U.S. MUNICIPAL BOND MARKET

The Oracle of Omaha, on Municipals

Who Is Warren E. Buffett?

Don’t let the image fool you. Warren Buffett is not only a successful investor, but he is also one of the most affluent individuals in the world. He earned most of his wealth by compounding assets in his investment partnerships, then later in shares of Berkshire Hathaway. But he also prefers to eat like a 6-year-old, drink cherry flavored cola, and he still lives primarily in the first house he purchased in 1958. “Buffett is not a simple person, but he has simple tastes,” a Forbes columnist once wrote.

His investing activity is followed closely and often mimicked. Fading copies of his annual letters to his partners were passed person to person for years on Wall Street. Now, much of Buffett’s writings have been published or can be found on the internet. His maxims are used as much by corporate or political leaders, business strategists, and even professional athletes as they are by investors. Buffett is known for being one of the most effective capital allocators of our time. He is also known for his urge to preach. It is this urge to preach that likely causes him year by year to opine on topics in his annual letter to shareholders not directly related to Berkshire’s businesses. Below, we expound on two of those topics, since they relate to state and local government and the municipal bond market.

Active versus Passive Management of Public Sector Funds

The advantages and disadvantages of active versus passive investing, portfolio asset allocation strategies, and investment expenses have been much in the news recently. Not only municipal bond investors, but also public sector managers and political actors have increasingly focused on the asset side of the investment of public funds generally and public sector pension money specifically. The importance of the topics surrounding the investment of public money was strengthened in recent years. Skepticism has grown toward alternative investments. Heavily managed or alternative investment returns have often not kept pace with an index of the market. A gradual shift has been occurring as public pension plan asset allocation strategies evolve. Plans pared conservative fixed income holdings and began to incorporate more equity positions in the 1980s and 1990s. In the last 10 years, alternative investments became popular. So far, very few in the public sector have shifted portfolio strategies altogether away from the current norm.

Some are taking action. Montgomery County, Pennsylvania, for example, moved about 90% of its pension assets into low cost index funds. Pennsylvania State Treasurer Joe Torsella is transitioning some state investments to exchange-traded funds. Also, the new North Carolina state treasurer is in the process of transitioning to a more passive investment strategy. Recently elected Treasurer Dale Folwell moved $3 billion of North Carolina’s assets to indexed investments because he does not believe the performance warrants the higher fees.

Buffett on Low-Cost Index Funds

Believe it or not, despite his decades of investing success, Buffett has had to defend his investment strategies along the way. While in public he typically does not give investing advice, he has openly pronounced investment fees can cut into investors’ earnings. It is not without criticism that about 10 years ago he offered a bet to professional money managers. Buffett wagered via Long Bets:

Over a 10-year period commencing on January 1, 2008, and ending on December 31, 2017, the S&P 500® will outperform a portfolio of funds of hedge funds, when performance is measured on a basis net of fees, costs, and expenses.

Please see analyst certification and important disclosures on page 4.
Comparison of Fund Performance

<table>
<thead>
<tr>
<th>Period</th>
<th>Fund of Funds A</th>
<th>Fund of Funds B</th>
<th>Fund of Funds C</th>
<th>Fund of Funds D</th>
<th>Fund of Funds E</th>
<th>S&amp;P Index Fund</th>
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<tbody>
<tr>
<td>Gain 2008-16</td>
<td>8.7%</td>
<td>28.3%</td>
<td>62.8%</td>
<td>2.9%</td>
<td>7.5%</td>
<td>85.4%</td>
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Source: 2016 Berkshire Shareholder Letter (p. 22), PNC Capital Markets

One investment manager accepted Buffett’s wager and recommended five “fund of funds” he expected to beat an index of the market. The results are close to being in, and the funds so far have underpaced the market index, leading Buffett to summarize in his 2016 letter to shareholders:

The bottom-line: When trillions of dollars are managed by Wall Streeters charging high fees, it will usually be the managers who reap outsized profits, not the clients. Both large and small investors should stick with low-cost index funds.8

The Status of U.S. Public Sector Pensions

The funding status of U.S. state and local government pensions is another topic in the news of late. The aggregate funding level for state and local governments in the Boston College Center for Retirement Research pension database is 72%.9 However, this is down from a high of 103%. Most plans are either well or sufficiently funded at this point. Eighty percent of plans have a funding level above 60%. Of the 20% at or below 59%, only 3% possess a funding level that is less than 39%. Significantly stressed public pensions still remain very plan specific, for now. Trouble is that no good options exist for reform, and all potential solutions require some type of financial pain or sacrifice. It is possible that public pension funding levels could worsen in coming years.

Buffett on Pensions

Warren Buffett began thinking and writing about the long-term costs of pension promises long before he started insuring municipal bonds and began mentioning the topic in his shareholder letters. In his 2013 annual report, Buffett reprinted a 1975 letter about pensions he wrote to Katharine Graham, then chairman of the Washington Post Company. Back then, well before the current funding dilemma, he seemed to focus on structural relationships in actuarial science. In the 1975 letter he wrote:

Actuarial thinking simply is not intuitive to most minds. The lexicon is arcane, the numbers seem unreal, and making promises never quite triggers the visceral response evoked by writing a check.10

Much later,11 in 2007, Buffett began focusing on the reality of pension liabilities, the ease at which they were promised, and lack of understanding by lawmakers and taxpayers:

Public pension promises are huge and, in many cases, funding is woefully inadequate.12

Citizens and public officials typically underappreciated the gigantic financial tapeworm that was born when promises were made that conflicted with a willingness to fund them.13

Unfortunately, pension mathematics today remain a mystery to most Americans.14

Warren Buffett has invested through several business cycles and has a firm grasp of how events and key factors can or will affect the public and private sectors. Most who follow him closely would likely say that he is not someone who exaggerates. He has historically illustrated a command of the psychology of investing, and of investors. Municipal bond issuers are likely still in the early innings of the public pension funding dilemma. It has yet to be seen whether the Oracle of Omaha is correct on public sector pensions.
Appendix: More Excerpts of Warren Buffett’s Writings on Pensions

Following are selected excerpts from the 1975 letter, specifically from a section called “The Irreversible Nature of Pension Promises”:

The first thing to recognize, with every pension benefit decision, is that you almost certainly are playing for keeps and won’t be able to reverse your decision subsequently if it produces subnormal profitability.

So, rule number one regarding pension costs has to be to know what you are getting into before signing up. Look before you leap. There is probably more managerial ignorance on pension costs than any other cost item of remotely similar magnitude. And, as will become so expensively clear to citizens in future decades, there has been even greater electorate ignorance of governmental pension costs. Actuarial thinking simply is not intuitive to most minds. The lexicon is arcane, the numbers seem unreal, and making promises never quite triggers the visceral response evoked by writing a check. (1975 letter)

Pension costs in a labor intensive business clearly can be a major size and an important variable in the cost picture, particularly in the world characterized by high rates of inflation. I emphasize the latter factor to the point of redundancy because most managements I know—and virtually all elected officials in the case of governmental plans—simply never fully grasp the magnitude of liabilities they are incurring by relatively painless current promises. In many cases in the public area the bill will be handed to the next generation, to be paid by increased taxes or by accredited use of the printing press... (1975 letter)

Unfortunately, the subject of pension assumptions, critically important though it is, almost never comes up in corporate board meetings. (I myself have been on 19 boards, and I’ve never heard a serious discussion on this subject.) And now, of course, the need for discussion is paramount because these assumptions that are being made, with all eyes looking backward at the glories of the 1990s, are so extreme. (2001 Fortune article)

Whatever pension-cost surprises are in store for shareholders down the road, these jolts will be surpases many times over by those experienced by taxpayers. Public pension promises are huge and, in many cases, funding is woefully inadequate. Because the fuse on this time bomb is long, politicians flinch from inflicting tax pain, given that problems will only become apparent long after those officials have departed. Promises involving very early retirement—sometimes to those in their low 40s—and generous cost-of-living adjustments are easy for these officials to make. In a world where people are living longer and inflation is certain, those promises will be anything but easy to keep. (2007 shareholder letter, p. 20)

Local governments are going to face far tougher fiscal problems in the future than they have to date. The pension liabilities I talked about in last year’s report will be a huge contributor to these woes. Many cities and states were surely horrified when they inspected the status of their funding at year-end 2008. The gap between assets and a realistic valuation of present liabilities is simply staggering. (2008 shareholder letter, p. 14)

Local and state financial problems are accelerating, in large part because public entities promised pensions they could not afford. Citizens and public officials typically underappreciated the gigantic financial tapeworm that was born when promises were made that conflicted with a willingness to fund them. Unfortunately, pension mathematics today remain a mystery to most Americans. (2013 shareholder letter, p. 21)

Investment policies, as well, play an important role in these problems. In 1975 I wrote a memo to Katharine Graham, then chairman of the Washington Post Company, about the pitfalls of pension promises and the importance of investment policy. (2013 shareholder letter, p. 21)

During the next decade, you will read a lot of news—bad news—about public pension plans. I hope my memo is helpful to you in understanding the necessity for prompt remedial action where problems exist. (2013 shareholder letter, p. 21)
Notes

1 Please see:
   Romy Varghese, “Pensions’ Bigger Fees to Wall Street Don’t Mean Gains,” Bloomberg Brief, April 13, 2017;
   Ben Carlson, “Pension Plans’ Risky Flirtation With Private Equity,” Bloomberg View, April 10, 2017;
   Matt Levine, “New York Discovers Wall Street Charges Fees,” Bloomberg View, April 9, 2017;
   Cat Rutter Pooley & Attracta Mooney, "U.S. Pension Funds Halve Private Equity Allocations," Financial Times, March 5, 2017;
   David Robinson, “Active or Passive Management: Why Not Take Both Approaches?” CNBC, February 22, 2017;
   Barry Ritholtz, “Shift From Active to Passive Investing Isn’t What It Seems,” Bloomberg View, October 28, 2016;

2 Please see:
   Pew Trusts, State Public Pension Funds Increase Use of Complex Investments, April 12, 2017;

3 Joe DiStefano, “Rebel Pension Results Boost the Case for Index Funds,” Philadelphia Inquirer, March 3, 2017;


5 Please see:

6 Long Bets challenge by Warren E. Buffett.


10 Berkshire Hathaway 2013 Annual Report, 1975 letter by Warren E. Buffett to Katharine Graham, section on Pensions, p. 120.

11 He wrote about pensions several years before the February 2010 Pew report: The Trillion Dollar Gap that brought broader attention to the topic of public sector pensions.


14 Ibid.