Connecticut's Pension Fund May Incur Loss of Up to $25 Million on Derivatives

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The Connecticut state treasurer's office says the state's pension fund could suffer losses of as much as $25 million from speculative investments in derivative instruments and foreign bonds.

Losses could go much higher depending on whether the state can find buyers for certain hard-to-sell portions of these investments.

Recently, state officials discovered that an $835 million portfolio managed directly by the treasurer's office had large unrealized losses on a $100 million position of so-called interest-only strips, or IOs, and a $15 million investment in a bond issued by a Mexican bank.

So far the state has sold about $65 million of the IOs and the Mexican bond, according to Taegan Goddard, deputy chief of staff at the treasurer's office. But the state has not been able to find buyers for securities with a face value of $36.1 million, he said.

IOs are created from the income flows from an underlying pool of mortgages that have been packaged and sold as securities.

The state's plans were reported yesterday in the Bond Buyer, an industry publication.

The $835 million portfolio is the only portion of the $11 billion pension fund for retired state employees and teachers that was directly managed by the treasurer's office, says Mr. Goddard. State Treasurer Christopher Burnham, a former investment banker, says Connecticut is in the process of reviewing the rest of the state pension portfolio managed by more than 60 outside managers, as well as the pension fund's investment policies.

Mr. Burnham says that the state auditor's office issued a report on the internal portfolio last fall and "at no time did they question the values" of investments in the portion managed directly by the treasurer's office, he said. The auditor's office "had to accept the internally generated value of those holdings" because they were difficult to price, he added.

In December, shortly after Orange County, Calif., filed for bankruptcy protection after incurring huge losses in its investment portfolios, then Connecticut Treasurer Joseph Suggs issued a news release saying the "state and municipal funds are safe from speculation and leverage." The release said that "state funds are invested prudently and conservatively."

Mr. Suggs said the release was in response to concerns that the state owned the same kinds of securities that got Orange County into trouble. He says that Treasury officials responsible for monitoring the pension fund's investment policies were aware of the IOs holdings and that he was "not sure" that he "would characterize them as speculative."

In November, Mr. Suggs lost an election to Mr. Burnham, who took office in January. Mr. Burnham says his office discovered that many of the investments in the portfolio, particularly the IOs, hadn't been properly priced.

Mr. Burnham asserts that before he was elected, his contacts in the bond markets referred to Connecticut as "the dumping ground, the buyer of last resort" for such volatile securities.

On the advice of a group of three outside firms called in to analyze the portfolio, the state decided earlier this month to begin selling the IOs and the Mexican bond. The firms asked for advice were RCM Capital Management of San Francisco, State Street Global Advisors of Boston, and Morgan Stanley Asset Management Inc., of New York.