

An Industry Perspective (November 2010)

Insight on Challenges Being Faced by Public Pension Plans

The Government Accountability Office (GAO) recently issued a report detailing the practices and risks state and local government pension plans are undertaking. Of note is the higher level of investment risk these plans have gradually taken on. The report was issued by the GAO in response to a request from the Senate's Committee on Finance to investigate the investment practices and governance structures of public pension plans. In addition to the historical use of alternative investments, the report discusses other approaches being implemented in an attempt to address governance, investment and funding challenges.

The **Pension Management Research Panel** recently delved into a number of issues facing public pension plans. The panel conducted primary research by questioning representatives from 70 different pension funds. Of those individuals questioned, 58 percent represent municipality or city plans, 23 percent are from state plans and the remaining 19 percent represent county or township plans. None of those polled are clients of SEI. Below is a summary of three findings from the research:

1. Underfunding Continues to Put Public Pensions at Risk

More than half (55 percent) of the pension funds questioned said the approximate funded status of the pension plan was 80 percent or lower.

The number of poorly funded state and local pensions is staggering; recent industry research suggests that the combined underfunded liability of state and local pension plans exceeds \$3.5 trillion¹. According to the GAO study, as a result of underfunding, governments may need to make significant fiscal adjustments, such as modifying employee benefits or increasing contributions to plans. Additionally, plans may alter investment strategies in an attempt to maximize returns by assuming increased risk².

Of the funds questioned in this study, nearly a third (32 percent) had an approximate funded status of below 70 percent and more than half (55 percent) are below 80 percent. Of concern is the trending decline in funded status over a ten-year period. According to an annual study on funded ratios of government plans, the average funding ratio for public pension plans was 106% in 2001 and 91% in 2002. The median (50th percentile) state pension plan had a funding ratio of 88%³.

¹ "The Crisis in Local Government Pensions in the United States" [Novy-Marx, Robert & Rau, Joshua](#) (October 2010)

² "State and Local Government Pension Plans" [United States Government Accountability Office \(GAO\)](#) (August 2010)

³ "2003 Wilshire Report on State Retirement Systems: Funding Levels and Asset Allocation" [Wilshire Consulting](#) (March 2003)

Given the current status of funded ratios, the number of public pensions willing to change their asset allocation strategies and incorporate new asset classes could be high. The GAO report specifically addressed this by suggesting that “an estimated 60 percent of large and medium plans anticipate changes to their investment strategies in response to the current economic environment.”

2. Use of Alternatives in Pension Portfolios is High

A very high percentage (81 percent) of the pension funds questioned said the pension plan has some allocation in alternative investments.

While alternative investments have traditionally been popular among nonprofit institutional investors such as foundations and endowments, use of this asset class has only recently gained popularity in pension portfolios. The GAO report revealed that “state and local plans reported gradually changing their asset portfolios over many years by increasing their allocations in higher risk investments partly in pursuit of higher returns, but also for diversification following well-accepted techniques of portfolio management given their long investment horizon.”⁴

Given that a large percentage of plans use alternatives, a reasonable follow-up question is the percentage of portfolio assets invested in alternatives. Nearly a fifth (16 percent) of the pensions questioned in this study invested more than 15 percent of the portfolio in alternatives. Additionally, the size of the pension fund - in terms of invested assets - seems to impact the amount allocated in alternatives. More than half (58 percent) of the funds with \$300 million or less capped the alternative allocation at 10 percent of the portfolio. The type of plan appears to matter as well: all of the state plans surveyed said they had some allocation in alternatives and more than one-quarter (28 percent) said allocation amounted for at least 31 percent of the entire portfolio. Meanwhile, municipal plans and city plans are much more conservative with alternatives; one-quarter reported that they had no allocation in alternatives at all. Of the municipal and city plans that do invest in alternatives, none had an allocation greater than 15 percent of the portfolio.

The most popular alternative investments currently used by the funds surveyed are venture capital, private equity, real estate, commodities and hedge funds. The funds with over \$300 million in assets invest in a much wider range of alternatives, with nearly half (46 percent) investing in timber and more than a third (34 percent) investing in energy.

While it appears that the majority of public pension funds are relatively conservative in their current allocation in alternatives, those allocations could increase. A recent study by J.P. Morgan suggested that this trend toward alternatives is most prominent in public pension plans, where alternative allocations are set to increase by 7 percent over the next two to three years⁵. Nearly half (44 percent) of the funds questioned in this study said they are considering investing in additional alternatives.

⁴ “State and Local Government Pension Plans” United States Government Accountability Office (GAO) August 2010

⁵ “Market Pulse: Alternative Assets Survey” J.P. Morgan Asset Management (September 2010)

3. Changes Addressing Governance and Management Challenges May Be Underway

Nearly a quarter (24 percent) of the pension funds questioned said their organizations have already implemented some of the governance changes highlighted in the GAO report.

The GAO summary suggested that public pension plans reported pursuing or implementing a variety of strategies to address challenges confronting them—whether related to governance, management of their investments or funding. These strategies include pooling assets to reduce the cost of managing investments, acquiring more skilled investment management talent and issuing debt in the form of pension obligation bonds in order to raise additional cash⁶.

- **Pooling assets to reduce the cost of managing investments**

Underfunded public pension plans have created enormous budgetary pressures for states and municipalities. The consolidation of pension assets into a larger pension system is a strategy that could alleviate some of the pressure, but the process is challenging. Defined benefit plans carry contractual obligations for participants; therefore changes to the structure of these plans must be carefully navigated. Over the years, a variety of different pension plans have pooled pension assets into larger systems, however less than a fifth (17 percent) of funds surveyed said they have already taken this step or are considering this strategy.

- **Acquiring more skilled investment management talent**

The investment management of public pension plans continues to gain complexity with the ongoing introduction of new, global asset classes and strategies. As previously stated, severely underfunded plans are increasingly looking into adding complex asset classes. Public pension plans derive income from three sources – employee contributions, government contributions and investment returns. Considering the changing factors in the market and that public pension plans derive 60 percent of revenue from investment returns⁷, management of these assets is paramount.

Only 2 percent of the pension funds surveyed handled all investment decisions internally. The vast majority (88 percent) use an investment consultant who researches and provides a selection of manager finalists, but ultimately an internal person(s) select(s) managers and monitor(s) performance. However, change may be on the horizon. More than a third (35 percent) of the funds using a consultant said they have at least a moderate level of interest in learning more about an outsourced model where the pension committee focuses on strategic initiatives, including asset allocation, and delegates the responsibility of researching and selecting managers to an outside partner. In fact, 10 percent of all pensions surveyed had already switched to this model.

⁶ “State and Local Government Pension Plans” United States Government Accountability Office (GAO) (August 2010)

⁷ “Pension fund investments are up, but gaps persist” Stateline.org (August 31, 2010)

- **Issuing debt in the form of pension obligation bonds**

Over the past 25 years, the use of pension obligation bonds (POBs) has been popular among government pensions because POBs convert current pension obligations into long-term, fixed government obligations. However, both the GAO and the Center for State & Local Government Excellence have expressed concern regarding the use of POBs by public pensions. And, even with an anomalous spike in 2003, the total amount of POBs issued in any given year has never exceeded 1 percent of the total assets in public pensions⁸.

Current popularity of these bonds as a tool to avoid funding shortfalls is also questionable, as an overwhelming majority (88 percent) of funds surveyed said they have not used this form of deficit financing.

Conclusion

Public and government pension funds continue to face challenges regarding managing investment portfolios. It is undeniable that risk exists in the management of these plans, and that the underfunded status of public and government pension funds will continue to be an enormous risk in the future. This research suggests that the trustees overseeing public and government pension plans are diligently attempting to develop strategies addressing some of these challenges. Portfolio construction is considering the benefits of new asset classes, but trustees are similarly considering new models for investment management that provide additional expertise. Many complexities that exist today can be addressed through an openness to make changes to how plans have historically been managed.

For more information please email seiresearch@seic.com.

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⁸ "Pension Obligation Bonds: Financial Crisis Exposes Risks" Center for State & Local Government Excellence (January 2010)