

States Begin to Address Long-Term Pension Obligations in Era of Fiscal Austerity Headlines the Bigger Risk to Municipal Bonds



Over the past few months, the municipal bond market has come under significant pressure as US public finance continues to capture media attention. While the headline risk is real, we challenge the validity of the underlying arguments regarding the creditworthiness of states and municipalities. In particular, we do not agree with predictions of widespread bond defaults and emphatically counter claims that state pension liabilities may be the impetus for such an outcome.

The majority of reports today fail to distinguish current operating deficits from longer-term pension liabilities. The media is indiscriminately grouping largely recession-related fiscal problems with longer-term obligations such as pension obligations and retiree healthcare costs. While it may be true that the current fiscal crisis and struggle to maintain necessary services in the immediate term is causing some municipalities to focus on short-term obligations at the expense of longer-term obligations, the reality is that states and localities have many years and various resources available to address pension underfunding — and many have already taken the initial steps toward pension reform. In fact, we would argue that current operating deficits will be resolved as the economy improves and that the recent Great Recession has actually shed light on the pension problem in such a way that, ultimately, may result in meaningful long-term structural reforms and improvements. This *ViewPoint* focuses primarily on pension plans and the options available to states to address unfunded pension liabilities.

Background

Pensions garnered broad attention in February 2010 when the Government Accounting Standards Board (GASB) proposed changes to the assumptions and methodology for calculating municipal pension funding status. In particular, GASB proposed that municipalities be required to both lower the discount rate and shorten the amortization period for unfunded liabilities. According to GASB, pension plans are assuming average investment returns of 8% (see Figure 1 on following page), which it considers too optimistic. GASB attributes the overstatement in many plans' funding statuses to these aggressive return assumptions. In addition, most pension plans amortize unfunded liabilities over 30 years; GASB recommends an adjustment to 15-20 years to reflect the remaining employment period in specific plans. Assuming these proposals were adopted, the reported funding status of many plans would decline dramatically. An updated GASB proposal is expected by the second quarter of 2011, with final rules for implementation anticipated in 2013 and beyond.



Barbara Novick, Vice Chairman, is head of Government Relations and Public Policy



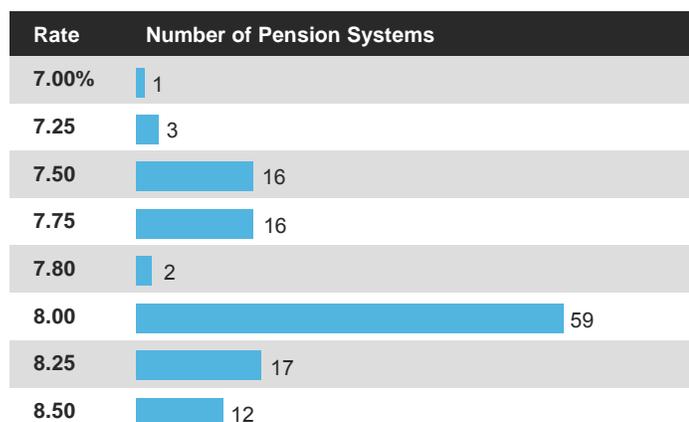
Peter Hayes, Managing Director, is head of the Municipal Bonds Group within BlackRock Fundamental Fixed Income



Joseph Pangallozzi, Director, is a credit research analyst within the BlackRock Municipal Bonds Group

Figure 1: Pension Plan Return Assumptions

Assumed annual rate of investment return of many of the largest US public pension plans



Sources: National Association of State Retirement Administrators; National Council on Teacher Retirement; *The Wall Street Journal*, March 23, 2011.

Since the release of the GASB proposal, numerous prognosticators have predicted a rash of municipal defaults. While the basis for these forecasts centers largely on current operating deficits, they also have brought significant attention to the funding status of pension obligations of various states. The consensus is that neither the Senate nor the House of Representatives is inclined to bail out any states. As a result, several parties have recently lobbied Congress to pass a law enabling states to declare bankruptcy. These bankruptcy advocates invariably cite the need for states to gain control over pension and healthcare benefits. Under the proposal, states would use bankruptcy as a way to renegotiate contracts with union employees, and would also change retiree benefits. Interestingly, no governors have asked for such measures. Furthermore, at the National Governors Association meeting in February 2011, the governors expressed concern that the mere proposal of a new bankruptcy law has already increased their financing costs. Subsequently, they appealed to Congress for an explicit repudiation of the idea.

Given the concerns around consistency and transparency, the Public Pension Transparency Act was introduced by Representatives Devin Nunes (R-CA) and Paul Ryan (R-WI) in December 2010. This Act would require states and municipalities to disclose financial information on public pensions to the Treasury and the public. Non-complying governments would be stripped of their tax-exempt bonding authority. As proposed, this bill would also ban a federal bailout of state pension plans. While the push for improved disclosure is a positive development, it appears unlikely that the Federal government will provide assistance to states or cities in the form of bailouts. Regardless of whether the bill becomes law, it reflects the broader need for pension transparency and reform.

The rating agencies also published reports in January and February 2011 addressing the pension obligations of municipalities. In its report, entitled "Combining Debt and

Pension Liabilities of U.S. States Enhances Comparability," Moody's announced a more formal approach to factoring in bonded debt and unfunded pension obligations as a measure of a state's total obligations. The Fitch report, entitled "The Reporting of U.S. State and Local Government Pension Obligations," addressed the challenges of comparing one fund to another due to "the wide range of permitted assumptions and methods" and recommended "standardizing some of these pension variables." Both agencies have indicated that they would begin recalculating states' debt burdens by factoring unfunded pension obligations into their ratings calculations. As such, pension liabilities would no longer be treated as "soft" obligations. While we could envision some negative rating

Timeline of Major Headlines

February 2010

- ▶ GASB proposes changes to pension funding assumptions and methodology.

September 2010

- ▶ Wall Street analyst Meredith Whitney releases report predicting widespread municipal bond defaults.

November 2010

- ▶ Former House Speaker Newt Gingrich makes speech requesting new law to enable states to declare bankruptcy.

December 2010

- ▶ Public Pension Transparency Act introduced to improve transparency into pension funding status.

January 2011

- ▶ Moody's publishes report, combines bond indebtedness and pension obligations as a measure of fiscal strength (or weakness).
- ▶ Illinois Governor Pat Quinn signs legislation temporarily increasing the state income tax rate by 67% to close budget gap. State is constrained in its ability to make actuarially recommended pension contributions.

February 2011

- ▶ Fitch releases report noting that lack of consistency makes it difficult to compare funding status across pension plans.
- ▶ Wisconsin Governor Scott Walker announces intentions to end collective bargaining for state public employees.
- ▶ Illinois issues \$3.7 billion pension obligation bond with proceeds earmarked for Illinois Teachers' Retirement System, Illinois State Universities Retirement System and Illinois State Board of Investment.

March 2011

- ▶ Ohio becomes the largest state to impose sweeping reforms on public-sector unions.
- ▶ Wisconsin passes law to restrict collective bargaining rights for most state workers (although a judge subsequently issued a temporary stay on implementation).

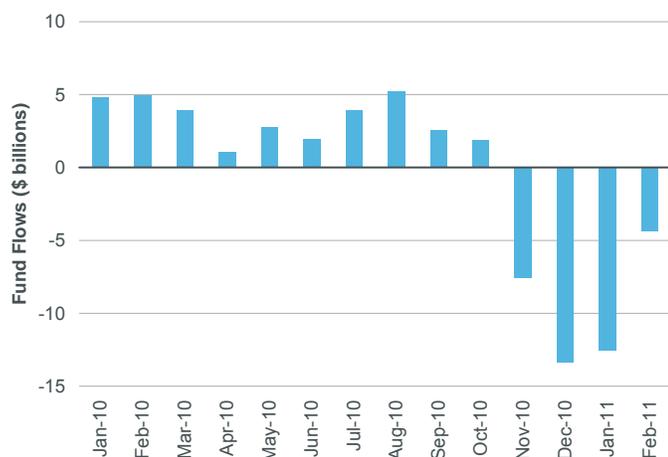
action for states that do not address pension underfunding issues, both agencies indicate in their reports that they do not expect to make widespread ratings changes. Interestingly, Fitch points out that local governments are responsible for a major portion of the underfunded pension liabilities reported for states. For local pension systems that are critically underfunded, have a high ratio of retirees to current plan employees and a high discount rate, maintaining system viability will be especially challenging.

Market Impact

Not surprisingly, the combination of default predictions and the call for a plan that would permit state bankruptcy has weighed heavily on the municipal bond market. After a high-profile default prediction in late 2010, the market suffered a spike in rates that resulted in price weakness and a pronounced steepening of the municipal yield curve. The market volatility was exacerbated by the uncertain future of the Build America Bond (BAB) program, which had been bolstering market technicals since its introduction in 2009. This program ultimately was left to expire at the end of the year. As a result of these developments, the fourth quarter of 2010 represented the municipal market's worst quarterly performance since 1994.

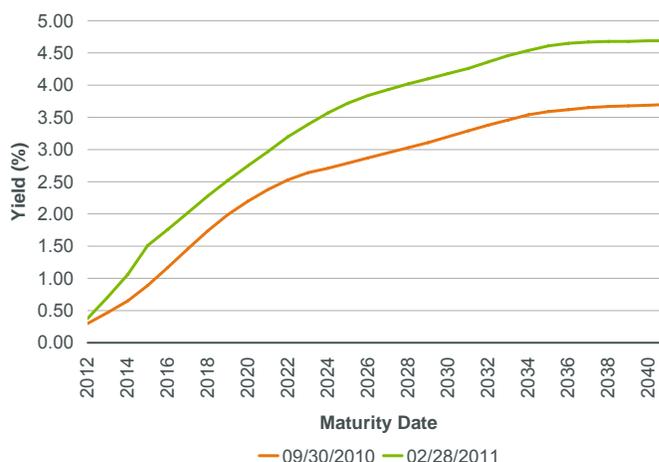
The onslaught of negative headlines also resulted in a loss of confidence among individual investors who buy municipal bonds or shares in mutual funds. From mid-November through year-end 2010, tax-exempt bond funds experienced weekly outflows averaging over \$2.5 billion. Long-term and high-yield funds saw the greatest redemptions, followed by state-specific funds to a lesser, but still significant, degree. The outflows continued in early 2011, applying additional upward pressure on municipal yields. By the end of February, tax-exempt mutual funds had experienced 15 consecutive weeks of outflows. Total assets redeemed since mid-November has been reported at \$39 billion. (See Figure 2 below.)

Figure 2: Municipal Bond Fund Flows



Source: Morningstar, Inc.

Figure 3: AAA-Rated Muni Spreads Widen Amid Negative Headlines, Outflows



Source: Municipal Market Data (MMD).

Overall, the steepening of the municipal yield curve was spurred on by Treasury market weakness, heavy supply and the record outflows. As measured by Municipal Market Data, yields for AAA-rated municipal bonds rose roughly 100 basis points (bps) for maturities 25 years and longer from September 30, 2010, to February 28, 2011. The spread from 2- to 30-year maturities widened from 340 bps to 430 bps over the same period. (See Figure 3 above.)

Headlines Don't Tell the Whole Story

Despite the recent volatility, we believe it is important to distinguish reality from hyperbole and would emphasize the following points in regard to the municipal bond market:

When it comes to defaults, the popular math does not add up. Predictions of a rash of municipal defaults, the most notable calling for 50 to 100 defaults totaling "hundreds of billions of dollars," have been light on details and based on questionable math. Debt service for most of the \$2.9 trillion municipal market is not at risk. Even the market's harshest critics agree that state debt service is well protected. About half of the market consists of very high-quality essential service providers, prominent not-for-profit institutions, dedicated-tax revenue bonds and pre-refunded bonds that are isolated from state budgetary problems. Local government debt — after removing the high yield sectors (tobacco, healthcare, land secured, corporate-backed) — represents just 15% of the market. We agree that outside of high yield, the local government segment is the most vulnerable. However, outstanding debt for the majority of local governments is typically less than \$40 million. The number of defaults would have to be in the thousands to reach the lofty dollar estimates hyped in the media. Based on our analysis, such a scenario is highly unlikely.

State defaults are remote; local defaults are likely to be limited. The municipal marketplace remains a vast universe, comprising more than 100,000 issuers, in which state and city defaults are very rare. State governments cannot declare bankruptcy, and the likelihood of default on general obligation (GO) debt by any state remains extremely remote. Local governments have a higher risk of default and some do have the ability to declare bankruptcy (in only 26 of the 50 states). Even so, for many reasons — economic, political and social — we expect bankruptcies to be minimal and isolated to mismanaged or weak credits. As demonstrated in the cases of Harrisburg, PA, and Nassau County, NY, most states have strong intervention measures that would likely come into play before a locality could declare bankruptcy. However, the worst underfunded pension systems could tip the weakest local credits — such as those of rust-belt areas with high legacy costs — into bankruptcy, depending on the level of state intervention.

Fiscal flexibility should allow states and most local governments to improve pension funding over the long term. The Rockefeller Institute reports that overall revenue collections in 41 states grew 6.9% from fourth quarter 2009 to fourth quarter 2010. If this preliminary figure holds, it would represent the fourth consecutive quarter of year-over-year revenue increases and the largest increase since second quarter 2006. At the same time, the National Association of State Budget Officers notes that state general fund spending has declined in real terms for an unprecedented three consecutive fiscal years, with a 9% drop noted in fiscal year 2010. The improved revenue picture should make it easier for governments to start funding more or all of their ARC (annual required contribution) payments. One recent report noted that, “even after the worst market crash in decades, state and local plans do not face an immediate liquidity crisis; most plans will be able to cover benefit payments for the next 15-20 years.”¹ Another study shows states running out of pension money between 2022 and 2030, depending on average returns.² Many avenues are available to avoid this fate. (See “Managing Pension Obligations: The Options” on page 6.)

The municipal bond market has a history of low defaults. A Moody’s default rate study released in 2010 shows a record of strong credit quality among municipal bonds. The report found that only 54 municipal issues defaulted over the period 1970-2009, with 78% of those concentrated in the high yield segments of the healthcare and multifamily housing sectors. Compared to corporate bonds, municipal bonds demonstrated much lower default rates and provided higher recovery values. As highlighted in Figure 4, the default rate over the past 40 years for investment-grade municipals was less than 0.25% compared to more than 2.50% for investment-grade corporate bonds.

Figure 4: Munis Remain a Low-Default Asset Class
Cumulative Historic Default Rates, 1970-2009

Rating Category	Moody’s		S&P	
	Municipals	Corporates	Municipals	Corporates
Investment Grade (IG)	0.06%	2.50%	0.25%	3.76%
Non-IG	4.55%	34.01%	6.75%	27.82%
All	0.09%	11.06%	0.33%	11.38%

Source: Moody’s Investors Service.

Although painful, the late 2010/early 2011 sell-off in the municipal market has been healthy in that it has created an opportunity for investors to purchase tax-exempt municipals at higher yields. Municipal bonds remain attractive compared to many other fixed income assets, given their favorable relative yields and track record of high quality and low defaults. In our view, the current environment could present a compelling buying opportunity in municipal bonds for long-term investors with the ability to weather interim volatility. (See related content and recommendations under “Investment Strategies for Today’s Municipal Markets” on page 8.) Ultimately, BlackRock advocates an approach that emphasizes credit research and selectivity among bonds. Our evaluation of municipal bonds has always included an independent credit review, and the recent volatility reinforces the importance of this approach.

State Pension Liabilities: A Long-Term Challenge, But Action Needed Now

The issue of pension funding clearly has factored into the media’s recent preoccupation with the municipal market and the ensuing headline risk. While we acknowledge that pension liabilities could be a contributing cause of future rating downgrades, we dismiss the notion that long-term pension funding issues will lead to a rash of municipal defaults. As a percentage of current budgets, debt service is manageable for states and the majority of localities. Annual pension contributions typically are not a significant part of government budgets. In some cases, this may reflect underfunding of what is actuarially recommended. Since pension funding is a long-term obligation, many municipalities have chosen to omit or reduce pension contributions in order to fund more immediate service obligations, especially during the recession. That said, lack of pension reform could cause problems in the long run. Heightened transparency in reporting guidelines and the use of consistent standards would be beneficial for investors. In addition, transparency would encourage state and local governments to take actions to improve pension funding, which would have long-term benefits. Regardless, analysis of municipal bonds must consider the unique status of governments as ongoing concerns and recognize that the present financial strain on current budgets is largely attributable to recessionary pressures and not to longer-term liabilities. In addition, many

1 Munnell, Alicia H.; Aubry, Jean-Pierre; and Quinby, Laura, “Public Pension Funding in Practice,” NBER Working Paper 16442, October 2010.

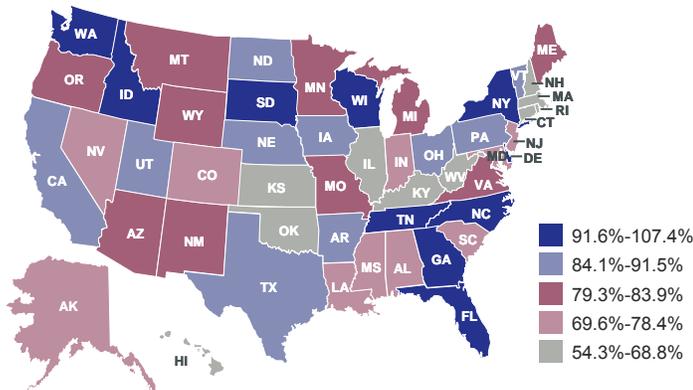
2 Rauh, Joshua D., “Are State Public Pensions Sustainable? Why the Federal Government Should Worry About State Pension Liabilities,” Social Science Research Network Working Paper Series, April 2010. Rauh and Novy-Marx, Robert, “The Crisis in Local Government Pensions in the United States,” October 2010.

states and local municipalities already have taken actions, and many more are considering actions, aimed at addressing the issue of unfunded pension obligations.

Current pension underfunding reflects a multi-year combination of weaker-than-expected investment results, previous benefit enhancements and employers' failure to make required annual contributions. As highlighted in Figure 5 below, many states recorded subpar funding ratios due to these factors. Given the current pension funding status of many plans, as well as the prevailing political climate, investors should expect continued headlines around these issues. According to a recent Wilshire Consulting study of 126 state retirement systems, the ratio of assets to liabilities grew from 65% in 2009 to 69% in 2010, due mainly to the US economy's recovery and improving asset values. While experts differ on the optimal funding status, most would agree that these levels are too low. Of greatest concern are studies predicting that the most severely underfunded plans may deplete their resources over the next 5 to 10 years (cities cited in papers written by Joshua Rauh and Robert Novy-Marx include Boston, Chicago and Philadelphia³).

While the news stories are disconcerting, they do not tend to acknowledge the many tools that governments can use to address underfunding. For example, governments can increase taxes, cut services, reduce benefits or increase employee contributions. A more detailed discussion of various options follows on page 6. Importantly, many states have already begun to take action. In the first 10 months of 2010, 19 states took steps to reduce their pension liabilities, either through cuts in benefits or increases in employee contributions. In 2009 and 2008, 11 and 8 states, respectively, took similar measures. Late in 2010, for example, New York State passed a "Tier Five" category for its retirement system that would effectively reduce pension benefits for new employees. In 2011, a growing number of governors and mayors have spoken out in "state of the state"

Figure 5: Pension Funding by State



Note: 2008 data for all states, except Ohio, which are for 2007.
Source: Pew Center on the States, 2010.

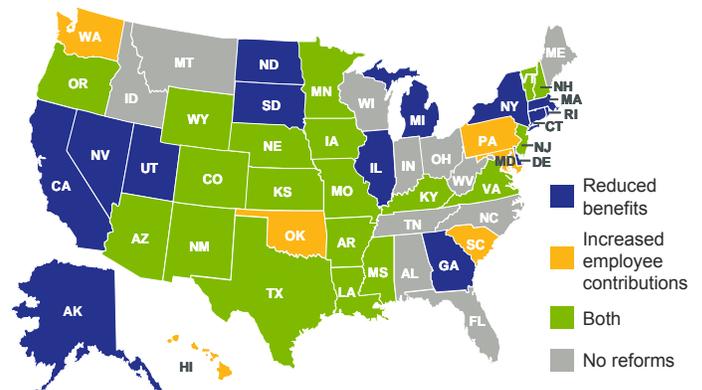
3 Rauh, "Are State Public Pensions Sustainable? Why the Federal Government Should Worry About State Pension Liabilities," and Rauh and Novy-Marx, "The Crisis in Local Government Pensions in the United States."

addresses and similar venues about the need to raise retirement ages, end spiking, eliminate early retirement incentives and curtail double-dipping. We expect to see a series of proposals in fiscal year 2012 budgets. Figure 6 below summarizes states' efforts at reducing pension liabilities.

Managing pension liabilities is an important factor in government finance and is part of our assessment of the overall credit quality of state and local governments. There is a growing consensus that policymakers must address funding mechanisms for these mounting liabilities. Because of various funding and cost control options available to states, we believe unfunded pension liabilities can be reduced significantly over time. *It is the lack of corrective action, not the obligation, that could hurt overall fiscal health and eventually lead to credit deterioration.* Even if various speculators are correct about all or portions of pension payments not being made, it is a "leap of logic"⁴ to assume that debt service, currently and historically low as a percentage of state and local budgets, will not be made in full upon the due date. As state budget problems persist, contract negotiations with unions may also yield concessions with substantial savings, especially if political pressure for such change grows among the electorate.

Without the ability to change contractual agreements with current employees and retirees, governments more frequently have resorted to the threat of layoffs in lieu of renegotiating prior benefits that are now unpaid. It is very possible that either workforce reductions (which reduce the number of years worked and thus accumulated benefits) or give-backs on benefits will reduce retirement costs. Studies predicting pension run-offs cannot easily factor in these changes and, quite appropriately, must consider only the current workforce and assume that existing benefits continue. These reforms are likely to be insufficient alone, but combined actions that raise taxes, cut spending, reduce benefits and add employee contributions can reduce pension underfunding over time.

Figure 6: Pension Policy Reform by State, 2001-2010



Note: Based on data collected by the National Conference of State Legislatures, which has tracked retirement reform legislation since 1999.
Source: Pew Center on the States, 2010.

4 Reilly, David and Denning, Liam, "Jumping Into Munis Requires a Leap of Faith," *The Wall Street Journal*, October 4, 2010.

State Pensions: Key Points

- ▶ While pension liabilities are cause for concern, they will not by themselves generate a rash of municipal defaults.
- ▶ Each state is unique in its funding status, as well as its political climate, fiscal condition and legal framework.
- ▶ Many states have already begun the process of addressing pension liabilities.
- ▶ Local governments have multiple tools available to them to address pension funding issues, although those few municipalities with extremely underfunded pension liabilities may be put under state supervision or seek bankruptcy protection.
- ▶ Initiatives to establish consistent methodology to calculate liabilities and to improve transparency will likely lead to additional corrective actions.

Managing Pension Obligations: The Options

As noted earlier, governments have many options for dealing with unfunded pension obligations, and many measures have been or are in the process of being implemented. Following is an overview of several tools available to municipalities. Each measure must be considered for its impact on taxpayers, retirees, current employees and employees not yet hired.

Raise the retirement age. This approach has been suggested for both existing and/or new employees. Massachusetts Governor Deval Patrick and New York City Mayor Michael Bloomberg have included retirement age proposals as part of a package of fixes. In 2010, ten states — Arizona, California, Colorado, Illinois, Mississippi, Missouri, Michigan, Utah, Vermont and Virginia — raised the retirement age and/or service requirement for normal retirement.

Increase contributions from employees. In 2010, Louisiana, Missouri, Utah and Virginia raised contributory rates for new employees. California, Colorado, Iowa, Minnesota, Mississippi, Vermont and Wyoming have increased rates for current employees.

Increase contributions by raising taxes and fees. While not specifically dedicated to pension contributions, a few states — namely Connecticut, Illinois and Minnesota — have passed or proposed significant tax and fee increases to address budget gaps.

Increase contributions by employers. In recent years, employers have skipped or deferred contributions. In addition, changes in state laws have effectively pushed costs down to counties, cities and school districts. At some point, these employers will need to restart contributions and/or make deferred payments.

Curtail spiking in the final years before retirement. Illinois, Louisiana and Nebraska passed “anti-spiking” laws several years ago that lower eligible increases in salary in the years just prior

to retirement. California and Massachusetts are considering similar measures. In addition, in 2010, eight states authorized a longer period for calculation of final average salary. The states are Arizona, California, Illinois, Iowa, Louisiana, Michigan, New Jersey and Virginia.

Limit, reduce or eliminate automatic cost-of-living adjustments (COLAs). Some states constitutionally protect retiree benefits while others have greater flexibility. Colorado, Minnesota and South Dakota each introduced measures to cut COLAs and are being challenged in court. Several states, including Maine, Oklahoma and Ohio, are actively considering reducing or freezing COLAs; other states, including Arizona, New Jersey and Washington, are considering eliminating COLAs. Washington Governor Christine Gregoire recently proposed repealing automatic COLAs. Likewise, New Jersey Governor Chris Christie recently signed into law measures that will roll back a 9% increase in pension benefits enacted in 2001 and suspend COLA increases for at least three years.

Disallow “double-dipping.” This would prevent an employee from retiring and collecting a pension from one public job while collecting a salary for a new role in the same system.

Means testing for benefits and/or taxing of benefits. While these approaches have not been widely pursued, some states are considering these options. Hawaii and Michigan have proposed taxing pension income.

Bond issuance. Several states and municipalities have issued pension obligation bonds (POBs) to help fund retirement systems. The state of Illinois recently issued a \$3.7 billion POB, which came to market with an average yield of 5.56% and single-A ratings from S&P and Moody’s. The state’s pension plans will need to earn in excess of 5.56% to benefit the pensions’ funding status. Conversely, a lower return would exacerbate the underfunding of the state’s plan.

Adjust asset allocation strategies. Many states have invested pension monies in hedge funds and other alternative investments in an effort to achieve higher returns on their investment. This trend is accelerating.

Freeze defined-benefit plans and move to mandatory defined-contribution plans. While many corporations and the Federal government have taken this approach, at the municipal level, there has been strong support for traditional defined-benefit plans. In the past few years, California, Alaska, Louisiana, Florida, Alabama, Arizona, Kentucky, Nevada, New Hampshire, North Carolina and North Dakota have considered this option as a way of shifting future liabilities to employees. To date, only Alaska and Michigan have implemented this option fully. Utah adopted a hybrid plan in 2010. In part, there has been strong union resistance. However, there is also concern that a switch puts near-term pressure on states to cover the unfunded portion of their liabilities if no new monies are coming into the defined-benefit plan from current employees.

Pension Reform at Work

It is important to understand that each state, which legislates its pension rules, is unique in regard to its overall budget, longer-term indebtedness, pension funding status and sources of revenue, as well as its individual political climate and ability to raise taxes and/or cut costs. Wisconsin and Ohio represent two recent examples of states that have taken a more stringent approach to address both current budget gaps and long-term pension liabilities.

Efforts at pension reform in Wisconsin recently erupted into a political standoff in which 14 Democratic senators fled the state to prevent a final vote. After stripping out budget bills, the Senate was able to pass the bill without a quorum, meaning the presence of the opponents was no longer required for a vote. The Assembly passed the bill and Governor Scott Walker signed it on March 11. The law ends collective bargaining rights for most public employees (police and fire personnel are exempt), except in salary negotiations. The law also raises employee pension

contributions to nearly 6% of pay from current minimal levels and more than doubles employees' healthcare contributions, to nearly 13% of healthcare premiums. (A county circuit court judge subsequently issued a temporary restraining order preventing the law from taking effect. At issue is whether a legislative committee violated the state's open meetings law.)

Late on March 31, a similar measure was signed into law in Ohio, which has the sixth-largest number of public-sector union members in the nation and twice the number of Wisconsin. Like the new law in Wisconsin, the Ohio law eliminates collective-bargaining rights (except for wages) and requires workers to pay more of their health and pension costs. However, the legislation goes further in making it illegal for workers to strike. Additionally, the law affects all public-sector union employees in the state, whereas the Wisconsin law exempts unions representing police, firefighters and state troopers. The Ohio legislation also broadens the factors that can determine layoffs or dismissals and limits the number of vacation days and paid holidays for long-time workers. Teacher contracts can no longer set ratios, such as the number of students per teacher, and pay is based on merit, not necessarily length of service. Ohio is the largest state to impose sweeping reforms on public-sector unions. Similar measures are moving through legislatures in Indiana, Tennessee, Idaho and Kansas.

It is difficult to say whether the erosion of collective bargaining will be part of benefit and pension reform in other states. Various national polls have indicated that a majority of the public still favors collective bargaining rights for public employees. However, in states where legislation is eventually passed, future rollbacks to reinstate collective bargaining may not carry the single-issue fervor that would result in the election of like-minded legislators. The larger point, and one that we have maintained throughout the current fiscal crisis, is this: States will pursue various avenues to balance budgets and achieve longer-term savings through spending reductions, including employee salaries, benefits and jobs. While efforts in some states may arguably go beyond the minimum necessary to remedy current budget gaps, the proposals underscore the determination of governors and legislatures to bring future spending obligations in line with available revenues.

Conclusion

We view pension liabilities as a challenge to governments' long-term fiscal integrity, but maintain that the greatest risk to the municipal marketplace today is in the volatility sparked by headlines and not, as some project, in the likelihood of defaults. Gaps in pension funding were created over the course of many years and will not be resolved overnight. Remedies to the pension problem will likely be painful for public employees, retirees and taxpayers. In addition, credit downgrades could result in especially egregious cases where fiscally strapped governments ignore the problem. Nevertheless, each state has

Recent Statements by Public Officials

"At every level of government — local, state, and federal — public sector pensions are a ticking fiscal time bomb. Florida has to bring its pension system into line with other states' plans by increasing employee contributions."

*Florida Governor Rick Scott,
Speech to Florida Council of 100, November 2010*

"City workers deserve a safe and secure retirement, but right now, they receive retirement benefits that are far more generous than those received by most workers in the private sector and that provide for a much earlier retirement age ... It would be great if we could continue to afford such generous benefits, but we can't."

*New York City Mayor Michael Bloomberg,
State of the City Address, January 2011*

"A series of loopholes and avoided decisions has left us [Massachusetts] with an unfunded pension liability of \$20 billion. That problem was not created overnight and it will not be solved overnight. I support the defined benefit program but without these reforms it is not sustainable."

*Massachusetts Governor Deval Patrick,
State House Press Conference, January 2011*

"If we cannot make the promises of your pension system more realistic, there will be no pensions for those who have earned them."

*New Jersey Governor Chris Christie,
Address to State General Assembly, January 2011*

"Pension reform can be hard to talk about. In the long run, reform now means fewer demands for layoffs and less draconian measures in the future. It's in the best interest of all Californians to fix this system now."

*California Governor Jerry Brown,
Gubernatorial Campaign, Summer 2010*

many levers to address fiscal challenges, including the pension issues discussed in this *ViewPoint*. States have been able to build their pension funds in the past; we believe they will be able to do so again — and with greater ease once the economy, markets and, in turn, their revenues fully recover from the Great Recession.

Until this occurs, it is reasonable to expect increased demand from bondholders, the general public and the US Treasury for more thorough and standardized information on pension funding. We believe consistency and transparency (via proper disclosure) are generally beneficial to all stakeholders in the long term, but must be applied with the recognition that state and local governments have unique standing and are susceptible to worse financial constraint in the short term if pension requirements are

overly stringent and punitive. Positive remediation is beneficial to employees, retirees and taxpayers, as well as to investors in the municipal markets. Ultimately, voters will determine whether the actions taken by their respective governments are appropriate for allocating resources in a way that meets prevailing sentiments on service delivery and the broader public welfare. Given the importance of these issues, we expect to see continued headlines, especially as states consider 2012 budgets. For investors, today's environment illuminates the importance of credit research in making sound investment decisions in the municipal space. Opportunities exist, and the market's recent downturn creates an attractive value opportunity for long-term investors, but selectivity is critical. "Investment Strategies for Today's Municipal Markets" below offers some thoughts for investors in the municipal bond market.

Investment Strategies for Today's Municipal Markets

We continue to find opportunity in the municipal markets, although careful credit analysis and selectivity are key in the current environment. While not comprehensive, following are several investment strategies that we would advocate in today's markets:

Focus on the intermediate portion of the yield curve. We favor a bias toward intermediate maturities, with a particular focus inside of 10 years. This area of the curve provides significant yield pick-up over shorter bonds without the principal risk of longer securities. Volatility in this portion of the curve is also less than would be seen on the long end.

Overweight tax-backed issues, especially dedicated-tax bonds and stronger state GOs. GO default is extremely rare. Among GOs, we prefer states over local governments, particularly states less susceptible to volatility from budgetary challenges. In the local segment, we generally prefer GO debt of school districts over cities and counties. Dedicated-tax bonds are attractive because they are backed by revenues that are specifically pledged to debt service; they benefit from legal protection and provide a measure of stability during economic downturns. We favor dedicated-tax bonds secured by broad-based revenue streams such as statewide sales tax, motor fuel tax and income tax.

Look for opportunities in pre-refunded bonds. "Pre-res" come with the tax benefit of a municipal bond, but with high relative safety because they are backed by US Treasuries. Pre-res are municipal bonds that were refinanced by the issuer to lock in a lower interest rate. With the proceeds from the favorable refinance, the issuer buys Treasuries, places them in an escrow account and uses the interest proceeds to pay the interest on the original municipal bond

until it is callable. That bond becomes known as a pre-refunded bond and is seen as quite safe, generally receiving an AAA rating. Pre-res also tend to be at the shorter end of the curve, helping to insulate a portfolio from volatility.

Favor education issues. The education sector has been insulated from much of the recent volatility. We prefer flagship public universities and private institutions. Despite losing state aid, lower tuition rates have enabled public universities to attract students away from less-selective private institutions. The most-selective private universities continue to benefit from growing demand and have seen their endowments recover with the upturn in the equity market. We tend to avoid highly leveraged private and charter schools that are encountering declining enrollment and political funding pressure.

Seek safety in essential service revenue bonds. Among essential services, we prefer public utilities and transportation. Within utilities, we see opportunities in public power and water & sewer bonds and favor established systems that serve wide user bases. Rate-setting autonomy and a diversified fuel mix are key credit positives for municipal utilities. In transportation, we recommend established toll facilities located in highly traveled corridors, whereas start-up facilities should be viewed with caution. We also favor origination and destination airports with sizable carrier diversification in the major markets throughout the country.

While not comprehensive, this offers a sample of the opportunities we currently see in the municipal marketplace. Meanwhile, our underweights presently include bonds related to tobacco, long-term healthcare, land deals and community development districts in areas with negative real estate fundamentals.

Investment involves risk. The two main risks related to fixed income investing are interest rate risk and credit risk. Typically, when interest rates rise, there is a corresponding decline in the market value of bonds. Credit risk refers to the possibility that the issuer of the bond will not be able to make principal and interest payments. There may be less information available on the financial condition of issuers of municipal securities than for public corporations. The market for municipal bonds may be less liquid than for taxable bonds. A portion of the income may be taxable. Some investors may be subject to Alternative Minimum Tax (AMT). Capital gains distributions, if any, are taxable.

This paper is part of a series of BlackRock public policy *ViewPoints* and is not intended to be relied upon as a forecast, research or investment advice, and is not a recommendation, offer or solicitation to buy or sell any securities or to adopt any investment strategy. The opinions expressed are as of April 2011 and may change as subsequent conditions vary. The information and opinions contained in this paper are derived from proprietary and nonproprietary sources deemed by BlackRock to be reliable, are not necessarily all-inclusive and are not guaranteed as to accuracy.

This paper may contain “forward-looking” information that is not purely historical in nature. Such information may include, among other things, projections and forecasts. There is no guarantee that any forecasts made will come to pass. Reliance upon information in this paper is at the sole discretion of the reader.

This material is being distributed/issued in Australia and New Zealand by BlackRock Financial Management, Inc. (“BFM”), which is a United States domiciled entity. In Australia, BFM is exempted under Australian CO 03/1100 from the requirement to hold an Australian Financial Services License and is regulated by the Securities and Exchange Commission under US laws which differ from Australian laws. In Canada, this material is intended for permitted clients only. BFM believes that the information in this document is correct at the time of compilation, but no warranty of accuracy or reliability is given and no responsibility arising in any other way for errors and omissions (including responsibility to any person by reason of negligence) is accepted by BFM, its officers, employees or agents.

The information provided here is neither tax nor legal advice. Investors should speak to their tax professional for specific information regarding their tax situation.

BlackRock is a registered trademark of BlackRock, Inc.

©2011 BlackRock, Inc., All Rights Reserved.

BLACKROCK[®]