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Public Pensions: The Multiplier Effect

by Doug Hoffer

Pension funds can play an important role not only in ensuring the economic security of a state's retirees, but also in promoting local economic-development goals. Historically, public pension funds' investment policies were narrowly construed, weighing only the rate of return for potential investments. Today, however, many elected officials and trustees recognize that considering secondary effects like local economic growth fulfills both a social responsibility and a fiduciary one.

That is why more trustees are investigating opportunities for "economically targeted investment" (ETI). As financial markets and economic conditions have changed and gaps in traditional sources of credit have appeared, barriers to government goals such as small business development and affordable housing have increased. Officials around the country are learning that pension fund investments, when done properly, can boost economic development without undermining fiduciary responsibility.

What and Why?

California Public Employees' Retirement System defines economically targeted investments as risk-adjusted market rate investments with collateral intent to improve "the economic well-being of the [state], its localities, and residents. Economic stimulation includes job creation, development, and savings; business creation; increases or improvement in the stock of affordable housing; and improvement of the infrastructure."[1]

ETIs are not a separate asset class but a *perspective* that gauges secondary effects as well as good financial returns:

- **Market rate returns.** "ETIs are distinguished from 'benevolent' or 'social' investments. Social investments are made by foundations, government agencies, non profits,and individuals whose primary purpose is to accomplish some social goal. In contrast, ETIs must be organized to yield a market rate of return commensurate with risk, liquidity, and transactional costs."[2]

- **Collateral benefits.** Although most investments yield a return to society, ETIs are distinct because they provide money to underfinanced sectors of the economy and fill "capital gaps."

The societal return from most corporate stocks and bonds is diffuse and may not provide direct social benefit to the state from which the investment originated. ETIs, however, direct both the investment and the social benefit to a defined geographic area. If Vermont pension funds, for example, target investments to Vermont, they can get a good return, help the Vermont economy, and boost the tax base (thereby supporting the security of the state employees they serve).

Because capital markets do not invest equally in all worthy investment vehicles, more pension funds are looking at ways to invest in the local economy without risking a poor return.[3]

Win-Win

Nonfederal public pension plan fiduciaries are bound by rules defined in state statutes, usually a variation of those found in the Employee Retirement Income Security Act (ERISA), the 1974 federal law governing private pension plans. These include cautions about prudence, diversification, and exclusive purpose (fiduciaries must discharge their duties for the *exclusive purpose* of providing benefits to participants and their beneficiaries and defraying reasonable administrative expenses).

The U.S. Department of Labor's most recent interpretive bulletin, July 2002, reiterates that the same fiduciary standards apply to ETIs as to other plan investments, so fund administrators are free to pursue them.

State and local pension plans offer potential for win-win investing. With trillions in assets, they can designate at least a portion to local economic development. The most recent comprehensive survey of public pension plans found at least 29 states have public pension plans with some form of ETI program.[4] Assets invested in ETI programs were estimated at about $55 billion, with residential housing and venture capital the most common ETI programs.[5]

Because mortgage-backed securities are safe and easily traded, public pension funds have made housing an important part of their ETI programs. According to the U.S. General Accounting Office (GAO), almost one-third of those programs are focused on residential housing, with investments in mortgage-backed securities, housing finance agency bonds, investment trusts (for example, AFL-CIO Housing Investment Trust), project financing, and direct financing.

Some pension funds stimulate local development through guaranteed Small Business Administration (SBA) loans, linked certificates of deposit, private placement, and targeted venture capital.

How Are They Doing?

According to the fiduciary standards, it is not enough to have a positive return: a market rate of return for comparable types of investments is required. In 1995, the GAO developed benchmarks for each type of ETI program. Then it surveyed U.S. public pension funds and found that most ETI programs were *outperforming* the benchmarks.

Today the numbers of ETI programs are growing. California's CalPERS and CalSTRS have large ones.[6] Together they have:

- committed $830 million for private equity investment in businesses in underserved areas;
- committed more than $4.3 billion to urban, in-fill real estate ventures, including $695 million for affordable housing;
- purchased $90 million in California home mortgages;

- purchased $260 million in California SBA loans; and
- vastly increased deposits in community lending institutions and credit unions.

In Massachusetts as of March 31, 2006, the market value of the Alternative Investment Portfolio, which includes venture capital and special equity partnerships, was $2.64 billion. The portfolio comprised 6.3 percent of the state's public pension trust funds, although the asset allocation allows up to 10 percent.[7]

As of December 31, 2005, the aggregate investments for all New York City ETI programs since inception amounted to more than $1 billion. The investments went toward renovation, new construction, or financing of more than 30,000 units of affordable housing and many small retail spaces. They "created thousands of construction jobs and financed child-care facilities and senior citizen centers. The five-year overall return on the pension funds' targeted investments was 6.30 percent and the 10-year return was 8.34 percent."[8]

The Texas Growth Fund was established in 1988 and invests in the local economy, too, specializing in "structuring equity and subordinated debt investments that finance buy-and-build strategies, internal expansions, and buyouts of small- to middle-market companies."[9] Through 2004, the Fund has invested more than $400 million in 44 Texas businesses.

And as of December 2005, the Washington State Investment Board had $1.3 billion (2.7 percent of total funds) in Washington-based investments, including public equity, fixed income, real estate, and private equity.[10]

Perceived Barriers

Issues remain. A challenge for funds is that direct investments, including ETIs, are time-consuming. That's why commingled real estate and mortgage accounts are popular. Because they provide liquid, diversified investments with solid returns, they are easier to implement.

A second concern is that complex direct ETIs often have high administrative costs. Mortgages and mortgage-backed securities entail fewer such expenses.

Finally, overzealousness and political interference sometimes cause problems, and fund managers need to be on guard. Connecticut, for example, lost millions in the 1990s by investing in the failing Colt Manufacturing Company to save jobs. Connecticut officials have since learned to give adequate consideration to risk-adjusted returns. In another instance, when oil prices collapsed in 1987, 40 percent of Alaska's in-state mortgages became delinquent or ended in foreclosure. Alaska learned that having 35 percent of its fund assets in mortgages was an unreasonable allocation.

But since the early days of ETIs, pension funds have developed more sophisticated in-house expertise and have hired established professionals to help manage the programs. The number of existing programs (and the billions invested) is evidence that ETI programs can succeed.

Economically targeted investments are prudent if well conceived and managed. Numerous public pension funds have utilized small portions of their assets to fill financing gaps for affordable housing, small business development, and venture capital. The available data suggest that return on investment is reasonable and comparable to similar non-ETI investments.

The primary responsibility of state pension boards is to protect the workers and retirees who depend on the funds' assets. However, with economically targeted investments, they have an opportunity to advance additional goals. To the extent a successful ETI program helps to create a more sustainable economy, it will directly benefit the workers and pensioners the funds represent.

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Endnotes

[1] CalPERS Statement of Investment Policy for Economically Targeted Investment Program, February 14, 2005; see http://www.calpers.ca.gov/eip-docs/investments/policies/other/economically-targeted/eco-target-inv-prg.pdf.

[2] R. Ferlauto and J. Clabourn, *Economically Targeted Investments by Statewide Public Pension Funds* (Washington, D.C.: The Center for Policy Alternatives), September 1993, p.4.

[3] U.S. Dept. of Labor, Advisory Council on Pension Welfare and Benefit Plans, "Economically Targeted Investments: An ERISA Policy Review," 1992.

[4] U.S. General Accounting Office, "Public Pension Plans: Evaluation of Economically Targeted Investment Programs," March 17, 1995.

[5] *Economically Targeted Investments: A Reference for Public Pension Funds* (Sacramento, California: Institute for Fiduciary Education), June 1993.

[6] See http://www.treasurer.ca.gov/publications/dbl/five_years.pdf.

[7] See http://www.mapension.com/InvestmentProgram/CoreDescrip.html#AltInv. The Pension Reserves Investment Trust (PRIT) Fund is a pooled investment fund established to invest the assets of the Massachusetts State Teachers' and Employees' Retirement Systems, and the assets of county, authority, district, and municipal retirement systems that choose to invest in the Fund.

[8] See http://www.comptroller.nyc.gov/.

[9] See http://www.tgfmanagement.com/investment/i2.html. The Texas Growth Fund "is an equity-oriented investment fund based in Austin. The TGF is backed by the state's four largest public trust funds: the Permanent School Fund (PSF), the Permanent University Fund (PUF), the Teacher Retirement System (TRS) and the Employees Retirement System (ERS). Each of these trust funds, as well as any local government trust fund, is authorized to contribute to TGF 'trusts.' Each of the four major state trust funds is represented on the Texas Growth Fund Board of Trustees."

[10] See http://www.sib.wa.gov/financial/pdfs/eti/2005.pdf. "The Washington State Investment Board manages $65 billion in assets for 34 separate state retirement and other trust funds."

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