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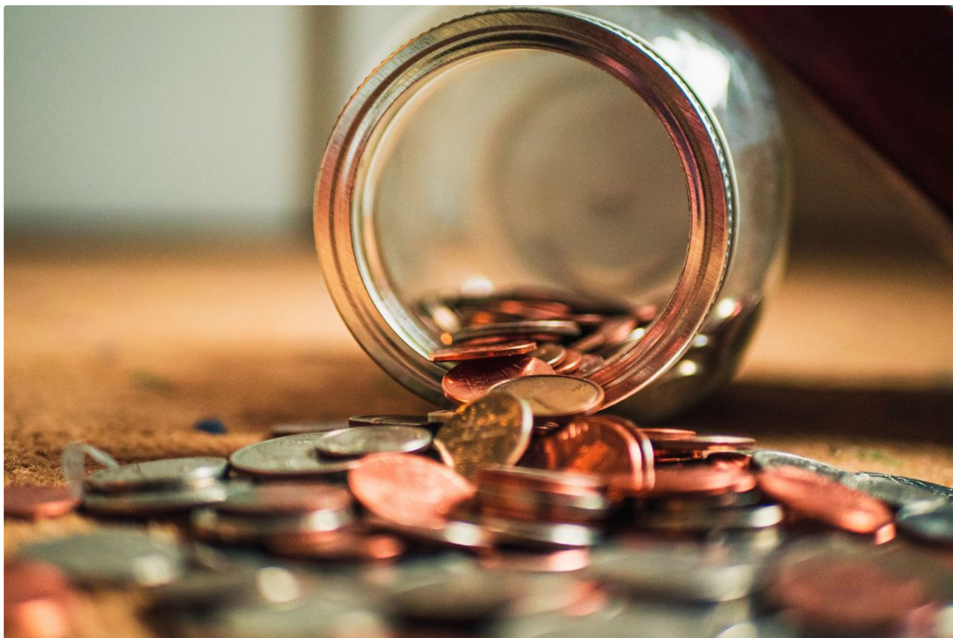
ALTERNATIVE INVESTMENTS

Pension Funds Chased Alternative Investments After the Crisis. They Missed the Bull Market.

COMMENTARY By Jay Bowen Aug. 26, 2019 8:00 am ET



Photograph by Josh Appel

Just when you thought the public pension space had satisfied its desire for alternative investments, their appetite has reemerged more ravenous than ever.

This trend is particularly pronounced for municipal pension funds, with alternatives, like hedge funds, private equity and real estate funds, comprising an ever-increasing share of the allocation. This drift, and its consequences, were captured in a Wall Street Journal article on Aug. 6 titled, "America's Pension Funds Fell Short in 2019."

Data from the Public Plans Database show that since 2005, commitments to alternatives have tripled to almost 27%. Over the same period, stock and bond exposure has fallen to under 49% from more than 60%.

This is disconcerting for a variety of reasons, not least is that many of these funds began their relentless pursuit of investments outside of traditional equities and bonds on the eve of what has become one of the longest bull

markets in U.S. history.

In the 10-year period ended June 30, stocks have generated annualized returns of 14.7% as represented by the S&P 500, while an elegantly simple blended index of 60% stocks and 40% bonds returned 10.6%. At the same time, according to the Investment Metrics database of public pensions, the median municipal plan produced an annualized return of 9.2%, while the Credit Suisse index of 9,000 hedge funds returned 5%.

Most of the investment decision-making process in the municipal pension fund arena flows from modern portfolio theory, which equates volatility with risk. Thus, diversification is pursued in an attempt to maximize returns and minimize risk.

This looks good on paper but in practice it has proven to be more about the theoretical, and less about what Charlie Munger has called "enlightened common sense." While obsessing over a plan's alpha, beta, and Sharpe Ratio might make for sophisticated finance committee meetings, in the real world of investing this methodology has been a prescription for mediocrity. In fact, Warren Buffett has lamented that what is taught about investing has gone backwards over the last 40 years.

The good news is that these plans have a powerful ally on their side: time. For all intents and purposes, they are for perpetuity. And just as they did not become underfunded overnight, neither do they need to right the ship immediately. It is imperative, however, that a few key principles be embraced in order to ensure the long-term viability of these defined benefit plans.

While it goes without saying that investment performance is vitally important, accounting for approximately 70% of funding for public pensions, a commitment by the plan sponsor to make regular and full contributions to the plan is also a critical factor for the current and future health of these funds. Not surprisingly, the worst offenders of this funding negligence, such as Illinois and New Jersey, have displayed a habitual pattern of pushing their obligations into the future, as the gap between actual versus required contributions has continued to widen.

It is also important for these plans to embrace a long-term investment approach, preferably 20 years. From an actuarial standpoint, they have the ability to do this, but the constant gyrating among asset classes using rearview mirror optics promotes a short-term mentality, when eyes should be firmly focused on the distant horizon.

In concert with this, they should also raise their equity exposure, with the Norwegian sovereign wealth fund as their model. In 2017, this trillion-dollar fund increased its long-term target asset allocation of the total fund to 70% stocks. Buttressing this position is post-World War II annualized rolling 20-year performance data, which captures 52 separate periods, and shows an average return of 10.9%, meaning stocks for the long term are a legitimate antidote for what ails many of these plans.

Finally, there should be an intense focus on fees, which can have a jaw-dropping impact on fund values over the long term. The increased reliance on alternative investments has coincided with a substantial increase in money management fees paid by public funds to the tune of about 30%, according to a recent report by The Pew Charitable Trusts.

While the current expansion and bull market are lengthy from a historical standpoint, these periods do not die of old age. Absent a policy blunder, this recovery could very well be mid—as opposed to late—cycle. In fact, we could be in for a 1990s moment, when subdued inflation, a stable dollar, and a burst of productivity growth made the latter half of the 1990s a golden era for stocks, with blistering annualized returns of over 28%.

Time is on their side but the reform process must begin in earnest as state and local retirement funds now amount to $9.1 trillion. With close to half of this total unfunded, their current status can only be described as tenuous.

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