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RESEARCH REPORT

MAY 1984

PENSION FUND INVESTMENTS AND PROPOSITION 21

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Proposition 21 on California's June ballot includes confusing and contradictory provisions on two entirely different subjects. On one hand, it offers new protections of the pension rights of public employees, which are borrowed from private sector experience, and are needed in California. On the other hand, it changes long-standing rules protecting the investment of the pension fund savings of public employees. The state's voters will have trouble making an informed judgment about the proposed changes in investment rules, because neither the pension funds involved nor the backers of Proposition 21 have furnished relevant data sufficient to explain or justify the need for such changes.

Proposition 21 is therefore not only contradictory and confusing, but on balance it may also offer more to threaten the economic interests of public employees in California than it offers to protect them.

1. Why change the investment rules?

The most questionable part of Proposition 21 is the proposal to eliminate the present 25% limit on the equity investments (primarily common stocks) of pension funds in California's three major public retirement systems. These are (1) the Public Employees' Retirement System or PERS, which has just become the largest single pension fund in the nation; (2) the State Teachers' Retirement System or STRS, covering all public school teachers; and (3) the 20 county retirement plans established under the County Employees' Retirement Law of 1937 (or the 1937 Act plans). The following data indicates the number of employees involved in these plans, the total assets of the plans, and the total investments which would be affected by the changes proposed in Proposition 21:

	Active Employees	Retired Employees	Total Assets (millions)	Total Investments (millions)
1. PERS (6-30-83)	527,500	203,200	20,283	19700
2. STRS (6-30-82)	260,326	81,806	9,829	9,463
3. 1937 Act Plans (12-31-81 to 12-31-82)	158,320	43,713	6,860	6,267
TOTALS	946,182	328,719	36,972	35,430

(Sources: PERS 1983 Annual Report; and the California State Controller's Annual Report on Public Retirement Systems, for calendar year 1981, fiscal years 1981-82.)

The assets of these plans are the pension fund savings of 1,275,000 public employees in California (946,000 active and 329,000 retired), and the investment returns on their savings to date. At present, these assets total more than $40 billion. The change in investment rules proposed in Proposition 21 could affect the future investment of 75% of this total, or $30 billion. The authors of Proposition 21 therefore have an obligation to explain why it is necessary to drop the present 25% limit on equity investments. Unfortunately, no such explanation has been advanced.

There is no information available from STRS or from the 1937 Act plans on the long-term, time-weighted annual earnings of their common stock investments, which could be compared to long-term, time-weighted annual earnings of other investment allocations. PERS, on the other hand, has long reported its operations and its investment transactions in greater detail than any other pension plan in California. But even PERS has not reported the comparative time-weighted annual earnings of its common stock investments, compared to the time-weighted annual earnings of its other investment allocations, in any year since PERS was originally authorized to make equity investments (in fiscal 1968-1969—to the constitutional maximum of 25% of PERS assets).

The PERS Retirement Betterment Committee, Inc., of Glendale, California, has made a 15 year PERS earnings comparison, by computing the percentage yields of different investment allocations for each year in the series (as these are reported annually by PERS), and then by averaging for the 15 year period. The results are as follows:

PERS INVESTMENT RETURNS
15 Year Average
1968-1969 to 1982-1983

Percent total return to Fund	6.75
Percent yield on all equity holdings (primarily common stocks)	3.66
Percent yield on all bonds and mortgages (i.e., fixed income securities)	9.69

These average annual yields over the 15 year period are not strictly comparable, as PERS points out in its annual reports. To quote from the 1983 PERS report, "....The dividend yield on equities is only a small part of the total return expected over the longer term."

The 3.66% average annual yield on equities over the 15 year period reported by the Retirement Betterment Committee includes the dividend yields in each year, and also includes the proceeds from equities sold in each year in the series (less transaction costs). But "the total return expected over the longer term" by PERS also includes the market value of the equities, which is expected to increase by much more than the dividend yield. PERS investment managers (and many others) expect and/or hope that the increase in market value of the equities (as reflected in current stock market prices) plus the dividend yields, will finally add up to more "over the longer term" than the rate of inflation, so that these investments will increase in real value.

The problem is that the investment managers and the pension funds either do not compile the data, or simply do not report the data, which would indicate whether this expectation and/or this hope is being realized.

During 1983, for example, PERS sold common stocks of 81 different companies at the market rates for these stocks, which brought proceeds to the pension fund of nearly $741 million. PERS had originally purchased these stocks for $519 million (i.e., the book value), so there was a gain of nearly $222 million from their sale. PERS reported the gain (and occasionally the loss) from the sale of each of these 81 common stocks in 1983—but did not report how long they had been held in the PERS portfolio, and did not allocate this $222 million gain on a time-weighted basis. Therefore, PERS investment performance with respect to these stocks could not be compared to PERS investment performance of bonds or real estate mortgages, or other investment allocations. It is not difficult to compile such information, and there is every reason to make it available if the investment managers want the authority to quadruple their investments in common stock.

The same kind of information would be useful with respect to PERS' annual reporting of its equities portfolio. PERS lists both the book value and the current market value of its common stock holdings as of June 30 of each year. On this date in 1983, for example, PERS owned stocks which it purchased for book value of nearly $4.2 billion, and these stocks then had a market value of $5.8 billion. Perhaps that accrual in market value will justify the rosy predictions in PERS annual reports about "the total return expected over the longer term." But who knows? What happens to the market value (compared to the book value) of common stocks over the longer term must be reported and understood and made comparable to other investment returns on a time-weighted basis--but PERS does not report the information on when the stocks were purchased, and how long they were held. Therefore, the difference between the book value of $4.2 billion and the current market value of $5.8 billion cannot be evaluated on a time basis.

Some spectacular reports about the performance of common stocks are frequently quoted in the press. For example, the *Los Angeles Times* (4/8/84) reported that PERS "outperformed the market in its stock holdings and reported an overall gain of 48% for the fiscal year ending June 30, 1983." That's fine, but what are the time periods involved in evaluating what this 48% really means? The *Times* report from PERS doesn't include this essential information, because PERS doesn't report it. If the common stocks included in the PERS portfolio as of June 30, 1983, had been held by PERS for an average of ten years, the average annual time-weighted rate of return would be only 4.8%—if all these stocks had been sold in 1983. Actually, only about 12% of PERS holdings of common stocks were sold in 1983, and we have no report or information from PERS to indicate the average annual time-weighted rate of return of these stocks which were sold. This rate of return would give the only real indication of what that "overall gain of 48%" actually means.

Earlier this year, PERS issued a comparison of investment returns on stocks and bonds, on a six year cumulative time-weighted basis (July 1, 1977 to June 30, 1983), which referred to "the very attractive returns realized on the stock portfolio," and called attention to "the general historical relationship of stocks out-performing bonds and short-term investments over longer time periods." But a six year comparison of returns does not deal with "longer time periods" and cannot establish any "historical relationship" with respect to PERS investments. What about the comparative rates of return in the 15 year period since PERS was authorized to invest in equities, beginning in fiscal 1968-69? We do not have this data from PERS, or from STRS, or from the 1937 Act plans, to justify the increase in equity investments which is proposed in Proposition 21.

Another kind of historical comparison is relevant. PERS now invests about 65% of its portfolio in fixed income securities, and no more than 25% in equities. In the nation's private pension plans, in the decade of the 1970s (to the end of 1979), this ratio was reversed; about 65% of private pension plan investments went into equities, and only about 25% went into fixed income securities. The results were disastrous. From 1970 to the end of 1979, the annual investment earnings of all private pension plans in the nation averaged only 4.3%. The cumulative annual rate of inflation in these same years averaged 10.6%, so that the plans lost to inflation alone an average of 6.3% a year in the decade. One of the nation's foremost pension authorities concluded that "mediocre investment performance by the private pension system exposes it not only to arguments against traditional prudent investment, but even calls into question the justification for having a private pension system." (Roy A. Schotland, *Journal of Labor Research*, Fall 1981.)

PERS did better the same ten year period (fiscal years 1970 through 1980), and reported total fund earnings averaging 5.96% a year. But its fixed income investments earned an average of 8.48% in this period. This total investment performance also lagged far behind the cumulative rate of inflation, and necessitated rapid increases in contribution rates. But compared to the overall performance of the nation's private pension plans, the investment performance of PERS was much better **because of the limit on equity investments.**

The spectacular gains of 1982-83 in market values of common stocks had to make up for a full decade of "mediocre investment performance" during the 1970s. Further, these spectacular gains must now be evaluated in terms of the spectacular losses of the 1970s. The appropriate comparative data, on a time-weighted basis, for all the years back to fiscal 1968-1969 is required to determine whether the proposal to drop the constitutional limit on the equity investments is justified.

Data exists to show that over long periods of time, total returns on common stock (i.e., dividends plus accruals in market value) have beaten the long term inflation rate, and have led to higher rates of return than investments in long term corporate bonds and T-bills. However, this data is based on the entire universe of historical capital market returns in the U.S. This data invites the analogy of a fifty cent slot machine in Nevada, representing common stock investments. It is nice to know that all four cherries can line up in a row, even though no one has ever really put in enough half dollars and pulled the handle enough times to make that result occur. However, if the pension fund managers are going to have complete freedom to play this machine, to the limit of the assets of the major public employee pension funds in California, it would be far better to know how many half dollars have already been put in, for how long a period, with what lesser kind of payoff. For there happen to be five, ten, twenty-five cent, and one dollar machines alongside, representing alternative investment allocation possibilities. The pension fund managers play these machines regularly as well—for the sake of diversity in investment policy, if for no other reason. We know how much they have put in the alternative machines, for how long, and what the payoff has been. We are entitled to have the same comparable information for the half dollar machine. There is no reason to segregate this machine and remove all limits on its use when we cannot measure and compare the payoff of this machine against the known payoff of each alternative machine being used.

Both PERS and STRS are now gearing up to bring in new investment managers—apparently in the expectation that both Proposition 21 and Proposition 22 will be approved by the state's voters in June. Proposition 22 would authorize compensation levels for the new investment managers which are far beyond the maximum salary levels now authorized by the State Department of Personnel Administration. PERS has indicated that it intends to allocate far more of its total investments to common stocks, to be managed "with the objective of surpassing equity market performance through active management." Where is the long term record to justify such potential risk in the investment of the pension savings of workers? The advocates of Proposition 21 have not furnished such a record. What data is available indicates that the risks may be far greater than the potential gains from stock market gambling on equities.

2. The need for the protection provisions of Proposition 21

In the private sector, the Employee Retirement and Income Security Act (ERISA) enacted by Congress in 1974 gave significant new protections of the basic pension rights of private sector employees. In particular, ERISA set up the ground rules to protect against conflicts of interest and violations of fiduciary obligations in the management of pension assets. ERISA made it clear that the pension fund savings of workers can be used only for retirement and related benefits, and for no other purpose. Since ERISA, there have been continual efforts to enact similar protections for employees covered by all state and local agency pension plans. Endorsed by all major public sector labor organizations, these efforts continue, but there is no optimism anywhere that Congress will soon enact the needed protection for all public agencies in the nation.

In the years since ERISA, California has struggled with tax backlash measures like Proposition 13, which have put serious financial constraints on the revenues of public agencies. Strapped for funds to continue normal governmental operations, some of these agencies have tried to use the pension fund savings of their employees for programs and purposes they were never intended to support. The euphemism for such uses of pension funds is "creative diversion." In fact, these are illegal raids on some huge aggregations of capital in the public sector funds of this state.

California may need the kind of ERISA protection which would make such raids illegal. However there are comparable legislative and constitutional protections for the pension plan savings of public employees in California, and they do not stop the temptation to raid pension funds. For example, a recent attempt to use $180 million in PERS contributions to help balance the California state budget was declared illegal by the courts. In this situation, public agencies which sought to use pension fund contributions for illegal purposes were not only obliged to make the contributions, but were also forced to pay penalties for late payments to PERS. It is not clear that the protective language borrowed from ERISA and added to other provisions of Proposition 21 would have stopped this kind of raid.

There are other ways of raiding pension plan savings—in the public sector and in the private sector—primarily by deferring contributions, and changing the actuarial assumptions and the funding schedules. These raiding techniques, which have been utilized both by UCRS and STRS, are subtle and are difficult to challenge in the courts. All employees and their pension fund representatives must be vigilant in protecting their savings. The need for vigilance will continue to increase, in proportion to the shrinking of government tax bases.

New requirements have been legislated in California in recent years for reporting and disclosure of public sector pension plan data. Unfortunately, the data now reported does not include adequate information on the major categories of investment allocations, on actual time-weighted rates of return on investments, on the funding levels of public sector pension plans, and on the actuarial assumptions that lie behind the funding schedules.

An important step was taken by the California legislature last year (in AB 672, Papan) to require the full reporting of this essential information by the major state funds, PERS and STRS. AB 672 was passed by both houses in the state legislature, but was vetoed by Governor Dukemejian. In the process, the Governor simply side-tracked an important evolutionary development of responsible state legislation needed to protect the huge stake which public employees have in the investment and funding policies of their primary California pension plans.

3. Beyond Proposition 21

It is the full reporting and disclosure of all relevant investment and funding information which would give to public employees in California the best assurance they could get that their pension fund savings (from deferred wages) are being handled responsibly. The "protection" language of Proposition 21 does not give them sufficient assurance. Instead, the proposal of Proposition 21 to remove the equity investment limitation, in the absence of full reporting and disclosure requirements, amounts to handing the investment managers a blank check.

The numbers which are written on any such blank check are the dollars saved from the wages of public employees for their retirement, disability and survivors' benefits. The employees have every right to full, detailed and complete information about how their savings are used by others, and how the decisions of others affect the investment returns and funding levels of their pension plans. What is involved in this right to know is nothing less than the final delivery of the promises which are made to employees, by others, about the final return to them of their own money.

Proposition 21 will be successful only if it sends a message to all public employees in California. The message is not only that they need to exercise constant vigilence to protect their pension funds; it is also that they are entitled to much more information than they now get on how their pension fund savings are invested, on what the actual rates of return are on these investments, and on how their pension plans are funded.

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