Bond Case Briefs

Municipal Finance Law Since 1971

Pew Report: State Public Pension Funds Increase Use of Complex Investments.

Overview

State and locally run retirement systems currently manage over $3.6 trillion in public pension fund investments, most of which are held by states. Broadly, half of these assets are invested in stocks; a quarter in bonds and cash; and another quarter in what are known as alternative investments, such as private equity, hedge funds, real estate, and commodities.

Although governments and employees contribute to pension funds, investment earnings on plan assets are expected to pay for about 60 percent of promised benefits. In a bid to boost investment returns and diversify investment portfolios, public pension plans in recent decades have shifted funds away from low-risk, fixedincome investments such as government and high-grade corporate bonds. During the 1980s and 1990s, plans significantly increased their reliance on stocks, also known as equities. And over the past decade, funds have increasingly turned to alternative investments to achieve investment return targets.

Greater investment in equities and alternatives can provide higher financial returns but also bring heightened volatility and risk of shortfalls. Most funds exceeded their investment return targets during the bull market of the 1990s but then suffered losses during the volatile financial markets of the 2000s—leading to higher pension costs for state and local budgets. The volatility inherent in public funds' investment strategies can be seen in more recent results as well, with large funds posting fiscal year gains of over 12 percent in 2013 and 17 percent in 2014, but only 2 percent in 2012, 4 percent in 2015, and 1 percent in 2016.

The shift toward more complex investment vehicles has also brought higher investment fees. State funds reported paying more than $10 billion in fees and investment-related costs in 2014, which amounted to their largest expense. Those fees, as a percentage of assets, have increased by about 30 percent over the past decade, a boost closely correlated with the rising use of alternative assets, which has more than doubled since 2006. Additionally, state funds are paying billions of dollars in unreported performance fees associated with these alternative investments.

Accounting and disclosure practices also vary widely among pension plans and have not kept pace with increasingly complex investments and fee structures, underscoring the need for additional public information on plan performance and attention to the effects of investment fees on plan health. Full and accurate reporting of asset allocation, performance, and fee details is essential to determining public pension plans' ability to pay promised retirement benefits. With more than $3.6 trillion in assets—and the retirement security of 19 million current and former state and local employees at stake—sound and transparent investment strategies are critical.

Research on U.S. public pension investments published in 2014 by The Pew Charitable Trusts highlighted the long-term shift toward stocks and more recent increases in the use of alternative investments. This report provides updated information on asset allocation, performance, and

reporting practices for all 50 states and looks deeper at the use of alternative investments by public pension funds. Specifically, this report finds:

- Government sponsors should consider investment performance both in terms of long-term returns and cost predictability. From this perspective, many fund portfolios are highly correlated with the up-and-down swings of the stock market, and expose state budgets to considerable risk and uncertainty.
- Investment performance varies widely among public pension funds, with only two of the funds examined exceeding investment return targets over the past 10 years. Although these results reflect the losses that occurred at the onset of the Great Recession, more recent performance, low interest rates, and forward-looking economic forecasts point to the need to closely examine long-term investment return targets.
- The use of alternative investments varies widely—from none to over half of fund portfolios. While examples exist of top performers with long-standing alternative investment programs, the funds with recent and rapid entries into alternative markets—including significant allocations to hedge funds—reported the weakest 10- year returns. Although longer time horizons will allow better evaluation of these investment strategies, funds and policymakers should carefully examine risks, returns, and fees in the meantime.
- The data do not reveal a best or one-size-fits-all approach to successful investing, but there is a uniform need for full disclosure on investment performance and fees. In 2014, more than a third of state-sponsored funds reported performance figures before deducting the costs of investment management. In addition, unreported investment fees—primarily performance payments made to private equity managers—totaled more than $4 billion in 2014, or about 40 percent above the $10 billion in reported investment expenses for that year.

Data sources

To examine these changing investment practices across the 50 states, The Pew Charitable Trusts used three sources covering the 73 largest state-sponsored pension funds, which collectively have assets under management of over $2.8 trillion (about 95 percent of all state pension fund investments):

- Data collected from state-sponsored plans' Comprehensive Annual Financial Reports, pension plan actuarial valuations, and other relevant documents published by individual public pension plans from 1992 to 2014, with a primary focus on asset allocation, performance, and fees from 2006 to 2014. In addition, performance data from 2015 were collected from plan documents.
- The U.S. Federal Reserve Financial Accounts of the United States data, which include aggregate economic and investment data on public pensions from 1952 to 2015.
- The Wilshire Trust Universe Comparison Service (TUCS) performance comparison data, reported quarterly from 1991 to 2016.

Together, these data sets provide a 60-year picture of aggregate investment trends and a detailed look at investment practices from 2006 to 2014 across the vast majority of state public pension funds.

Important terms

Three main types of investments are discussed in this report:

- Fixed-income investments. Can include domestic or international bonds issued by governments or corporations. Because they generate predictable streams of income paid at designated times, fixed-income investments are generally considered lower-risk than other investments.

- Equities. Stocks, held by investors, that represent partial ownership of a company; can be domestic or international. Equities do not guarantee a return and generally have the potential for both higher returns and greater losses than bonds, making them typically riskier than fixed-income investments.
- Alternative investments. Generally include private equity, hedge funds, real estate, and commodities, and typically lack an established public exchange, have low liquidity, and can be more difficult to value than stocks or bonds. Alternative investments typically carry higher fees than fixed-income investments or equities and can be used to diversify investment portfolios or to achieve higher rates of return—although often at higher levels of risk.

The glossary at the end of the report includes a more complete list of definitions; the appendix includes a detailed explanation of the common types of alternative investments.

Download the full Report.

The Pew Charitable Trusts

April 12, 2017

Copyright © 2020 Bond Case Briefs | bondcasebriefs.com