www.mi-macsite.com

SPRING 2014

However, it sometimes leads to pursuing riskier investments to obtain higher returns which ultimately lead to more investor risk.

Pension Plans: Private & Public

Recently many pension plan trustees have increased investment in alternative funds, consisting primarily of hedge funds. Why do pension funds invest in hedge funds? Here's part of the answer. Even after fees which can be whopping, pensions often earn more money on these investments than they otherwise could. And this in turn means school districts and local governments characterized by defined benefit pension plans which must make up shortfalls in years where investment earnings don't keep up with retiree withdrawals, come out ahead. So while yes, fees are higher, so are returns (hopefully), and in the end, it saves public pension plans from having to "rob Peter to pay Paul" as an investment advisor put it.

The trend of increasing alternative investments within pensions continues. According to a report by Cliffwater LLC, an adviser to institutional investors, from 2006 to 2012 state pension funds more than doubled their allocations to alternative investments. This includes private equity, real estate and yes, hedge funds. Totaling almost $600 billion, these nontraditional investments are now 24 percent of public pension fund assets. In the same six-year period, funds reduced investment in stocks to 49 percent from 61percent.

Why? A look at the numbers tells a story. In the last 10 years, the average U.S. public pension returned 6.4 percent a year, less than the 8 percent return guaranteed to government employees. To mitigate the strain on state budgets, state pension funds have started to rely on alternative investment schemes in hopes of achieving loftier returns.

According to Cliffwater, it seems to be paying off. Alternative investments, in part made up of pushes into hedge funds, explain the above-average performance of 19 of the 20 top-performing state pension funds over the last 10 years. When pension funds allocated less of a portfolio to alternatives, returns were less too. [Refer to the chart on page 12]

In December 2013, the City of Detroit entered bankruptcy. With word that city pensions would be reduced, alarm bells began to chime across America wherever other public pensions are in force. Decisions made by investment professionals matter. Who wants a repeat of Detroit? Who wants to be Detroit?

To avoid bankruptcy going forward, major cities are beginning to evaluate opportunities for "enhanced investments" in a world of lowered return expectations. In that world, hedge funds are attractive: they can provide a cushion. Typical returns can be higher even net of fees, and there is ample room for diversification. Today they are considered a viable option to increase return, and Michigan too finds them appealing.

Prequin's Hedge Fund Investor Profiles is an online service. It tracks 254 US-based public pension funds investing in the hedge fund asset class. These pension funds have increased their allocation to hedge funds; in 2013 9.3% of total assets sat in hedge funds, an increase from 8.3% in 2012.

The Municipal Employees' Retirement System of Michigan and City of Phoenix Employees' Retirement System have each increased their target hedge fund allocations. Michigan doubled its target from 5% of total assets to 10% 4th quarter 2013; Phoenix moved from a 10% target allocation for solely investing in long/short equity funds, to 15% target to the whole hedge fund asset class.

The Big "If"...But what if the math doesn't add up? What if they are wrong? What if fees are higher and hedge fund returns are not accurate, in fact are lower?

Political writer, David Sirota in a Salon article cited a report that states, "The bulk of U.S. state pension funds praying for an alternatives miracle, buying the hedge fund myth, are doling out huge fees and getting mediocre returns." He pointed to another report that showed that "had pensions steered clear of Wall Street's most risky investment schemes in recent years and simply invested in Treasury bonds, 'their

Mac Quarterly Newsletter
Municipal Advisory Council of Michigan

Buhl Building 535 Griswold, Suite 1850 Detroit, Michigan 48226
Phone: 313-963-0420 800-337-0696 FAX: 313-963-0943 Email: mac@macmi.com Internet: www.mi-macsite.com

SPRING 2014

assets would be more than $850 billion greater than they are today.'"

Sirota called hedge fund investments a "transfer of retirement income to Wall Street." With market dynamics ever-changing, pension funds both public and private, are seeking alternative methods to enhance revenue. And these investments often come at a price; they include burdensome fees buried in small print on a back page.

For example, David Crane a lecturer at Stanford University wrote in a Bloomberg article titled *Public Pension Funds Need to Show the Money* that Pennsylvania's state pension investments include hedge funds, and retirees pay $770 million in fees each year.

Sheelah Kolhatkar wrote an article in the July 11, 2013 issue of Bloomberg, titled, *Hedge Funds Are for Suckers*. In the piece, Kolhatkar noted the poor returns of some of the largest hedge funds. He also said at the time, over eight of the past 10 years, a simple S&P 500 index outperformed the HFRX Global Hedge Fund Index.

But there are winners. Some funds do offer big returns, net of fees and do bolster the returns of pensions [see the chart] when properly employed.

Rank	Public Pension Fund	Annualized Private Equity Return	
		5-Year	10-Year
1	Massachusetts Pension Reserves Investment Trust (PRIT) Fund	9.1%	15.4%
2	Los Angeles County Employees Retirement Association	10.2%	N/A
3	Teacher Retirement System of Texas	6.3%	15.5%
4	Houston Firefighters' Relief and Retirement Fund	9.3%	13.6%
5	Minnesota State Board of Investment (Combined Funds)	7.7%	14.4%
6	Iowa Public Employees' Retirement System	7.9%	14.1%
7	San Francisco Employees' Retirement System	7.4%	13.1%
8	Utah Retirement System	6.2%	13.5%
9	Pennsylvania Public School Employees' Retirement System	6.6%	13.0%
10	Contra Costa County Employees' Retirement Association	7.1%	12.7%

Source: Pension Pulse BlogSpot

DID YOU KNOW

- Globally 65% of hedge fund assets are from institutions. [Source: Prequin Special Report: Hedge Funds pp16, October 2012.]

- In Michigan, the Office of Retirement Services uses four defined benefit plans, a hybrid plan (defined benefit and contribution combined) and two defined contribution plans. In total, 530,000 people participate in the plans.

- As of June 30, 2012, the State of Michigan Retirement System (SMRS) invested $10.86 billion, or about 22% of its $49.56 billion investment total portfolio in alternative investments. [Source: page 1 www.michigan.gov/documents/treasury/FINAL_397236_7.pdf]

View more facts on the next page

Mac Quarterly Newsletter
Municipal Advisory Council of Michigan

Buhl Building 535 Griswold, Suite 1850 Detroit, Michigan 48226
Phone: 313-963-0420 800-337-0696 FAX: 313-963-0943 Email: mac@macmi.com Internet: www.mi-macsite.com

SPRING 2014

Endowments in Michigan

- The University of Michigan endowment was valued at $7.7 billion June 30, 2012. The university invests in alternative investments, $5 billion in all, and $797 million is in hedge funds.

- Michigan State University had an endowment of $2.7 billion in June 2012. A full 25% of a Common Investment Fund focuses on an absolute return. A portion of it too is invested in hedge funds.

"MAC Quarterly" is a newsletter written for Municipal Advisory Council of Michigan members and business associates. If you have questions you would like discussed in the newsletter, please contact the MAC office. We will answer your questions or find an expert to address the topic and share the information with you in a future issue.

BOARD OF DIRECTORS

Chairman
Paul R. Stauder
Stauder, Barch & Associates

Secretary
Bill Terlesky,
Fifth Third Securities

Treasurer
Brenda Voutyras
Stifel Nicolaus

Trustees
Rebecca Gersonde,
Heber Fuger Wendin

Chris Manown,
Raymond James & Associates, Inc

Cindy Higgins
Comerica Securities

Joel Piell
Miller Canfield

MAC STAFF

Director
Jim Bickley

Director of Information
Technologies
Sean Fulcher

Information Specialists
Jacqueline Brown
Bernadette Garr
Debbie Prunkard

Newsletter – Content
Writer/Publisher/Editor
Madeleine Miehls
www.WriteSideOfBusiness.com