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Looking Through the Credit

Oregon Public Employees Retirement System or Open Purse?



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“PERS Makes More Millionaires than the Lottery,” appeared as an attention grabbing headline in the Oregonian on April 24, 2011. On November 27, 2011, the front page of the Oregonian featured an article titled “How PERS’ Flow of Red Ink Has put the State at Risk.” While these headlines are engineered to sell newspapers, they also reflect the fear that the Oregon Public Employees Retirement System (“PERS”) is out of control. Our State’s pension system sits at the epicenter of a passionate debate between public employees seeking to maximize retirement benefits following years of hard work and taxpayers concerned about mounting pension deficits and years of spiraling contributions.

However, the overall health of our State’s pension system is also of great importance to investors due to its broad economic impact. PERS affects the income and spending of retired employees, taxes to cover employer contributions and the risk the state assumes when structuring the PERS portfolio. Economic activity generated by PERS retiree benefit payments is estimated in the PERS report *PERS: By The Numbers*, dated November 11, 2011, to sustain an estimated 29,124 Oregon jobs and approximately \$881 million in wages to Oregon’s economy; providing a total economic value of \$3.2 billion to Oregon. Therefore, PERS is a significant component of our credit research as we evaluate the fiscal health of the State of Oregon and local governments.

PERS Overview

Unlike defined-contribution plans, such as a 401k plan where contributions are made at a set amount and the return on investment is determined by the market, PERS is a defined-benefit plan. Retirement benefits under PERS are determined by a set formula with employer contributions varying depending upon investment returns and certain other actuarial factors. As a result, the contributions required by PERS vary. Due to the uncertainty of future investment returns, this variance creates a significant amount of budgetary grief for local governments making long-term planning decisions. In addition to contributions, unfunded balances require frequent review since the unfunded liability of a local government can vary from year-to-year depending upon investment returns. However, the benefit to retirees is a guaranteed retirement with the employer bearing all investment risk.

The most significant misconceptions about PERS relate to the process used to calculate benefits and future contributions. An actuarial analysis is used by PERS to compare the current assets of PERS to future obligations. The analysis is derived through a series of assumptions based primarily upon: payroll growth, investment returns, life expectancy of retirees and expected retirement dates of active employees.

When the liabilities accrued exceed the assets available, the system has an Unfunded Actuarial Liability (“UAL”). The UAL is calculated for each employer on an individual basis and varies significantly from employer to employer depending upon the level of contributions provided by the employer and the pool of participants covered by the employer. PERS liabilities tend to be most significant to smaller governments due to the overhead and a lack of administration available to manage their liabilities. However, not all Oregon local governments participate in PERS. According to PERS, 5% of public employees are not PERS participants. Local governments that are not PERS participants do not have exposure to the risks of PERS and often either contract with an outside provider or do not offer a pension plan. Another misconception



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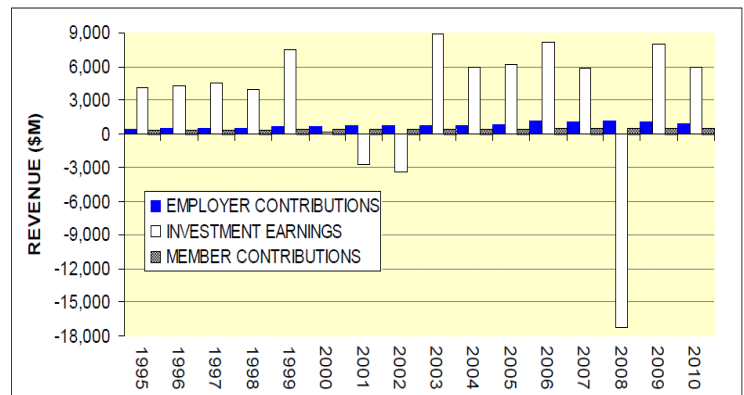
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is that PERS is funded primarily through local governments' employer contributions. As seen in the following chart, contributions by employers are dwarfed in comparison to investment earnings, magnifying the impact of investment performance. Furthermore, the chart demonstrates that over the past 16-years, PERS has only experienced three years of negative returns with investment earnings being the primary contributor to revenues in 12 of the 16 years. However, the dependence upon investment returns is one of the main weaknesses of PERS, since this revenue source can also be an expense, as experienced in 2008.

Prior to fiscal year 2008, PERS was overfunded at 112% of funded status. Following substantial investment declines, the program ended the year funded at 80%, which is still considered a healthy funding level. Since PERS performance is correlated to the performance of the underlying investments, bad years for PERS occur at the same time as bad years in the economy. Despite undeniably wild swings in value, the benefit of market based returns is that PERS is able to rebound prior to other states with less responsive pension systems. To further complicate any analysis, many local governments have issued pension obligation bonds to reduce their UAL. These bonds are typically not reported by local governments in their annual financial statements as a component of their UAL, rather they are reported as a long-term obligation. To properly assess the true magnitude of a local government's pension liability, pension obligation bonds must be considered together with the UAL to determine the total size and impact of a government's pension liability. A portion of our credit analysis focuses on the adequacy of the level of funding to determine the overall pension liability.



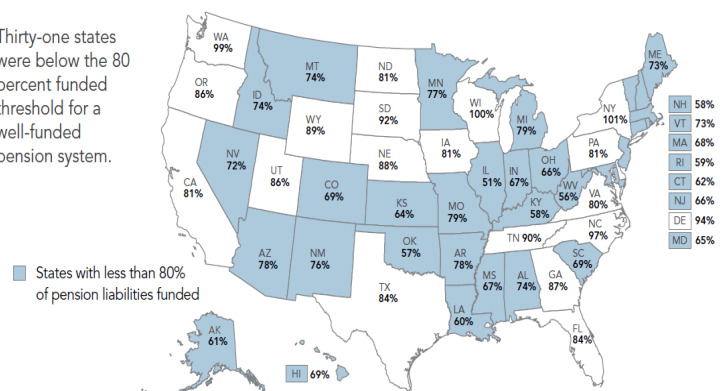
Source: PERS: By the Numbers, Oregon Public Employees Retirement System, November 2011 Report

While not often promoted, the State of Oregon operates one of the healthier pension systems in the country. The Pew Center on the States ("PCS") April 2011 Report *The Widening Gap: The Great Recession's Impact on State Pension and Retiree Health Care Costs* analyzes 2009 and 2010 data on states' funding of pensions and placed Oregon PERS as the 11th best in the United States, measured in terms of overall funding. Furthermore, 31 states fell below the 80% funded threshold for a well-funded pension system with Oregon comfortably above the 80% threshold at 86%. However, these statistics can be deceptive. In the case of the state of Washington, the state operates two pension systems which are collectively funded at 99%, with one system underfunded and the other system overfunded.

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States' Public Sector Pensions 78% Funded in FY09

Thirty-one states were below the 80 percent funded threshold for a well-funded pension system.



Source: PEW Center on the States, April 2011 Report



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PERS Reform

Discussions of PERS reform have generated controversy for years, largely focusing on claims of exorbitant benefits, excessive costs and potential rate increases. Following the 2001 recession, the PERS actuary projected a UAL in excess of \$18 billion. Reforms were later implemented in 2003 resulting in the creation of Oregon Public Service Retirement Plan (“OPSRP”), a retirement program consisting of a defined-benefit program and an individual account program similar to a defined-contribution program. Prior to the reforms, PERS used outdated mortality tables resulting in the average retiree outliving the actuarial assumptions. Further reforms were made to align the actuarial assumptions with PERS retirees.

Not all PERS participants receive the same benefits. Historical revisions to the PERS system have resulted in the creation of multiple tiers following the implementation of reforms. Currently, PERS is divided into three tiers: Tier 1 consists of employees hired before January 1, 1996 and provides a guaranteed rate on investments of 8%; Tier 2 consists of employees hired between January 1, 1996 and August 28, 2003, and does not have a guaranteed investment rate, instead accounts are credited at market rates; and finally Tier 3, or OPSRP, is for employees hired on or after August 28, 2003 offering a less generous formula than Tier 2 employees. PERS uses two primary benefit calculation methods: a formula-based method available to all members (“Full Formula”); and a calculation available exclusively to Tiers 1 and 2 in which an employee’s account balance is matched by the employer upon retirement (“Money Match”). Due to the use of the money match calculation, Tier 1 and 2 retirees often receive benefits at a significantly higher income replacement level than Tier 3, which has resulted in benefits exceeding the recipients final salary amount in certain cases.

The City Club of Portland released a report earlier this year, in May, offering multiple recommendations estimated to reduce PERS costs by over \$2 billion. In their report, the City Club found that PERS retirees enjoy excessive benefits with incomes of 77%, not including social security, of pre-retirement wages relative to an “adequate retirement benchmark” of 75% to 80% replacement of final pay including social security. Among the recommendations proposed by the City Club, the most significant cost savings at \$1.7 billion was estimated to be realized through replacing the money match benefit calculation with a risk free rate of return. By reducing the assumed rate of return, the size of the UAL would ultimately be reduced and generate the estimated savings. Reducing the assumed rate of return would result in increased PERS contributions by local governments to provide the additional funding necessary to cover retiree benefits. However, previous court decisions have limited options for PERS reform and any potential reduction in benefits would likely be met with passionate opposition from both employees and their respective unions.

Credit Ratings

Recently, ratings agencies have become increasingly interested in government pension funding and the fiscal preparedness of local and state governments. Beginning this past February with Standard & Poor’s and ending in August with Fitch Ratings, the State of New Jersey was downgraded by all three credit rating agencies due to mounting budgetary pressure from pension and employee deficits. From an investor perspective a downgrade lowers the market value of the bonds and from a taxpayer’s perspective



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a downgrade increases debt service expenses of future bond issues. In Oregon, we have benefitted from increased attention on pension funding as Oregon's credit rating was upgraded by Standard & Poor's in March of this year from AA to AA+ due, in part, to an "above-average pension funding ratio on a mark-to-market basis."

PERS Future

While there are few certainties about the future of pensions, increased reporting requirements are a safe bet. The Governmental Accounting Standards Board ("GASB") has issued an exposure draft relating to public pensions proposing moving the unfunded actuarial liability from the notes to the financials section of local governments' financial reports. The effect of this move would be to report the UAL on the balance sheet rather than merely reporting the balance in the notes section, which could unfairly burden certain governments since PERS participants do not have discretion over decisions made by PERS. However, as noted above, Oregon PERS is better funded than other state pension plans and generally more conservative. Therefore, the impact of the proposed changes is expected to be less severe for PERS than for other pension systems.

Conclusion

PERS is often unfairly portrayed in the news as a large open bag of money pilfered by public employees and neglected by politicians. In the story claiming that PERS creates more millionaires than the lottery, an article was later printed by the Oregonian correcting the overstatement, and in the case of the headline printed on November 24th regarding "PERS' Flow of Red Ink," the author failed to mention that the \$13 billion dollars referenced in the article is the UAL of PERS and the percentage funded has actually improved in recent years. As we saw earlier this year, a state's pension fund can have a direct impact on its credit rating and therefore affects borrowing costs and secondary market bond values. Through our credit research we have noticed that most municipalities are not only aware of their PERS liability, but either have made measures to address increasing costs or are taking measures to control costs such as reducing payroll and reducing operating expenses. Finally, our analysis extends beyond individual PERS liabilities and encompasses debt incurred to offset PERS liabilities and other underfunded public employee benefits.

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