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**Pension Funds and
the Bond Market:
Municipal Perspective**

Joseph Pangallozzi, Director

October 11, 2011

The opinions expressed are as of October 2011 and may change as subsequent conditions vary.

State and local fiscal challenges and pension reform are creating headlines...

The New York Times

Meredith Whitney's Muni Bond Prediction Draws Scrutiny

By NELSON D. SCHWARTZ

Published: February 8, 2011

ASSOCIATED PRESS

NJ paves way on tightening public worker benefits

By BETH DeFALCO

Published: July 6, 2011

chicagonews
cooperative

Tackling Pension Crisis is a Herculean Task

By DAVID GREISING

Published: July 2, 2011

The New York Times

Broke Town, U.S.A.

By ROGER LOWENSTEIN

Published: March 3, 2011

ATLANTA JOURNAL-CONSTITUTION

Pension overhaul allows Atlanta to reduce layoffs, restore services

By Ernie Suggs

Published: June 30, 2011

The New York Times

States Want More in Pension Contributions

By STEVEN GREENHOUSE

Published: June 15, 2011

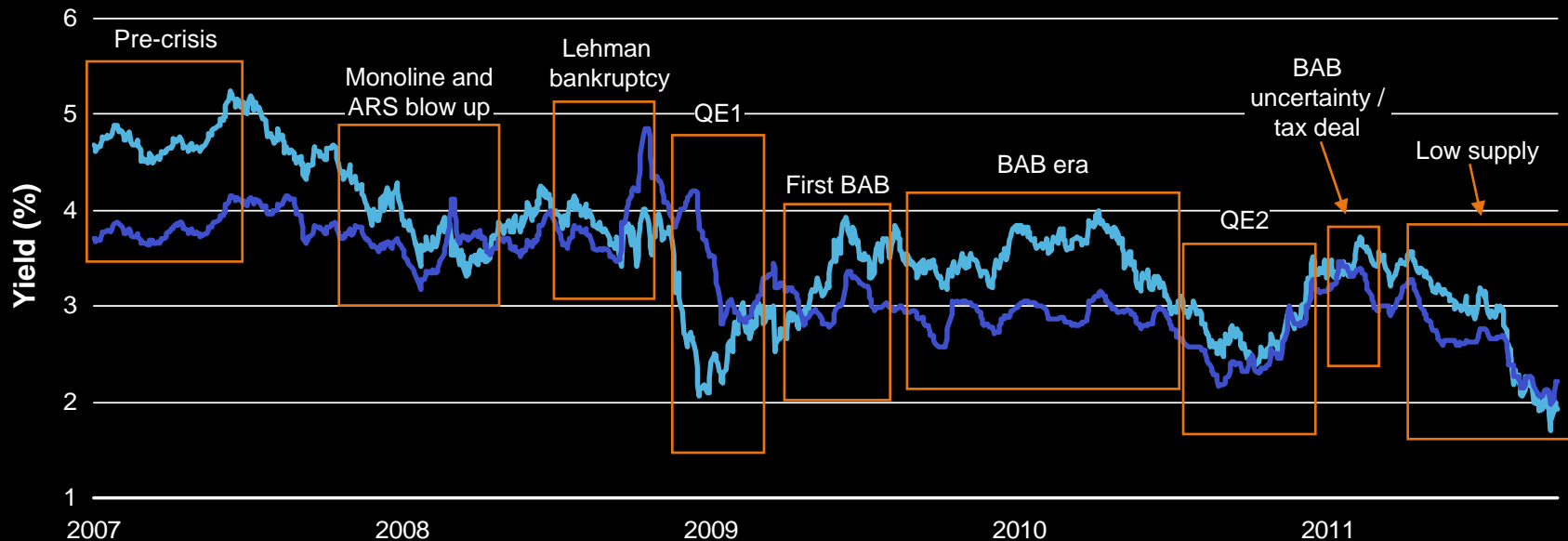
...and market volatility...

Relative value volatility has increased

Municipal market trying to morph from a rates to a credit market

Cheaper municipal to treasury ratios will be new paradigm

10-year municipal and US Treasury rates and events 2007–present



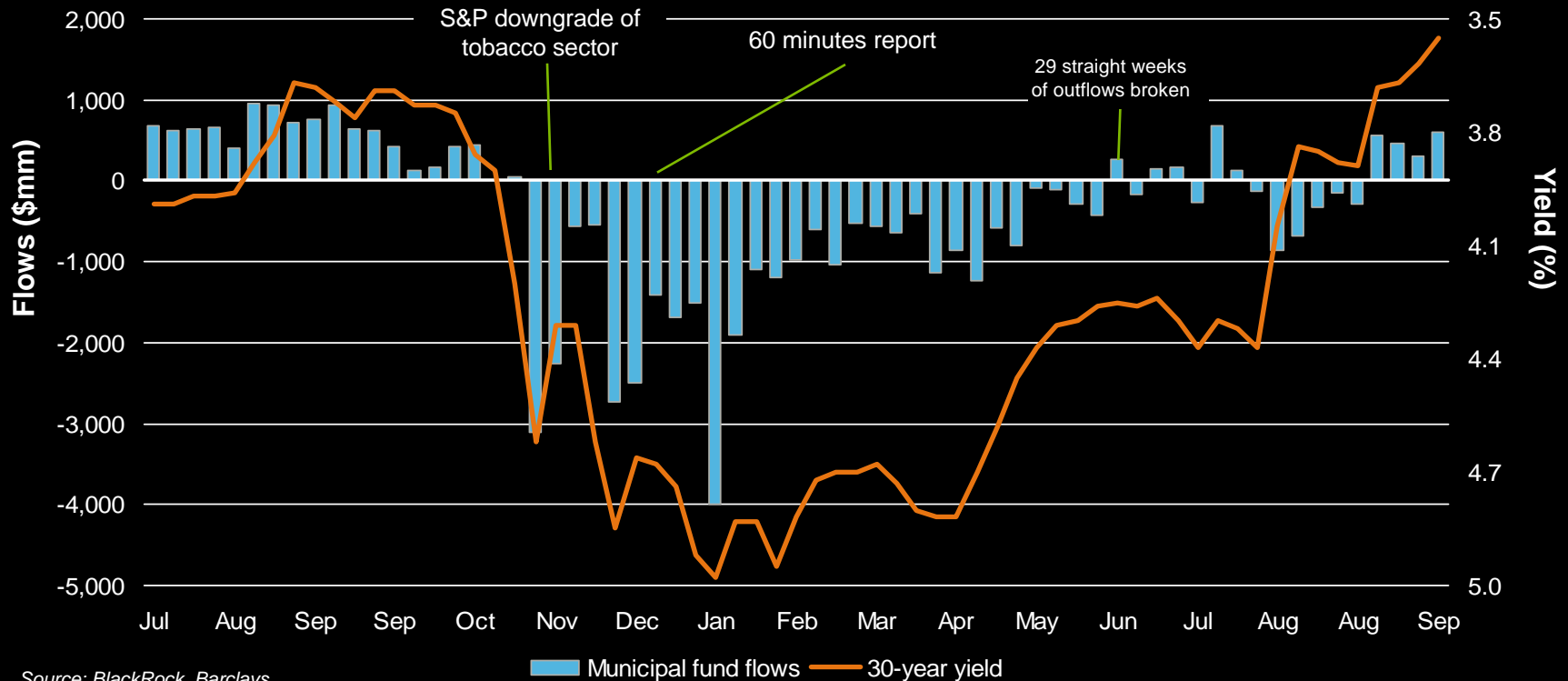
Source: MMD, Bloomberg
As of September 30, 2011

— 10-year US Treasury Yield — 10-year Muni Yield

...as well as fund outflows until recently...

29 week streak of outflows in the municipal market broken in June
Signs of demand increasing: greater correlation to municipal ETFs

Tax exempt mutual fund flows and performance



Source: BlackRock, Barclays
As of September 30, 2011

...but is the media attention warranted?

Headlines do not tell the whole story

- When it comes to defaults, the popular math does not add up
- State defaults are remote; local defaults are likely to be limited
- Fiscal flexibility should allow states and local governments to improve pension funding over long term
- Municipal bond market has a history of low defaults

Cumulative historic default rates, 1970-2009				
	Moody's		S&P	
	Municipals	Corporates	Municipals	Corporates
Investment Grade	0.06%	2.50%	0.25%	3.76%
Non-Investment Grade	4.55%	34.01%	6.75%	27.82%
All	0.09%	11.06%	0.33%	11.38%

Source: Moody's Investor Services

Focus on public pensions intensifies in Congress...

Congress has held oversight hearings to evaluate transparency and funding of public pension plans

U.S. Congressional hearings		
Date	Committee	Hearing
May 2011	House Ways and Means	Transparency and Funding of State and Local Pension Plans
Apr 2011	House Oversight	State and Municipal Debt: Tough Choices Ahead
Mar 2011	House Oversight	State and Municipal Debt: The Coming Crisis? Part II
Feb 2011	House Judiciary	The Role of Public Employee Pensions in Contributing to State Insolvency and the Possibility of a State Bankruptcy Chapter
Feb 2011	House Oversight	State and Municipal Debt: The Coming Crisis?
Feb 2011	Senate Budget	Challenges for the U.S. Economic Recovery

...at the Government Accounting Standards Board...

GASB proposed changes to financial accounting and reporting rules for public pensions, after lengthy deliberation

GASB exposure drafts

Objective

- Increase transparency and uniformity through standardized methodology and disclosure

Timeframe

- Published in July 2011
- 90-day comment period closes on September 30, 2011
- Three public hearings scheduled for October 2011
- Final rules expected summer 2012

Key recommendations

- Move net unfunded pension liabilities from the notes to a prominent place on the balance sheet
- Change the discount rate for plans whose assets do not cover projected benefits to a 30-year municipal bond rate (from one based on an expected rate of return)
- Require all plans to use entry-age normal actuarial cost method to allocate present value of projected benefits
- Require immediate recognition of a government's net pension liability in the event of changes (instead of doing so over a 30-year basis)
- Require municipalities that are part of larger statewide pension systems to report their portion of the collective liability (instead of just annual costs and payments)

...and among state and local politicians

“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

“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



“A series of loopholes and avoided decisions has left 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

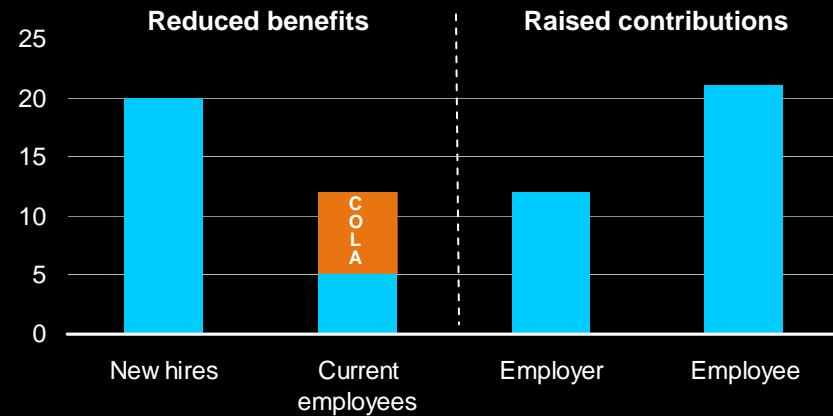


States and municipalities have options...

Multitude of potential reforms

- Raise retirement age
- Increase contributions from employees
- Increase contributions by employers
- Limit, reduce or eliminate automatic cost-of-living adjustments (COLAs)
- Disallow “double-dipping”
- Introduce means testing for benefits and/or taxing of benefits
- Issue pension obligation bonds (POBs)
- Adjust asset allocation strategies
- Freeze defined-benefit plans and move to mandatory defined-contribution plans

Actions taken by states to improve funding, 2008-2011



Source: Center for Retirement Research at Boston College, National Conference of State Legislators

...and many are taking steps toward reform

Actions taken vary widely across states and municipalities

Hawaii

- Increased employee contributions
- Increased vesting period for new employees
- Raised retirement age

Illinois

- Issued \$3.7 billion in pension obligation bonds

Massachusetts

- Introduced proposals to increase retirement age, eliminate early retirement subsidies, introduce an “anti-spiking rule” and eliminate “double dipping”

Michigan

- Replaced DB plan with hybrid plan for certain employees
- Reduced COLAs for certain employees

New Jersey

- Eliminated COLAs for current and future retirees
- Raised retirement aged for certain employees
- Required employees to pay more of their pension costs

New York

- Passed legislation reducing pension benefits for new employees

Ohio

- Eliminated collective bargaining rights for employees except in wage negotiations
- Law also broadens factors determining layoffs and dismissals

Utah

- Replaced DB plans with hybrid plans
- Offered alternatives of DC plan or hybrid plan
- Reduced COLAs

Wisconsin

- Eliminated collective bargaining rights for most employees except in wage negotiations

Atlanta, Georgia

- Increased contributions from current employees
- Increased vesting period for employees
- Raised retirement age for new employees

...while credit fundamentals appear to turn the corner...

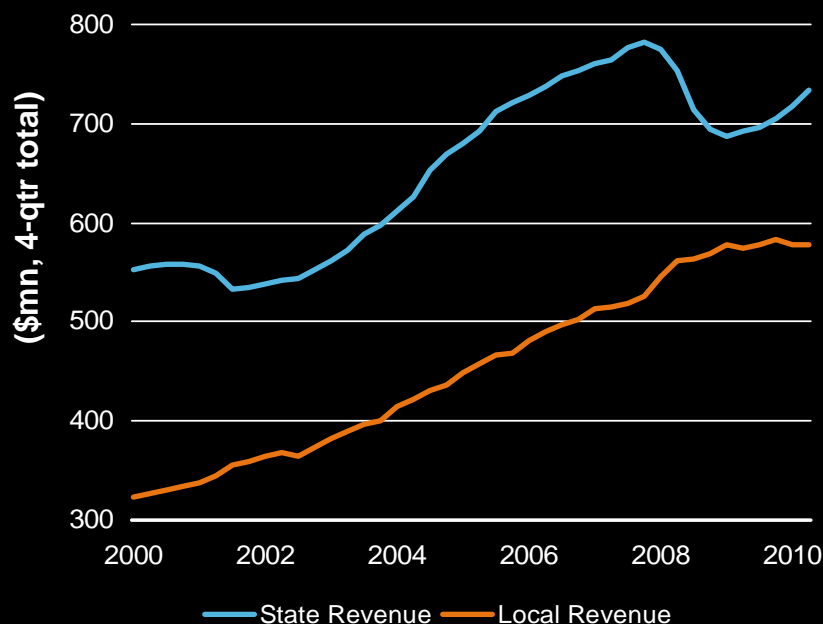
Short-term problem: Budget deficits; long-term problem: pensions and benefits

Economic activity was a slight tailwind, but remainder of 2011 is unclear

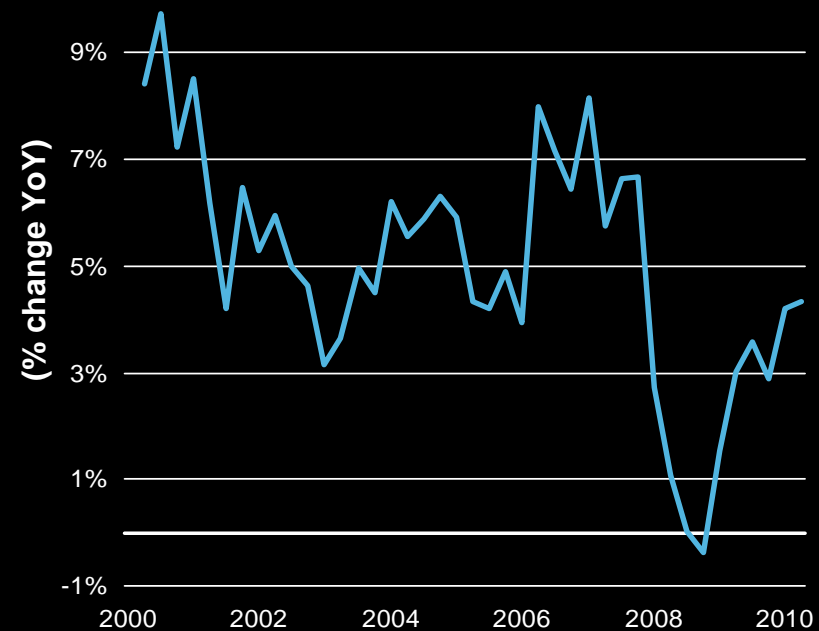
Budgets getting balanced, as spending cuts implemented

Cuts are being pushed to local level, fiscal challenge will reside with locals

State and local tax revenues



State and local government spending



Source: BlackRock, US Census Bureau Quarterly Summary of State and Local Tax Revenue, Bureau of Economic Analysis, Rockefeller Institute
As of March 31, 2011

...helping municipals to stage a comeback

4Q 2010 was the worst quarterly performance since 1994

2Q 2011 was the best second quarter performance since 1992

Year-to-Date Fixed Income market performance (thru September 30, 2011)



Source: BlackRock, MMD, Barclays Live

Pension liabilities as a pricing determinant is not apparent

Pension Funded Ratios

Worst States

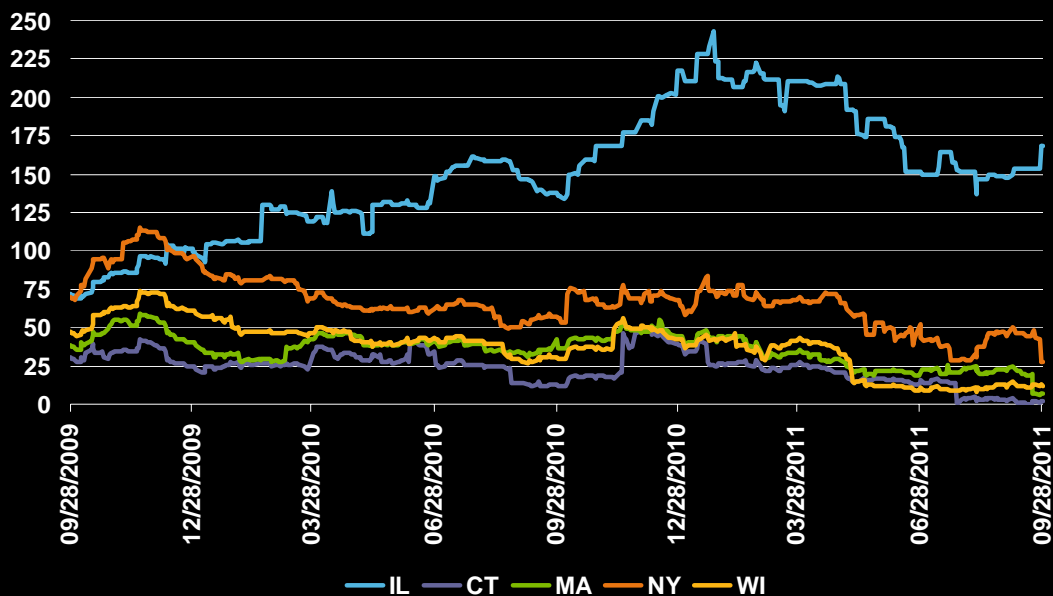
	IL	CT	MA	NH
Total Outstanding	162,891	44,605	95,914	11,645
G.O.	81,703	22,652	31,363	2,232
Revenue	81,188	21,952	64,584	9,413
10-yr Spread to MMD	170	5	8	8
CDS	275	158	130	-

Best States

	NY	WI	WA	NC
Total Outstanding	356,708	43,640	79,645	56,433
G.O.	78,124	19,562	35,459	14,809
Revenue	278,583	24,078	44,186	41,624
10-yr Spread to MMD	25	12	21	2
CDS	143	114	106	92

Source: BlackRock, SIFMA, Thomson Reuters

Selected state GO – 10 year spread to MMD



Municipal opportunities – states vs. sovereigns: “states win”

Structure of debt is different limiting rollover risk for municipals
State debt and deficit levels do not indicate crisis levels

Issuer	Public Sector Debt as % of GDP	Deficit as % of GDP	5yr CDS Aug. 2011	5yr CDS Sept. 2011
Europe				
Portugal	83.20%	6.70%	860	944
Italy	118.10%	5.70%	345	501
Ireland	94.20%	38.50%	750	834
France	83.50%	9.30%	160	193
Greece	144.00%	8.90%	1700	6372
Spain	63.40%	9.70%	355	395
North America				
Mexico	41.50%	1.90%	138	196
Canada	34.00%	5.40%	50	58
USA	88.90%	8.90%	56	58
US States				
California	13.53%	1.20%	194	215
Illinois	20.98%	0.80%	224	262
Michigan	16.52%	0.20%	138	147
New Jersey	30.18%	2.20%	147	147
New York	10.04%	0.90%	135	117
Texas	7.76%	0.70%	76	83

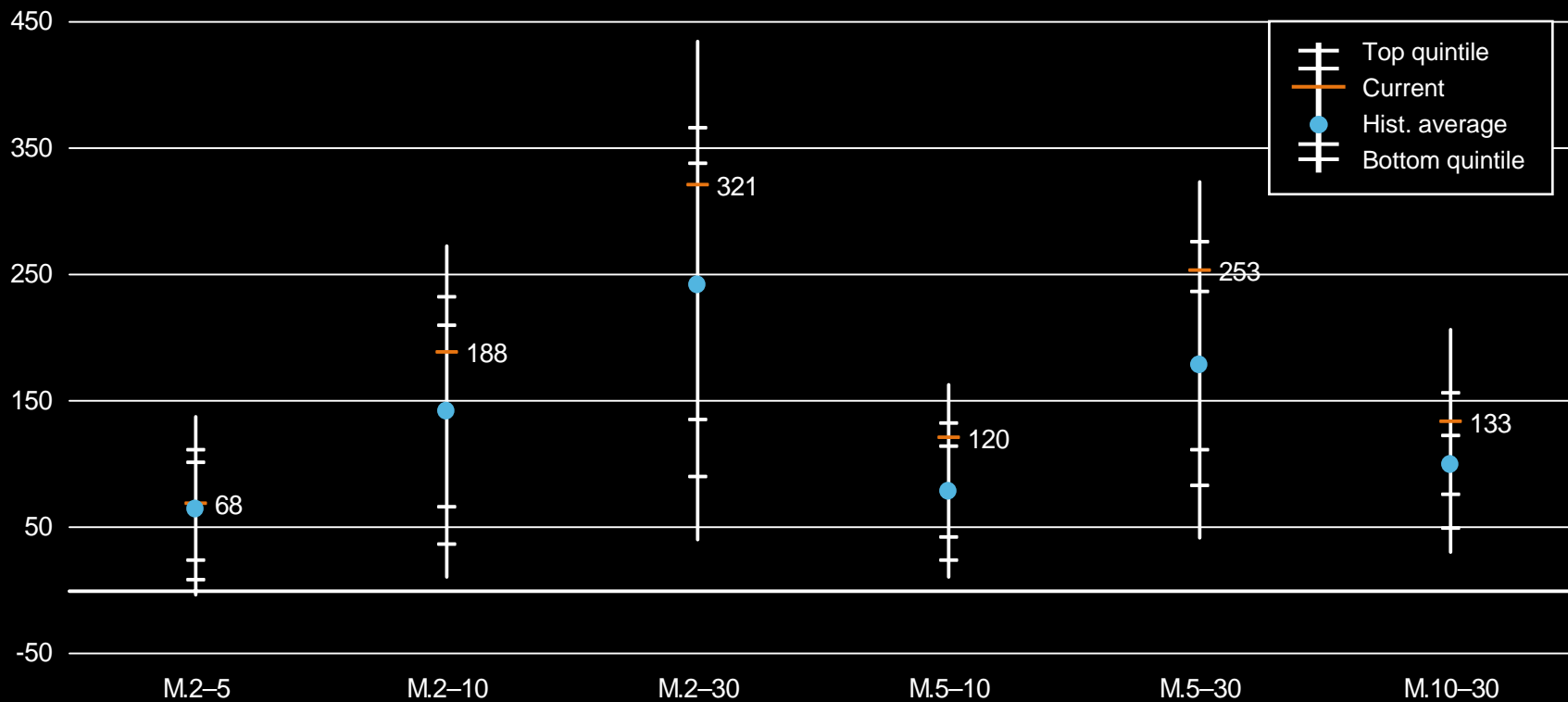
Source: BlackRock, World FactBook, World Bank, S&P, Moody's, CBPP

Municipal opportunities – Yield Curve

Curve continues to be very steep

“Operation Twist” may lead to further flattening, depending on new issue supply

Municipal yield curve slope



Source: BlackRock, MMD
As of September 30, 2011; Historical range 1999 through 2011

Municipal opportunities – Credit

Spreads still historically wide

As high quality and high yield have both moved, spreads have recently trended sideways

Municipal credit spreads

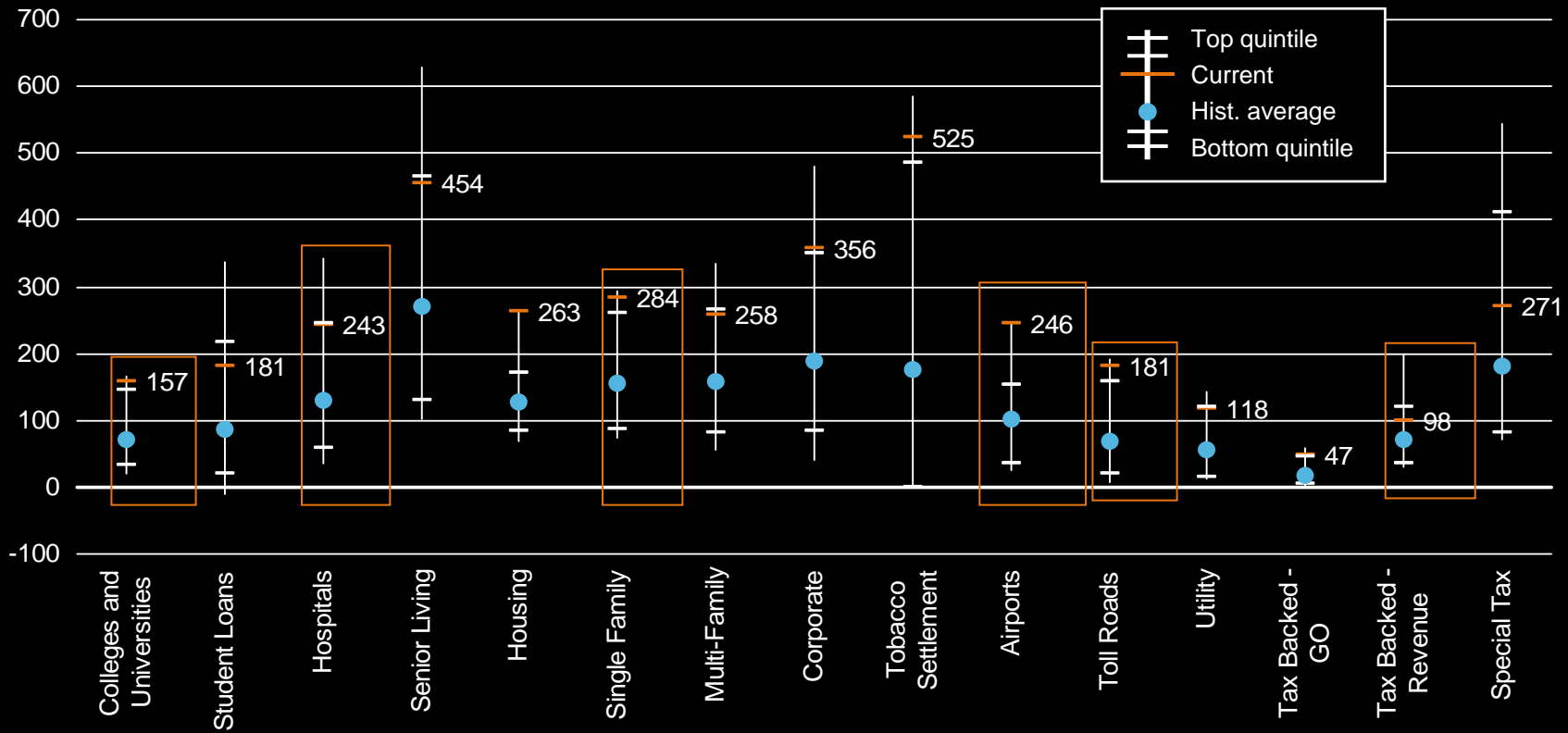


Source: BlackRock, MMD
As of September 30, 2011

— A — BBB

Municipal opportunities – Sectors

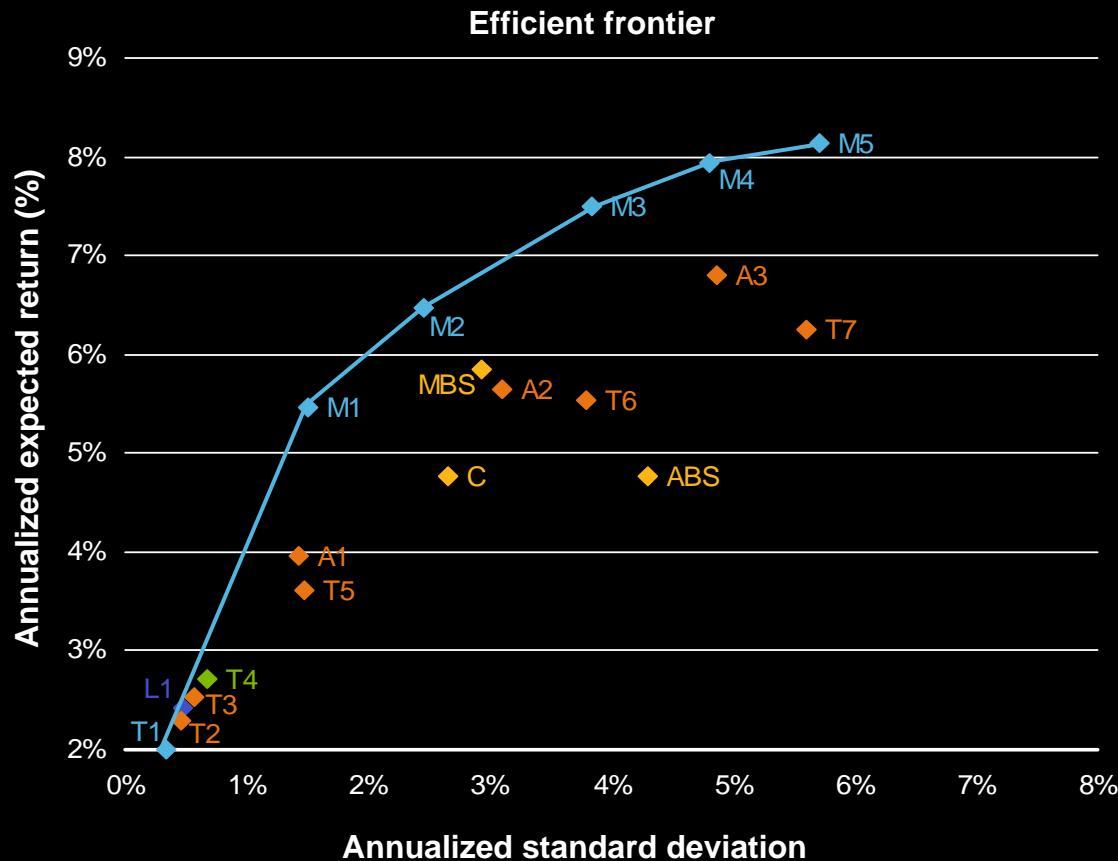
Spread to AAA – sectors



Source: BlackRock, JP Morgan
As of September 30, 2011; Historical range 1999 through 2011

Municipal opportunities – After Tax Yield

Municipal and treasury indices' annualized total return and volatility



Barcap indices / sub-indices	
M1	1–2 year Muni
M2	2–4 year Muni
M3	4–6 year Muni
M4	6–8 year Muni
M5	8–12 year Muni
L1	3-month Swap
T1	1–3 month Treasury
T2	3–6 month Treasury
T3	6–9 month Treasury
T4	9–12 month Treasury
T5	1–3 year Treasury
T6	3–5 year Treasury
T7	5–7 year Treasury
A1	1–3 year Agency
A2	3–5 year Agency
A3	5–7 year Agency
C	1–3 year Credit
MBS	US MBS
ABS	AAA ABS

Time series from June 30, 2001–June 30, 2011
 Marginal tax rate of 35%

Optimistic outlook for municipals

Continue to monitor mutual fund flow

Issuance may continue to surprise to the downside, causing a scarcity premium and opportunity for outperformance

Credit story is stabilizing for states but less for locals, and certain revenue sectors offer the best opportunity for yield

In a period of strong seasonality – coupon and principle reinvestment may lead to net new supply being negative

We maintain a neutral duration stance – a still steep yield curve warrants an allocation to the long end of the market

Opportunities exist today due to wide spreads, a steep yield curve and within many revenue sectors of the market

Risks to our outlook

- Significantly slower economic growth
- Jefferson County, AL outcome
- Significant spike in supply
- New federal austerity
- Cap or elimination of tax exemption

Muni market is now a “stock pickers” market; security selection will be critical going forward

Important notes

Past-performance is not a guarantee of future results.

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