The Singular Role of Public Pension Funds

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Institutional Investors and Corporate Governance

- Global focus (and increasing controversy) about institutional investor stewardship
- Institutional engagement raises difficult issues
  - On what issues should institutions engage?
  - Can institutional investors trade off value for values?
  - Where do institutional values come from?
  - Potential agency costs
  - Politics and backlash

Institutional Investors Are Not All the Same

- Most commentary focuses on mutual funds
  - They own a substantial segment of the market
  - Concentration has created economies of scale
  - Mutual funds have developed sophisticated governance teams
- But mutual fund managers

The Big Three.

- A ... maximize fu
- W ... t it should r

Our Thesis

- Public pension funds should be understood as principals, not agents
- Accordingly, they should be allowed (but not compelled) to pursue objectives beyond exclusively maximizing fund economic value
- Their governing statutes, investment policies and governance structures determine these objectives

Why are Public Pension Funds Different?

- Retiree claims are contractual because most public pension funds are defined benefit plans
- Retirees do not benefit from superior investment returns or suffer from poor returns
- Most public workers never become eligible for a pension
- Pension shortfalls can be increased through taxes or contribution increases
- Legislatures, investment policies and board structures determine fund objectives
- Funds are politically accountable for their decisions

Overview of Public Pension Funds

- We focus on state and local pension funds
- Public pension funds are funded by
  - Employee contributions
  - Tax dollars
  - Returns on their investments
- Upon retirement, public employees receive a defined benefit based on
  - Average salary
  - Years of service

Examples from the Paper

CalPERS

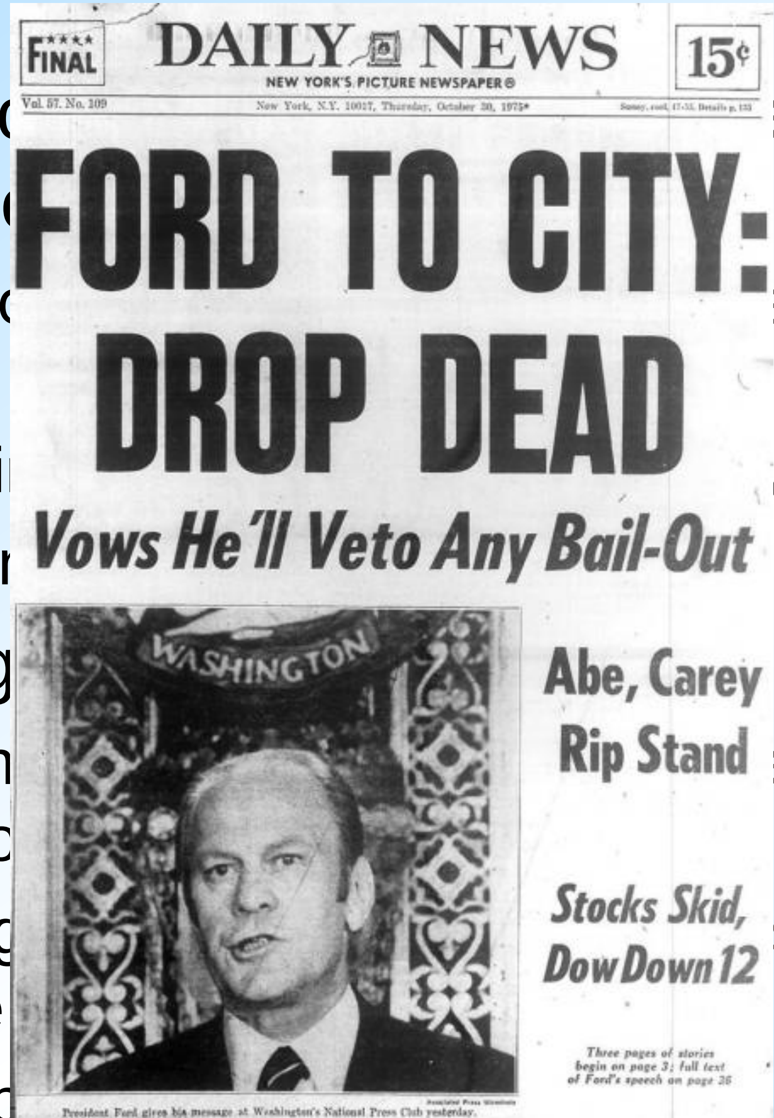
Office of the New York
STATE COMPTROLLER
Thomas P. DiNapoli
NYS COMMON RETIREMENT FUND

TRS
TEACHER RETIREMENT SYSTEM OF TEXAS

NYCERS
NYC Employees' Retirement System

Public Pension Funds and Investing

- Initially pensi… …ed largely on local investm…
  - "Legal lists" … …estments, largely local bonds
  - Legislation li… …y-traded equities
  - 1975 NY Pe…
- Things chang…
  - Increasing in… …er returns as an alternative to…
  - Asset manag… …sion fund assets (and receive…
  - Beneficiary p… …, not a constraint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Vol. 57. No. 109 — New York, N.Y. 10017, Thursday, October 30, 1975*

FORD TO CITY: DROP DEAD

Vows He'll Veto Any Bail-Out

WASHINGTON

President Ford gives his message at Washington's National Press Club yesterday.

Abe, Carey Rip Stand

Stocks Skid, Dow Down 12

Three pages of stories begin on page 3; full text of Ford's speech on page 26

Public Pension Funds and Socially-Oriented Investing

- Early users of investment screening
  - South Africa
  - Sin stocks
  - Guns
  - Oil & Gas
- Targeted investing
  - Local investment – ETIs
  - Local infrastructure projects
  - Support for state and local bond issuances

Public Pension Funds and Corporate Governance

- Public pension funds were among the first institutional investors to engage in corporate governance
- CalPERS' "Vote No" Campaign
- Shareholder proposals
- Sup
- Lea gation

Cracker Barrel
D COUNTRY STORE

We value this engagement (unlike the current SEC?)

So What is the Problem?

- Beneficiary primacy imposes fiduciary duties on institutional investors that are generally understood to require prioritizing fund economic value
  - SEC rules for mutual funds
  - ERISA/DOL rules for retirement plans
  - Public pension funds have been subject to similar analysis
- Beneficiary primacy creates litigation/liability risk for public pension funds, which limits the above-described activities
- Politics increases these risks
  - Decisions to divest
  - Refusals to do business with “woke” companies
  - Furthering local initiatives and industries

Litigation Challenges

- *City of Baltimore (*challenge to city ordinances requiring public pension funds to divest from South Africa)
- *Wong v. NYCERS* (challenging decision by NY City pension funds to divest from fossil fuels)
- *Keenan v. Oklahoma* (state statute enabling Treasurer to blacklist firms that discriminate against the oil and gas industry)
- Although courts generally uphold fund decisions, they pay lip service to beneficiary primacy
- We propose instead to discard it

We argue

- Although agency theory supports beneficiary primacy for mutual funds
- Public pension funds should be understood as principals, not agents
- Legislation, investment policies, fund governance structure (i.e. board representation) determine fund objectives

See, e.g. Illinois Infrastructure Development Act, establishing a portion of the state's investment portfolio to be devoted to building and strengthening the state's infrastructure and real estate.

Our Analysis is of Key Importance for Corporate Governance

- Because of the limitations of intermediaries, principals play a critical role in corporate governance
- Public pension funds have been transformative
- The law should facilitate rather than constrain their behavior
- Our analysis has potential implications for other investors – faith investors, sovereign wealth funds, retail investors

Counterarguments

- Do existing beneficiaries lose rights?
- Will eliminating beneficiary primacy exacerbate underfunding?
- Is there a limiting principle?
- Won’t our proposal make public pension funds more political?
- What about self-dealing by fund managers?

Fred Buenrostro
Former CEO of CalPERS

We welcome your input