INVESTING

Watch What Indexing Does for Public Pensions

By Marc Levine

The unfunded liabilities of public pensions are out of control across the country. My state, Illinois, is the most severe case, with only 40 percent of those liabilities funded.

Given the magnitude of the problem, and the political and legal obstacles to fixing it, it remains tempting to underplay the importance of straightforward financial changes that could put the funds on much more solid ground. Worsening the problems of public pension systems nationwide is that they have proved to be poor investors. Standard and Poor's recently released a study showing that about 75 percent of pension funds' vehicle of choice -- actively managed portfolios -- underperformed their benchmarks.

Hundreds of billions of dollars have been poured into wildly expensive hedge funds with little understanding and abysmal results. That has proved to be a colossal mistake -- one that some states have been trying to rectify in the last few years.

Several state pension funds -- including Illinois, Kentucky and Rhode Island -- have slashed their hedge-fund allocations. In 2015, California's public pension system, Calpers, announced that it was getting out of hedge-fund investments and reported unimpressive high-cost private equity performance over 30 years.

A fundamental impediment to investment performance is the political nature of public pensions themselves. Lucrative investment management fees often serve as a honeypot. In the pension world, it is not unusual for friends of legislators, political donors and so on to get special treatment. Boards are not constructed to maximize investment expertise, but rather to represent various political constituencies. Trustees usually do not have existing investment knowledge and nearly all have limited time to dedicate to this voluntary service.

It isn't that unsophisticated pension trustees do too little. It is that they try to do too much. Most pension boards spend too much of their time hiring and firing investment managers. It turns out that this activity and these managers accomplish virtually nothing. Pension consultant Wilshire Associates Inc. estimates that less than 5 percent of pension-investment performance can be attributed to individual investment managers beating benchmarks.

None of this should come as a surprise. In 2008, Emory University's Amit Goyal and Arizona State University's Sunil Wahal published a widely noticed study looking at more than 8,000 hiring decisions at pension funds. They found that, in aggregate, investment managers' excellent past performance became mediocre within one year of being hired.

Wahal told me he believes more recent data would support the study's conclusions and, "if anything, the volatility associated with the financial crisis is likely to have exacerbated the behavior documented in the earlier period."

Warren Buffett says he has observed the unnecessary hiring and firing firsthand. During Berkshire Hathaway Inc.'s 2016 annual meeting, the legendary investor told the crowd, "I've talked to huge pension funds, and I've taken them through the math, and when I leave, they go out and hire a bunch of consultants and pay them a lot of money. It's just unbelievable."

At the Illinois State Board of Investment, we manage $20 billion in retirement assets. In 2015, our board experienced substantial turnover. As we understood these realities, our response was simple: Within a year, we terminated more than 75 percent of our investment managers and hedge-fund managers.

Typically, when a pension fund dismisses an investment manager, it moves the money to another active manager. Unfortunately, the new manager performs no better and frequently worse than the one who was fired. The Illinois State Board of Investment avoids that fool's errand; we have replaced our terminated managers with more than $8 billion of index funds.

Indexing gets us market returns at no cost. For our board, this means no new active managers to understand, hire, monitor and potentially fire. Costs have plummeted, and because index funds outperform nearly all active managers, our performance will improve. With a much simpler portfolio, it is now easier for the staff to manage and the board to provide oversight.

Across the pension industry, consultants, investment managers and staff employees all have an interest in making this seem harder than it is. Academic research and practical experience should lead pension trustees to spend their time on what drives returns -- asset allocation. And designing and maintaining an appropriate allocation does not require investment sophistication or a lot of time. Neither does using indexing.

Most important, indexing is the antidote to the inherent limitations politics places on pension investing. Eliminating the fees associated with active investment management removes incentives for political meddling. And for pension trustees, it eliminates nearly all investment review work that they have neither the time nor experience to effectively perform, and which is of dubious value to begin with.

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