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WHERE IS YOUR MONEY?
— INVESTMENTS OF CALIFORNIA PUBLIC PENSION FUNDS

by Teresa Ghilarducci

(Editor's Note: The Editor goofed, and published the wrong draft of LCR No. 88 (April 1983). That was the author's first draft, which was then revised and expanded. Here is the correct version, with apologies for the mix-up. A few points are repeated from LCR No. 88, but some important new points have been added here.)

During the final weeks of his administration, Governor Brown's Pension Investment Unit (PIU) published a report on the portfolios and share of debt of 1,000 firms and public agencies owned by the 24 largest California public sector pension funds. This extensive and path-breaking study, *Investments of California Public-Sector Pension Funds* (Dec. 1982), attracted little notice and will undoubtedly be ignored by the new California Governor. It deserves special attention.

The data of the report, without editorial comment, challenges the common notion that some consistent principle guides the investment of California's public sector pension funds, now totalling more than $100 billion.

Diverse Portfolios -- The distribution of investments between corporate holdings, state and local bonds, housing, real estate, US treasury bills, foreign debt, etc. would be the same if a common pension investment strategy existed. Yet there are vast differences between funds. Only four funds have any real estate holdings, and only Los Angeles County has more than 2% of its fund in real estate. Almost 50% of the San Mateo County fund is in housing and housing related investments, while San Joaquin has none. The University of California has over 70% of its funds in common stock, and is the only fund (of those that can so invest) with over 25% of its assets in corporate short term debt.

Is it prudent for all 24 funds to hold more foreign government and international agency debt than US government debt? Does it make sense that most funds invest in Fortune 500 companies and not in venture capital? All 24 funds own almost 25% of the outstanding debt of St. Louis County Water Co. Is that a better investment than San Bernardino Development bonds for California public sector workers? Does prudence make sense?

Reason Beyond Prudence -- "Prudence" is the plan manager's response to any query about current investment practices. ERISA (Employee Retirement Income Security Act of 1974) defines a prudent action as that which would be taken by a person "acting in a like capacity and familiar with such matters. . . in the conduct of an enterprise of a like character and with like aims." Thus a prudent man is, by definition, a pension asset manager who acts like all other pension asset managers.

Pension fund managers insist they invest to obtain the maximum return for the least risk. Yet, no index measures the riskiness of an asset; the manager's judgement and expeience reigns and the fund's rate of return is left as the sole "objective" index of performance. The historic or promised rate of return becomes the sole criteria cited in defense of or opposition to a proposed acquisition of a specific asset. For example, labor unions indict investments in equities because of the low "rate of return," and critics decry calls for investments in home mortgages because "returns" are low compared to those of money market funds.

Unfortunately the "rate-of-return" is the most abused statistic in the pension field. Since the rate changes daily, its reported value depends on the time period used. It also depends on the unit of measure, book or market value.

A good pension manager maximizes the rate of return and insures the fund's ability to pay benefits as they come due. Therefore, unlike most trust funds, pension funds must strive both to obtain good earnings and to maintain stable contributions (the latter objective is often overlooked). Pension plan managers have a nonconventional responsibility--get high returns like normal investors, while maintaining long-run full-employment of plan members. Funds must be judged by their ability to fullfill these ends.

The St. Louis County Water Company may yield 15%, but if California municipalities can't sell bonds, local employment might decline, causing fund contributions to call. Fund growth (and adequate benefits) stems from two sources, earnings and contributions. Steady contributions into the fund are just as important as a fund's rate of return.

Benefit Cuts and Alternative Investments – In October 1982, California's Pension Investment Unit negotiated commitments from approximately 12 funds, and initiated legislation to require California public pension funds to purchase instate housing, real estate, and small business debt. However, mandated investments can be replaced by instruments providing a "higher rate of return" or other "better investments." This caveat may undo the intention behind PIU's pioneering effort. PIU did not develop a method for plan trustees to compare rates of return over the long run, or to evaluate risk--in other words, a method for determining a "better" investment. Neither the current law nor the practice of conventional institutional investors provides such criteria. The construction of such an index remains a major challenge.

The two year Pension Investment Unit was an innovative and sincere effort to move huge amounts of money to aid California's economy. However it was not a pension reform effort, because it failed to develop any agenda for benefit improvement or change. To public sector workers it may seem that it is just someone else now after their money (even if "someone" is not anti-labor and is responsive to California's capital and housing needs).

California public employees have accepted major cuts in benefit promises, and the PERS (Public Employee Retirement System) remains a tempting target for the revenue-starved state. Multi-tiered benefits for PERS, and the periodic "borrowing" raids on PERS and STERS (state teachers) are attacks on public sector pensions. Efforts to shore up pension benefits by workers may have to expand into unconventional and creative areas--such as pension investment reform.

One-third of all public pension fund trustees represent plan members or beneficiaries. They are primarily a silent and disaggregated group. They work alone and rarely speak up. This must change. Every call for "alternative investment" should include a committment and responsibility to secure pension benefits for the plan participants. This writer feels that only the participants and their representatives qualify as pension reformers.

Reference – *Investments of California Public-Sector Pension Funds, Dec. 1982*, available at the Institute of Industrial Relations, U.C. Berkeley, Berkeley, CA 94720; $20 to organizations, $10 for individuals. Make checks payable to the "Regents of the University of California."

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