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AMERICAN COMPASS

Public Pension Accountability

REQUIRE TRANSPARENCY IN MANAGEMENT OF PUBLIC MONEY

WHAT'S THE PROBLEM?

Public pension managers are responsible for **$5 trillion in assets** for state and local pension systems but face misaligned incentives.

Pension underfunding creates **political pressure to achieve unrealistic returns**, pushing managers toward risky alternative investments.

These investments charge enormous fees while avoiding disclosures that would allow the public to evaluate their performance. **When these gambles go bad, taxpayers are on the hook**.

PHONY HAPPINESS, REAL FAILURE

State and local pension managers rely on private investment firms to invest retirement funds for millions of Americans.

Pensions are under political pressure to deliver implausibly high returns to compensate for chronic underfunding. To fulfill politicians' promises, pension managers turn to risky "alternative investments" like private equity (PE) and hedge funds because they promise high returns. But these investments consistently underperform simple market index funds.

What these investments *do* deliver are enormous fees for those running them. The illiquidity and opacity of these investments also shield pension managers from accountability—murky reporting requirements and incomplete data make these investments hard to properly value. It's easy to see why a politically appointed pension manager would prefer difficult-to-value assets promising high returns at some far-off date. Retirees are promised their pensions regardless of how the funds perform; it is taxpayers who are left holding the bag.

WHAT'S THE SOLUTION?

Capital imbued with public purpose, like state and local pension funds, should be invested transparently. Congress should pass legislation requiring reasonable public reporting standards for private funds that invest and collect fees on public-purpose capital:

1. **Pre-registration of public benchmarks.** Private funds investing public-purpose capital should be required to identify and publicly disclose upfront the benchmarks that they propose to outperform.

2. **Public release of annual performance.** These private funds should also be required to publish comprehensive financial statements on an annual basis, including the timing and amount of all cashflows into and out of the fund, deal size and structure for all transactions, and annual marked-to-market valuation for each asset held in the fund. Congress should direct the SEC to establish appropriate financial reporting standards for this purpose.

RESTORING SANE INVESTMENT

These reforms will require pension managers to clearly understand and confront the risks they take, enabling elected officials and the public to evaluate their performance. **Requiring pre-registration of public benchmarks** would force funds to choose between setting reasonable expectations for pension managers, or setting unreasonable ones against which their performance could be evaluated and their fees calibrated. **Disclosing annual performance** against these benchmarks will help pension managers pick the most effective firms and allow policymakers and analysts to assess performance.

FREQUENTLY RAISED OBJECTIONS

"INVESTORS ARE BEST POSITIONED TO POLICE THEIR OWN INVESTMENTS AND ENSURE STRONG RETURNS."
Maybe that's true for people investing their own money, but public pension managers are under pressure to chase higher returns regardless of risk and participate in investments for which they cannot be held accountable. Meanwhile, PE and hedge fund managers are incentivized to raise and invest as much as possible, collecting fees on every dollar managed and every transaction executed. But since the mid-2000s, they have performed no better than simple public index funds.

"THERE ARE ALREADY TOO MANY BURDENSOME REPORTING REQUIREMENTS."
Financial markets rely upon accessible and reliable information, and financial actors engaged with the public should provide that information publicly. Investment managers are free to play with their own private money privately, but if they want to charge top dollar to manage trillions of dollars in public money, the public has a right to evaluate how well they are doing.

"THIS WILL RISK AMERICANS' RETIREMENT FUNDS."
Pension funds are already at risk. Political pressure to deliver unrealistically high returns leads managers to find alternative investments that too often fail. To take one example, the Pennsylvania Public School Employees' Retirement System invested 51% of its $62 billion fund in alternative investments so risky it prompted an FBI fraud investigation. In general, greater exposure to alternative investments is correlated with worse performance for public pensions funds.

KEY FACTS

29M Americans with retirement benefits promised through state public sector pension systems[1]

$5T Assets controlled by state and local pension systems (2022)[2]

35% Share of private equity investment from pension funds, the industry's largest source of capital[3]

5 OUT OF 52 State pension systems that outperformed a basic 60% equities, 40% bonds portfolio over the past decade (2019)[4]

$230B Management fees collected by PE firms over the last decade[5]

FURTHER READING

Oren Cass. "Confronting Coin-Flip Capitalism." *American Compass*, 2021.
A pro-market agenda for financial reform that includes these proposals.

"A Guide to Private Equity." *American Compass*, 2021.
An introduction to the private equity industry that highlights its diminishing returns.

Jessica Hamlin. "'Warning signs': PE could impact public pension plans' funding status this year." *PitchBook*, 2023.
An analysis of the impact of private equity's low returns on public pensions.

Neil Weinberg. "Investing Novices Are Calling the Shots for $4 Trillion at US Pensions." *Bloomberg*, 2023.
A breakdown of the public pension management system.

ABOUT AMERICAN COMPASS

Our mission is to restore an economic consensus that emphasizes the importance of family, community, and industry to the nation's liberty and prosperity. American Compass is a 501(c)(3) nonprofit organization.

For more information, visit americancompass.org

[1] "State Public Pension Fund Returns Expected to Decline." *The Pew Charitable Trusts*. 2022.
[2] "Public Pension Assets: Quarterly Update (Q3 2022)." *National Association of State Retirement Administrators*. 2022.
[3] William W. Clayton. "How Public Pension Plans Have Shaped Private Equity." *Maryland Law Review*. 2022.
[4] "Public Pension Performance: Comparing Pension Investments to Passive Index Portfolios." *Institute for Pension Fund Integrity*. 2019.
[5] Ludovic Phalippou. "An Inconvenient Fact: Private Equity Returns & The Billionaire Factory." *University of Oxford, Said Business School*. 2020.