CalPERS Earnings No Longer Last Among Big Funds

POSTED BY : ED MENDEL SEPTEMBER 22, 2014 IN LOCAL GOVERNMENT

Three years ago CalPERS investment earnings hit bottom in a Wilshire consultants report that ranks the performance of big pension funds — dead last among its peers over the previous five years.

Last week a new Wilshire report showed CalPERS investment earnings steadily climbing up the ranks, finishing in the top quarter of big pension funds during the last three years.

In *the report that* ranks 49 public pension funds with portfolios of $10 billion or more, not only were CalPERS investment earnings in the top quarter during the last three years, but risk (as measured by volatility) was in the bottom quarter.

"That's a great combination," Andrew Junkin of Wilshire told the CalPERS board. "I can't promise that it will be that way forever going forward. That's certainly the Goldilocks outcome. But it's a good place to be, and we should recognize it and enjoy it."

The nation's largest public pension fund is slowly recovering from giant losses during the recession. The portfolio peaked at $260 billion in the fall of 2007, plunged to about $160 billion in March 2009, and had climbed to $299 billion last week.

But CalPERS is still underfunded. It has about 76 percent of the projected assets needed to pay promised pensions. And that assumes investments will earn 7.5 percent a year, which critics say is too optimistic, though down from 8 percent last decade.

With a change in actuarial method, CalPERS is no longer keeping employer contribution rates low by spreading investment gains and losses over 15 years and refinancing debt each year.

The goal now is to get to full funding in 30 years. A series of rate increases, one expecting longer lives, will have boosted annual employer contributions to CalPERS roughly 50 percent when phased in over the next few years.

And after the huge losses, there is a new focus on risk. In a routine three-year adjustment of investment sectors last February, the CalPERS board looked at three options expected to yield 7.5 percent, and chose the one with the lowest risk of losses.

Still, CalPERS remains at the mercy of the markets. Investments are expected to provide about two-thirds of the money for pensions. To hit the earnings target, the portfolio leans toward stocks and other higher-yielding but riskier investments.

"If economic growth is generally favorable, the portfolio will likely perform well over time; if economic growth falters, the portfolio may underperform expectations, possibly by a material amount," Allan Emkin of Pension Consulting Alliance told the CalPERS board in an opinion letter last February.

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Asset Class Component	Portfolio A	Portfolio B	Portfolio C	
Global Equity	47%	50%	52%	50%
Global Fixed Income	19%	17%	16%	17%
Inflation Sensitive	6%	5%	4%	4%
Private Equity	12%	12%	12%	14%
Real Estate	11%	11%	11%	9%
Infrastructure and Forestland	3%	3%	3%	2%
Liquidity	2%	2%	2%	4%
Expected Compound Return (1-10 yrs.) :	7.15%	7.27%	7.35%	7.25%
Blended Return (1-60 yrs.)[1] :	7.56%	7.66%	7.72%	7.63%
Expected Volatility :	11.76%	12.22%	12.52%	12.45%
Potential Discount Rate:	7.50%	7.50%	7.50%	7.50%

How the California Public Employees Retirement System is viewed as an industry leader and trendsetter, if not a mover of markets, was on display last week. CalPERS announced the end of its hedge fund program, a $4 billion shift over the next year.

Hedge funds were not part of the three-year plan for allocating investments adopted in February. CalPERS wanted a longer look at the funds that charge very high fees, while recently producing low yields and little loss protection during the downturn.

"Hedge funds are certainly a viable strategy for some, but at the end of the day, when judged against their complexity, cost, and the lack of ability to scale at CalPERS' size, the ARS (hedge) program is no longer warranted," Ted Eliopoulos, the new CalPERS chief investment officer, said in a news release last week.

Strategies used by hedge funds vary. They often "hedge" a bet on a stock or bond by also betting against it, sometimes with borrowed money. They are famous for a "2 and 20" fee: 2 percent of assets under management and 20 percent of profits.

The CalPERS decision to exit 24 hedge funds and six hedge "fund-of-funds" drew mixed reviews in the financial press. Examples: Bad timing, given many expect a market correction. Why did they wait so long, given the poor performance of hedge funds?

But in general, an industry leader eliminating, rather than reducing, hedge fund holdings was expected to draw the attention of other institutional investors and public pension funds, possibly altering their views or investment decisions.

"It is likely to reverberate across the investment community in the United States, where large investment funds look to CalPERS as a model because of its size and the sophistication of its investments," said a New York Times story on Sept. 16.

A Wall Street Journal story on Sept. 15 said CalPERS "is a bellwether for investment trends at other public plans. Any shift it makes will likely influence others because of its size and history as an early adopter of alternatives to stocks and bonds."

When Wilshire ranked CalPERS investment performance last among big pension funds as of Dec. 31, 2011, it's average annual earnings for the five previous years was 0.57 percent, not that far below the median, 1.86 percent.

But the top performers in the fifth percentile (*see Wilshire report* p. 20 where CalPERS is "Total Plan") averaged earnings of 6.12 percent, not far below the CalPERS target of 7.5 percent during a major economic downturn.

With its new focus on investment risk and what some officials have called "back to basics," CalPERS hopes to improve its investment performance during the next big dip in the business cycle or even a crash.

"Following the 2008 financial crisis, CalPERS began examining ways to ensure it was less susceptible to future large drawdowns," the CalPERS hedge fund news release said last week. "The System restructured its investment operations, improved its internal oversight and control functions, and refocused some of its investment programs."

During the fiscal year ending last June 30, CalPERS investments earned 18.4 percent, boosting the five-year earnings average to 12.5 percent and the 20-year average to 8.4 percent.

So, if earnings averaged more than the 7.5 percent target for two decades, why is CalPERS still underfunded with only 76 percent of the projected assets needed to pay pensions promised in the future?

The answer is timing, and the value of the investments on which the earnings are made. Earning 8.4 percent on $260 billion yields more money than earning 8.4 percent on $160 billion, the value of CalPERS investments after the large drawdown.

Wilshire's Junkin told the board that the CalPERS investment performance, after ranking in the top quarter the last three years, begins to drop over a longer time span due to "the well-known real estate issues that start to come into play."

Eliopoulos led an overhaul of the troubled CalPERS real estate portfolio. He was acting chief investment officer, succeeding the late Joe Dear, before a permanent appointment last week put him in charge of an investment staff of nearly 400 persons.

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ABOUT ED MENDEL

Reporter Ed Mendel covered the Capitol in Sacramento for nearly three decades, most recently for the San Diego Union-Tribune. More stories are at Calpensions.com.

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CalPERS Receives $249.3 Million from Bank of America Mortgage-backed Securities Settlement

SACRAMENTO, CA - The California Public Employees' Retirement System (CalPERS) has received $249.3 million in damages from Bank of America, the result of a federal investigation settlement announced in August by California Attorney General Kamala Harris.

This puts CalPERS total recovery on losses the Pension Fund sustained from investments in mortgage-backed securities at more than $500 million.

"This is money that rightfully belongs to our members for their long-term retirement security," said Anne Stausboll, Chief Executive Officer for CalPERS. "We're glad that those who misled investors about the risks of mortgage-backed securities continue to compensate our members for their losses. We thank the California Attorney General's Office and the U.S. Department of Justice for their diligent efforts."

Bank of America came under federal criminal investigation over its role in the 2008 financial crisis due to its misrepresentation of mortgage-backed securities it sold, along with those securities sold by two companies it acquired in 2008, Merrill Lynch and Countrywide Financial.

CalPERS is the largest public pension fund in the U.S., with approximately $290 billion in assets. CalPERS administers health and retirement benefits on behalf of 3,090 public school, local agency, and state employers. There are more than 1.6 million members in the CalPERS retirement system and more than 1.3 million members in its health plans. For more information about CalPERS, visit www.calpers.ca.gov.

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