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As Retirees Outnumber Employees, Pensions Seek Saviors.

Desperate for more money, public pension systems have been making high-risk investments hoping for a higher profit. But they may ultimately cost taxpayers more.

The $300 billion California Public Employees' Retirement System began showing its age this year: It started paying out more money to retirees than it gained in contributions and investments. In roughly 20 years, CalPERS' retirees will outnumber active workers by a ratio of nearly 2-to-1 in some of its plans.

In fact, a lot of state and local pension systems are already showing their age. Back in the 1970s, the typical pension fund had four to five times more active employees than it had retirees. Today, that ratio has slipped to 1.5-to-1 and is falling.

In the investment world, financial planners advise older individuals to steer their retirement accounts toward more conservative, fixed-income investments, such as bonds. The idea is to reduce the risk that an investment could turn south just when it's time to start withdrawing funds.

But most pension plans have been doing the exact opposite. In search of high returns, they have been turning to alternative investments. The focus has mainly been on hedge funds and private equities. Hedge funds are investment pools in high-risk assets that are aggressively managed for big or so-called absolute returns. Private equity funds pool money to buy companies with the goal of selling them or taking them public for a profit. Both funds' managers typically charge 2 percent of the total investment value as a fee (roughly twice the rate of more traditional fund managers), and managers take a 20 percent cut of the profits. They are by their very nature opaque, built on secret investment formulas that make tracking money in the funds next to impossible. The investments have been sold to institutional investors as a way to diversify and lower a plan's dependence on the swings of the stock market. But many are now questioning whether, for public pension plans — especially maturing plans that are paying out more than is coming in — these high-risk, high-fee investments are worth it.

CalPERS has decided that hedge funds aren't. Last year, the system announced it was divesting the $4 billion it had in those funds as part of the system's "flexible de-risking" strategy, investor-speak for making the pension system more conservative as it enters its golden years. The pension board is also evaluating ways to step down its assumed rate of return, a move that would reduce the pressure to take investment risks.

CalPERS is among a few pension systems that are dialing back enthusiasm for alternative investments. But concerns have been mounting for years. The lack of transparency and high fees paid out in these types of investments have contributed to pay-to-play scandals in at least three states. An investigation by the U.S. Securities and Exchange Commission (SEC) into 400 hedge funds found that half charged bogus fees and expenses. This summer, 13 state treasurers penned a letter to the SEC calling for regulations requiring that private equity firms more clearly outline the types of fees they charge.

Still, becoming a more conservative investor — even to reduce risk — is politically difficult. When pension funds reduce the expectations of what they will earn per year on their investments, governments may have to increase the amount of money they — or their employees — pay into the fund. So in the current investment market where low-risk bonds offer minimal returns, some pension systems continue to shift their money into high-risk assets. But these attempts to beat the market come at the expense of transparency, and they may ultimately cost taxpayers more.

Most pension portfolios have a long-term investment return target between 7 and 8 percent a year. Historically, plans achieved that with relative ease. But a lot has changed in the past 20 years. In 1992, the median pension fund's assumed rate of return was 8 percent, and U.S. Treasury securities paid out 7.67 percent, according to an analysis by the Pew Charitable Trusts and the Arnold Foundation. That means a pension portfolio's overall investments only had to perform slightly better than the bond market — not a very big gamble. By 2012, pension plans had lowered their return assumptions to a median 7.75 percent, but the 30-year Treasury bond returns had plummeted to just under 3 percent. The pressure on pensions to boost investment returns intensified tenfold.

Other factors have made things worse. In the late 1990s and early 2000s, many governments took funding holidays. Thanks to robust returns on stock market investments, half of all state pension plans were fully funded, according to Pew research. Meanwhile, state legislators increased benefits for retirees without increasing funding — adding to the long-term liabilities of their pension plans. The 2008 recession soured the investment picture, but pension funding ratios were already on the decline. State plans were funded on average at 85 percent of liabilities in 2006, according to Pew. By 2014, it was 74 percent, a Governing analysis found.

With strained budgets, most governments have not rushed to put extra money into their retirement systems. That puts pressure on pension plans to make up the difference. "This whole system works as long as governments are willing to make their payments no matter what," says Donald Boyd, director of fiscal studies at the Rockefeller Institute of Government. "So now pensions are relying more on investments than ever before. It makes you feel as if they're trying to fix a problem that wasn't their making."

According to data from the Boston College Center for Retirement Research (CRR), the typical pension fund a decade ago had about 1 percent of its assets sitting in alternative investments. By 2013, that had ballooned to 14 percent — a value of nearly $1 trillion. Some plans invest far more. Pennsylvania's teachers and state employees plans — which both face benefits cuts as the state struggles to fund them — have more than 40 percent of their money in alternative assets, according to the CRR.

The appeal is in the returns the funds produce. In fiscal 2015, the pensions' public equity portfolios (a.k.a. stocks) did not perform well. Private equity portfolios, however, came in with returns that were near or at double digits. Hedge fund returns were far lower, and most pension plans have reported their overall fiscal 2015 returns were less than 5 percent for the year.

One reason hedge funds may not be helping the bottom line could be their fees. Pension officials have maintained that the high fees associated with alternative investments are worth the above-average returns. But studies show that low-cost indexed funds (low-fee portfolios that replicate the movements of a specific financial market) can outperform hedge funds for a fraction of the cost. Recently The Economist compared the return from an S&P-indexed portfolio and the average return from hedge funds. The analysis found that the indexed portfolio easily outperformed the hedge funds. In other words, as The Economist put it, "hedge funds are a very expensive way of buying widely available assets." In keeping with that logic, Nevada Chief Investment Officer Steve Edmundson last year began moving the state pension funds' stock and bond investments into securities that track market indexes.

For CalPERS, which has been invested in hedge funds for more than a decade, it was time to call it quits. The hedge fund program “wasn’t having a significant material impact,” says Cal-PERS spokesman Joe DeAnda. “At the same time it’s very complicated, very complex, and the fee structure is higher.” In order for the absolute returns to potentially have a larger impact, CalPERS would have to invest a lot more than $4 billion out of its $300 billion portfolio. “There wasn’t a strong desire to go that route,” DeAnda says.

Of even greater concern for some is the lack of transparency in how these funds operate and in how they are charging fees. “With alternative investments, all I have is a contract. I can’t see the assets,” says Chris Tobe, a former Kentucky Retirement Systems trustee and author of Kentucky Fried Pensions, a book alleging a culture of corruption surrounding the fees the system paid to managers. “The numbers on it are the numbers [the managers] decide to give to me,” he adds. “I’m not allowed to look under the hood.”

Hank Kim, the executive director of the National Conference on Public Employee Retirement Systems, admits “it’s entirely appropriate” to ask whether a public plan should be investing in a very opaque arena. But he likens the situation to a Coca-Cola shareholder asking the soft drink company to reveal its secret recipe. “The question is what is proprietary for a business,” he says. “For private equities and hedge funds, their business model is the secret sauce.”

The lack of transparency leads to a lot of confusion about where pension plans’ money is going. Fees to asset managers are inconsistently reported, which makes it impossible to reasonably compare pension plans. For example, South Carolina’s retirement system in 2013 paid $500 million in fees to asset managers — the same amount that New York City paid in fees for a portfolio more than five times bigger. A follow-up report released earlier this year by the fund analysis firm CEM Benchmarking — and commissioned by the South Carolina Retirement System — found that the state discloses more fees than is typical. In fact, the report estimated, pension funds are disclosing less than half of the private equity costs they actually incur.

In worst-case scenarios, the secretive environment can lead to scandal. In the late 2000s, the SEC investigated funds in California and New York, alleging that investment firms made improper payments to politically connected middlemen in exchange for investments from the pension funds. In New Mexico, the state’s investment account and teacher pension fund lost an estimated $150 million as a result of politically driven investment decisions that underperformed. The scandal drew multiple lawsuits and a guilty plea to tax evasion by a former broker.

As alternative asset managers openly target institutional investors, there may be an opening for public pensions to demand more transparency from them. While state treasurers have called on the SEC to apply pressure, some pension systems are already demanding better transparency. CalPERS, frustrated with the lack of uniformity in the data it receives from its private equity managers, developed its own reporting template. DeAnda says the system soon plans to use that data to publicly report its private equity cash flow.

Pension systems can also do a better job of disclosing all the fees they pay. Rhode Island’s treasurer recently pushed through a new investment policy requiring transparency from investment managers to disclose all fees, expenses and fund-level performance. It’s a turnaround from the previous treasurer, now-Gov. Gina Raimondo, who drew criticism by refusing to disclose information related to fees and performance while shifting more state investments into alternatives.

But pension systems cannot truly act independently of lawmakers. For instance, many need approval from lawmakers to lower their long-term investment return assumptions. While CalPERS does not have that restriction, politics is still at play in determining how quickly the system can implement some of its decisions. Its plan to lower its return assumption, for example, would take place over a decade. “If [pension plans] were really independent, they wouldn’t care what lawmakers thought,” Boyd says of the overall dilemma state and local pension plans face. “They’d lower their assumptions, become a lot more conservative and ask the governments to pony up now. It’s a very, very difficult situation to be in.”

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