
Protecting and Politicizing Public Pension Fund Assets: Empirical Evidence on the Effects of Governance Structures and Practices

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TABLE OF CONTENTS

INTRODUCTION.....	188
I. OVERVIEW OF PUBLIC PENSIONS AND GOVERNANCE	192
A. <i>The Problem of Underfunding</i>	192
B. <i>Pension Fund Investment Practices</i>	194
C. <i>The Board of Trustees: Stewards or Politicians?</i>	195
II. FUNDING LEVELS AND ACCOUNTING ASSUMPTIONS.....	200
III. INVESTMENT PRACTICES AND PERFORMANCE	204
IV. EMPIRICAL EVIDENCE ON THE IMPACT OF GOVERNANCE ON INVESTMENT PERFORMANCE AND STRATEGIES	208
A. <i>Investment Performance Results</i>	211
B. <i>Determinants of Shareholder Activism and Economically Targeted Investments</i>	215
V. CONCLUSION AND DISCUSSION.....	216

INTRODUCTION

The 2670 public retirement systems¹ for teachers, police, firefighters, government officials, and other public servants represent a significant part of the U.S. economy. Fourteen million state and local government employees participate in these programs, an additional six million people currently receive retirement benefits, and these funds collectively hold over two trillion dollars in assets.² Public pension assets grew significantly with the strong equities markets of the 1990s,³ and by 2000, these funds owned over 10% of the domestic equity market.⁴ Not surprisingly, therefore, public pension funds have become the topic of much academic, political, and economic debate.

Many commentators initially viewed this ownership growth as a positive development and encouraged pension funds to use their power as shareholders to push for governance reforms at major corporations.⁵

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¹ U.S. CENSUS BUREAU, EMPLOYEE-RETIREMENT SYSTEMS OF STATE AND LOCAL GOVERNMENTS: 2002, GC02(4)-6, 14 (2004).

² *Id.* at 1, 20. Nine of the ten largest employee pension funds in the United States are public pension funds. John H. Ilkiw, *Investment Policies, Processes and Problems in U.S. Public Section Pension Plans: Some Observations and Solutions from a Practitioner*, in PUBLIC PENSION FUND MANAGEMENT 211, 214 (A. R. Musalem & R. Palacios eds., 2003). General Motors has the only private pension fund in the top ten. *Id.*

³ For example, the Wisconsin Retirement System saw its assets rise from \$23.9 billion in 1991 to more than \$64 billion in 1999. LEGISLATIVE AUDIT BUREAU, AN EVALUATION: STATE OF WISCONSIN INVESTMENT BOARD 3 (2001). The strong market performance of the late 1990s led various states to drop their prohibitions on investments in equities by public pensions. For example, West Virginia amended its constitution in 1997 to allow investments in equities. Jun Peng, *Public Pension Funds and Operating Budgets: A Tale of Three States*, 24 BUDGETING & FIN. 59, 67-68 (2004).

⁴ Mark Sarney, *State and Local Pension Plans' Equity Holdings and Returns*, 63 SOC. SEC. BULL. 12 (2001).

⁵ Bernard S. Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 UCLA L. REV. 813, 886 (1992) (developing "the case for measured legal reform to facilitate institutional shareholder voice"); John C. Coffee, Jr., *Liquidity Versus Control: The Institutional Investor as Corporate Monitor*, 91 COLUM. L. REV. 1277, 1367-68 (1991) (stating that public policy should encourage public pension funds "to assume a monitoring role"); Roberta Romano, *Less is More: Making Institutional Investor Activism a Valuable Mechanism of Corporate Governance*, 18 YALE J. ON REG. 174, 176 (2001) [hereinafter Romano, *Less is More*] (noting that some commentators believe that "more active engagement in corporate

In California, for example, the California Public Employees' Retirement System ("CalPERS") is the largest pension fund in the United States⁶ and the most active (and controversial) in demanding corporate governance reform.⁷ CalPERS's actions have included a role in the removals of Michael Eisner as Chair of the Walt Disney Company and Richard Grasso as Chair of the New York Stock Exchange.⁸ Not everyone sees this activism as a positive development, however, and the role of public pensions in corporate governance reforms has become the subject of intense debate. A major controversy developed in California when Governor Arnold Schwarzenegger proposed to replace the current system of defined benefit pension plans for state and local employees with a defined contribution system.⁹ This proposal would phase out

governance by institutional investors can substitute for the discipline imposed on managers by the threat of a hostile takeover"); see also JAMES P. HAWLEY & ANDREW T. WILLIAMS, *THE RISE OF FIDUCIARY CAPITALISM: HOW INSTITUTIONAL INVESTORS CAN MAKE CORPORATE AMERICA MORE DEMOCRATIC* 172-74 (2001) (encouraging institutional investors to monitor and push for reforms at corporations in which they invest); Gordon L. Clark & Tessa Hebb, *Pension Fund Corporate Engagement: The Fifth Stage of Capitalism*, 59 REL. INDUSTRIELLES 142, 163-64 (2004) (arguing in favor of "pension fund corporate engagement," and stating that "pension funds are redefining the power relationships within the firm").

⁶ CalPERS controls more than \$180 billion in investments. Dale Kasler, *Governor's Plan Could Erode CalPERS Clout*, SACRAMENTO BEE, Feb. 28, 2005, at A1. The California State Teachers' Retirement System ("CalSTERS") controls an additional \$120 billion. *Id.*

⁷ Phyllis Plitch, *Moving the Market: CalPERS May Shift on Proxy Voting; New Approach to Target Services by Audit Firms, Let Directors Off the Hook*, WALL ST. J., Mar. 14, 2005, at C3.

⁸ Floyd Norris, *Corporate Democracy and the Power to Embarrass*, N.Y. TIMES, Mar. 4, 2004, at C1; Sundeep Tucker, *"Ideological Puritan" Who Alienated by Belligerence*, FIN. TIMES, Dec. 2, 2004, at 27. CalPERS has also been active on social issues, such as encouraging corporations to provide more disclosure on concerns about global warming. Dale Kasler, *For Pension Boards, Politics Are Nothing New, Some Say*, SACRAMENTO BEE, Feb. 15, 2005, at A1.

⁹ Tom Abate, *Pension Proposal Gets Support; Constitutional Amendment to Overhaul System Introduced*, S.F. CHRON., Jan. 25, 2005, at C1. In a defined benefit plan, the government (as the employer) promises to pay an employee a retirement benefit based on the employee's salary and years of service. Edward A. Zelinsky, *The Defined Contribution Paradigm*, 114 YALE L.J. 451, 455 (2004). In a defined contribution plan, the employer's only funding obligation is to contribute a certain amount (such as a certain percentage of the employee's salary) to the employee's retirement fund. *Id.* The employee's retirement income depends on the employer's and employee's contributions to the fund and any investment earnings. *Id.*

In addition to California, several other states have shifted, at least in part, to a defined contribution plan or are considering such a move. See Arleen Jacobius, *Oregon Legislature Mulling New Pension Plan to Cut State's Deficit*, PENSIONS & INVESTMENTS, Apr. 14, 2003, at 2 (noting Oregon's consideration of adopting "hybrid" or defined contribution plan to help reduce \$16 billion funding shortfall); *States' Interest in Adding DC Plans on the Rise*, PENSIONS & INVESTMENTS, June 11, 2001, at 23 (stating that at least ten states were

CalPERS over a period of years and put an end to its governance activism. Adding to this controversy, shortly before the Governor's proposal, union leader Sean Hannigan was voted out as the president of CalPERS's board, reportedly for being too aggressive in pushing corporations for governance reform.¹⁰

While the debate surrounding public pensions' involvement in corporate governance remains prevalent, recently, the focus in public pensions has somewhat shifted. Public pensions now face increased scrutiny due to concerns about mismanagement and underfunding and accusations of misuse of fund assets. A 2004 Wilshire Associates report found that 93% of state pension plans are under-funded (a \$366 billion shortfall in aggregate).¹¹ *The New York Times* recently referred to the city of San Diego as an "Enron-by-the-Sea" due to its diversion of assets from pension plan contributions to other city needs, which created a \$1.2 billion pension deficit.¹² A *Wall Street Journal* commentary suggested that trustees at some pension funds are likely in breach of their fiduciary duties and costing their states' taxpayers hundreds of millions of dollars.¹³

The growing concern over public pensions and their ability to effectively serve the retirement planning needs of state and local government employees centers on the governance of those funds. As policy-makers and commentators have placed an increased focus on the governance of corporations due to the scandals at Enron, Global Crossing, WorldCom, and others,¹⁴ a similar focus on public pension fund governance has developed. In February 2005, Wyoming became the first state to adopt the Uniform Management of Public Employee Retirement Systems Act ("UMPERS"), approved by the Uniform Law

considering adding defined contribution plans as alternatives to defined benefit plans). Currently, 90% of public employee plans are defined benefit plans. Gordon Tiffany, *Public Employee Retirement Planning*, 28 EMP. BENEFITS J. 3, 7 (2003). Some states offer a combination of defined benefit and defined contribution plans. *Id.*

¹⁰ Mary Williams Walsh, *CalPERS Ouster Puts Focus on How Funds Wield Power*, N.Y. TIMES, Dec. 2, 2004, at C1.

¹¹ Julia K. Bonafede, Steven J. Foresti & Benjamin J. Yang, *2004 Wilshire Report on State Retirement Systems: Funding Levels and Asset Allocation*, Mar. 12, 2004, at 1 (copy on file with author).

¹² John M. Broder, *Sunny San Diego Finds Itself Being Viewed as a Kind of Enron-by-the-Sea*, N.Y. TIMES, Sept. 7, 2004, at 14.

¹³ *Pension Fund Shenanigans*, WALL ST. J., Aug. 20, 2004, at A12.

¹⁴ For a review of these scandals, see Lawrence A. Cunningham, *The Sarbanes-Oxley Yawn: Heavy Rhetoric, Light Reform (And It Just Might Work)*, 35 CONN. L. REV. 915, 923-36 (2003).

Commission in 1997.¹⁵ The governance issues of concern to those seeking reform are not only the inappropriate use of fund assets, but also the basic ability of the board of trustees to effectively manage the fund.

This Article contributes to the debate on public pensions by considering empirical evidence on the systematic impact of different governance structures and practices on pension fund performance. In addition to reviewing past studies, this Article analyzes the most comprehensive data set available to allow the debate to move beyond anecdotal evidence and toward a more comprehensive understanding of public pension fund governance.

Part I provides an overview of the funding and investment practices of public pension funds. This part also discusses the structure of public pension fund boards of trustees and the incentives of the different categories of trustees. Part II discusses the empirical evidence of political influence over funding decisions, as well as the actuarial assumptions that affect the sponsor government's required financial contributions to the plan. Part III provides a review of the empirical studies on pension funds' investment performance and the potential for political influence to cause lower returns. Part IV presents an empirical analysis that further investigates the findings of previous studies and considers additional governance factors that may have a significant impact on pension fund performance and strategic actions. Part V discusses the policy implications and concludes.

The data used for the analysis in Part IV and for descriptive purposes throughout the paper comes from surveys of state and local pension systems conducted by the Government Finance Officers Association and the Public Pension Coordinating Council (the dataset is referred to as "PENDAT"). These surveys were conducted approximately every other year between 1990 and 2000.¹⁶ This survey typically includes 250 to 300 pension systems per year. Although this is only a fraction of the state and local pension plans, the sample covers a significant percentage of

¹⁵ Press Release, National Conference of Commissioners on Uniform State Laws, Wyoming Enacts Important State Law on Managing Public Employee Retirement Systems (Mar. 18, 2005), available at <http://www.nccusl.org/Update/DesktopDefault.aspx?tabindex=2&tabid=33> (last visited Oct. 14, 2005). Full text of UMPERS is available at <http://www.law.upenn.edu/bll/ulc/ulc.htm#mpersa> (last visited Oct. 14, 2005). For a discussion of UMPERS by the reporter for the Act, see Steven L. Willborn, *Public Pensions and the Uniform Management of Public Employee Retirement Systems Act*, 51 RUTGERS L. REV. 141 (1998).

¹⁶ Drafters of PENDAT changed some of the survey questions over time. This places some limits on the analysis reported in Part IV.

total pension membership and assets in the United States. For example, the responding pension systems to the 1996 survey covered 81% of all public plan members in the United States and held 81% of plan assets.¹⁷ The analysis below used an unbalanced panel of all surveys available that include the variables of interest.¹⁸

I. OVERVIEW OF PUBLIC PENSIONS AND GOVERNANCE

A. *The Problem of Underfunding*

Approximately 90% of public pension plans are structured as defined benefit (“DB”) plans.¹⁹ Under a DB plan, employee and government contributions are pooled, and these assets are used to pay retirees a benefit based on a formula considering years of employment, salary, cost of living adjustments, and other factors.²⁰ The plan’s sponsor (the state or local government) is responsible for ensuring that the fund assets are sufficient to provide for current and potential liabilities. In contrast, under a defined contribution (“DC”) plan, which are common for corporate pension plans, employees have control over the investment of their retirement funds, and those investment earnings determine their retirement income.²¹

The state of the economy bears directly on DB pension funding. If a DB pension fund obtains sufficient market returns through its investments, then the government sponsor may be able to lower its annual contributions to the fund. On the other hand, if the pension fund does not earn sufficient investment returns and liabilities are greater than assets, the government must use taxpayer money to increase plan

¹⁷ Michael Useem & David Hess, *Governance and Investments of Public Pensions*, in PENSIONS IN THE PUBLIC SECTOR 133 (Olivia S. Mitchell & Edwin C. Hustead, eds. 2001).

¹⁸ Some of the survey respondents indicated that the board did not have control over investment decisions. In most cases, an investment board separate from the pension system’s board of trustees made investment decisions for the system. These systems were excluded from the dataset, as this study was concerned with the impact of different board structures on investment decisions. In addition, from year to year, the responding pension systems may change.

¹⁹ Tiffany, *supra* note 9, at 3.

²⁰ *Id.* at 7.

²¹ In the past thirty years, most private pension plans, such as those sponsored by a corporate employer, have shifted from defined benefit plans to defined contribution plans. Jonathan Barry Forman, *Public Pensions: Choosing Between Defined Benefit and Defined Contribution Plans*, 1999 MICH. L. REV. 187, 188-92 (1999).

assets through additional contributions.²² Since these additional contributions typically must come from the government's general fund, they compete for funding with other government projects that often have greater political urgency.²³ This conflict becomes particularly problematic during periods of slow economic growth. Due to especially low investment returns during such periods, the pension system requires that the government sponsor make additional contributions to the fund. The government sponsor is typically unwilling to make these necessary additional contributions, however, because it is also suffering from budget problems due to lowered revenue caused by the economic slowdown.²⁴

In the short-term, the government may have legitimate reasons for reducing its contributions to the pension fund. If government revenues are low due to cyclical reasons, then reducing contributions is essentially a short-term loan that the government will repay with higher contributions when economic growth picks up.²⁵ However, this method of fund management requires that the government overfund the pension plan during periods of budget surplus. Not surprisingly, this rarely occurs.²⁶ Consistent underfunding ultimately shifts current funding problems onto future taxpayers.²⁷

Because taxpayers bear the risk in public pension funds, the funding level of these plans — the ratio of plan assets to the present value of participants' earned benefits — is a significant political issue at state and local levels. Whereas federal law requires private pension plans to meet certain funding levels and insurance requirements, public pension plans

²² In 2000, the state's required contribution to CalPERS was \$160 million. By 2005, the annual contribution rose to \$2.6 billion. Tom Campbell, *State Needs to Convert to a Predictable Pension System*, SACRAMENTO BEE, Mar. 2, 2005, at B7.

²³ Peng, *supra* note 3, at 60.

²⁴ *Id.* at 63-64. Pension planners attempt to alleviate problems from economic downturns with "asset smoothing" techniques to spread out unusual losses or gains over a period of years (typically five years). William B. Forna, *Public Sector Retirement Systems: What Does the Future Hold?*, 28 EMP. BENEFITS J. 13 (June 2003).

²⁵ Peng, *supra* note 3, at 60; see also Olivia S. Mitchell & Robert S. Smith, *Pension Funding in the Public Sector*, 76 REV. OF ECON. & STAT. 278, 278 (1994) (noting that underfunding a pension plan is borrowing by government that is kept "off the books").

²⁶ Peng, *supra* note 3, at 60. However, the pension surplus is often used to free government funds for other projects. *Id.* at 68-69. In the late 1990s, the New York City pension fund used its surplus to reduce the City's contribution to the fund. *Id.* Due to an economic downturn a few years later, the fund's assets dropped from \$105 billion to \$79 billion in two years (July 2000 to June 2002), and the plan became underfunded. *Id.*

²⁷ *Id.* at 60.

do not face such requirements.²⁸ The plan's funding level has far-reaching implications, impacting tax rates, salary negotiations with public employees, investment ratings of government bonds, and property values.²⁹ Despite these significant impacts, however, pension funds are consistently underfunded. The unfunded liability of the Illinois state pension fund, for example, is approximately twice the size of its annual state budget.³⁰ Further, as noted above, 93% of all state pension plans were underfunded in 2003.³¹ This number contrasts strikingly with the number of underfunded pension funds just a few years ago. At the end of the strong market of the 1990s, for example, only 31% of pension systems were underfunded, and the average system had a funding level of 115%.³²

B. Pension Fund Investment Practices

Typically, the pension fund's board of trustees has authority over the fund's investment decisions. When investing pension system assets, the board must make three basic decisions.³³ First, the trustees must determine how to allocate the fund's assets between stocks, bonds, cash, property, and other categories of assets. Second, within those asset categories, the trustees must select investment products, such as index funds, growth funds, large cap and small cap stocks, short-term or long-term bonds, and so on. Finally, the trustees must choose investment managers for the selected products and set performance standards against which those managers will be measured.

Historically, public pension fund boards have been comprised of conservative investors, which has led to low returns. As discussed above, the trustees allocate the fund's assets into different investment categories.³⁴ Until the mid-1990s, many pension funds had little or no

²⁸ Stephen P. D'Arcy et al., *Optimal Funding of State Employee Pension System*, 66 J. OF RISK AND INS. 345 (1999).

²⁹ *Id.* at 345; see also Daniel P. Mahoney, *Toward a More Ethical System of State and Local Government Retirement Funding*, 14 J. PUB. BUDGETING, ACCT. & FIN. MGMT. 197, 202 (2002) (noting use of pension funding levels by bond rating organizations).

³⁰ Bonafede et al., *supra* note 11, at 2.

³¹ *Id.* at 1.

³² *Id.* at 3.

³³ GORDON L. CLARK, PENSION FUND CAPITALISM 138-39 (2000).

³⁴ Some researchers argue that asset allocation can explain up to 90% of the variability in the return on assets over time. Gary P. Brinson et al., *Determinants of Portfolio Performance*, 42 FIN. ANALYSTS J. 39 (July/Aug. 1986) [hereinafter *Determinants of Portfolio Performance*]; Gary P. Brinson et al., *Determinants of Portfolio Performance II: An Update*, 47

equity investments in their portfolios. As a result, several studies found that private pensions outperformed public pensions by approximately one percentage point during the 1990s.³⁵ For example, the average fund in the PENDAT dataset in 1991 allocated approximately 37% of its assets to domestic stocks. By contrast, a sample of large private pension systems in that year allocated an average of 51% of assets to domestic stocks.³⁶

Because of the strong market performance of the 1990s, many state and local governments pushed for pension plans to increase their investments in equities as a way to solve underfunding problems.³⁷ For example, in 1996, the last three states with complete prohibitions on investments in equities removed their prohibitions.³⁸ From 1990 to 2000, the average plan in the PENDAT database increased total investments in equities from less than 40% of their portfolio to nearly 60%. For all state and local funds in the United States for the fiscal year ending in 2002, the average fund held approximately 49.6% of their assets in domestic stocks and international securities.³⁹ By the end of the 2003 fiscal year, state pension funds allocated an average of approximately 65% to equities.⁴⁰

Although public funds have improved their asset allocations, there exists some evidence that public pension funds still earn lower returns than private pensions.⁴¹ This is commonly attributed to political interference with the fund's management and investment decisions. To understand these critiques, the next section considers the trustees' incentives and their potential impact on strategic choices.

FIN. ANALYSTS J. 40 (May/June 1991) [hereinafter *Determinants of Portfolio Performance II*]; see also Ilkiw, *supra* note 2, at 214-21 (outlining asset allocation decision process).

³⁵ Julia L. Coronado et al., *Public Funds and Private Capital Markets: The Investment Practices and Performance of State and Local Pension Funds*, 56 NAT'L TAX J. 579, 582 (2003); Mark Sarney, *supra* note 4, at 15.

³⁶ Eli Amir & Shlomo Benartzi, *The Expected Rate of Return on Pension Funds and Asset Allocation as Predictors of Portfolio Performance*, 73 ACCT. REV. 335, 341 (1998).

³⁷ Useem & Hess, *supra* note 17, at 136-37.

³⁸ *Id.* at 136.

³⁹ U.S. CENSUS BUREAU, *supra* note 1, at 11. Using 1998 data, Coronado et al. found in their study that public pensions had a higher allocation of assets in equities than private pensions. Coronado et al., *supra* note 35, at 590-91. Public plans in their study invested 53% of their assets in equities compared to private funds investing only 49%. The difference is likely explained by the fact that the public funds in their sample were on average ten times larger than the private funds. *Id.* It is also important to note that there does not appear to be a relationship between asset allocation by the fund and its funding level. Bonafede et al., *supra* note 11, at 11-12.

⁴⁰ Bonafede et al., *supra* note 11, at 2.

⁴¹ Coronado et al., *supra* note 35, at 591-93.

C. *The Board of Trustees: Stewards or Politicians?*

Members of the board of trustees are typically selected to serve on the board in one of three ways. First, some trustees are elected by plan members themselves. Second, ex officio trustees serve on the board due to holding a particular public office, such as state treasurer or controller. The trustees in the third group are appointed by either a chief elected official (e.g., the governor or mayor) or by a governing body (e.g., a legislative committee). In the PENDAT database, the average board had 36% elected trustees, 15% ex officio trustees, and 44% appointed trustees.⁴² The CalPERS board, for example, has thirteen total trustees, including six elected by the plan's members,⁴³ two appointed by the Governor, one appointed by a Senate committee, and four ex officio trustees.⁴⁴

Similar to corporate boards of directors having inside and outside (or independent) directors with differing incentives, the manner in which pension fund trustees are selected often impacts their decision making. Politically affiliated trustees (appointed and ex officio trustees) can be compared to inside directors and member-elected trustees to outside directors.⁴⁵ In corporate governance literature based on agency theory, inside directors are expected to have a conflict of interest with shareholders, whose interests they are supposed to protect. With respect to controlling agency problems within the firm (e.g., excessive CEO salaries), inside directors are expected to side with management.⁴⁶ Outside directors, on the other hand, are generally considered to be sufficiently independent from the CEO, such that they can protect

⁴² These figures are for 1998, but the board structures were consistent over time. The remaining 5% not accounted for in the text fell into an "other" category.

⁴³ One trustee is elected solely by retired members, and three are solely elected by active members. See CalPERS website, available at <http://www.calpers.ca.gov/index.jsp?select=AboutCalPERS>) (last visited Oct. 14, 2005).

⁴⁴ *Id.* The four ex officio members include the State Treasurer, the State Controller, the Director of the Department of Personnel Administration, and a designated member of the State Personnel Board. *Id.*

⁴⁵ See generally David Hess & Gregorio Impavido, *Governance of Public Pension Funds: Lessons from Corporate Governance and International Evidence*, in PUBLIC PENSION FUND MANAGEMENT 49-89 (A. R. Musalem & R. Palacios eds., 2003) (applying lessons from governance of for-profit and non-profit corporations to governance of public pension funds).

⁴⁶ The inside directors show a loyalty to top management because the CEO controls the trajectory of those directors' careers within the firm. Laura Lin, *The Effectiveness of Outside Directors as a Corporate Governance Mechanism: Theories and Evidence*, 90 NW. U. L. REV. 898, 900-01 (1996).

shareholders' rights when they may be harmed by top management's behavior.⁴⁷

Likewise, researchers argue that politically-appointed trustees do not make decisions based on the interests of pension beneficiaries, but principally to improve their own political situations. For example, a former ex officio trustee of the New York City pension fund publicized her role in the fund's corporate governance activism during her campaign for public office.⁴⁸ The political situation of these trustees creates short-term interests that can conflict with the significantly longer-term interests of plan beneficiaries.⁴⁹

In addition to personal political motivations, outside political pressure, such as from the local mayor or governor, may be placed on politically-affiliated trustees. Since the politically-appointed trustee is typically a member of the same political party as his or her executive-appointer, he or she may be susceptible to such pressures. For example, in the area of proxy voting, politically-affiliated trustees may be pressured to vote against mergers or vote for anti-takeover devices in situations where that vote has a high local political value (e.g., to preserve local employment), even if it will have a negative effect on share value.⁵⁰ Recently, for example, the Governor of California removed four appointed trustees from the California State Teachers' Retirement System's ("CalSTERS") board after they voted to oppose his proposal to reform the public pension fund.⁵¹

Political pressures can also impact the investment decisions of the fund. Politically-affiliated trustees may fund initiatives that provide local benefits (often referred to as "economically targeted investments") due to the political advantages they provide.⁵² These decisions may be

⁴⁷ For a review of the theory and empirical evidence on independent directors, see Sanjai Bhagat & Bernard Black, *The Uncertain Relationship Between Board Composition and Firm Performance*, 54 BUS. LAWYER 921 (1999); Lin, *supra* note 46, at 900-01.

⁴⁸ Roberta Romano, *Public Pension Fund Activism in Corporate Governance Reconsidered*, 93 COLO. L. REV. 795, 822 (1993) [hereinafter Romano, *Activism*].

⁴⁹ Coronado et al., *supra* note 35, at 580; Fornia, *supra* note 24, at 15; see also Michael Peskin, *Asset/Liability Management in the Public Sector*, in PENSIONS IN THE PUBLIC SECTOR 195, 203 (Olivia S. Mitchell & Edwin C. Husted eds., 2001) (noting that complexity of issues, large pool of assets, and lack of representation of long-term concerns make management of pension assets susceptible to short-term political pressures).

⁵⁰ Romano, *Activism*, *supra* note 48, at 798.

⁵¹ Dale Kasler & Clint Swett, *Governor Axes Four CalSTERS Directors: The Quartet Had Voted to Oppose Schwarzenegger's Pension Plan Overhaul*, SACRAMENTO BEE, Feb. 11, 2005, at A1.

⁵² See *infra* notes 117-30 and accompanying text.

made without giving appropriate weight to the risk-return characteristics of the investment.⁵³ Politically-affiliated trustees may also be pressured to select investment advisors based not on their performance, but on a preference for in-state managers.⁵⁴ In many cases, these investment managers may be small and unable to take advantage of economies of scale on transactions, which reduces fund performance. In other cases, the selection of investment managers may be based on political connections. In Maryland, the state pension system was accused of continuing a relationship with a management firm that had strong ties to the governor, even though it was consistently one of the fund's worst performers, and it received fees two to three times greater than other money managers.⁵⁵ Taken together, these problems have led commentators to argue that public pension funds with trustees who are susceptible to political pressure will perform significantly worse than funds with boards having more politically-independent trustees.

As addressed above, independent trustees are those elected by the plan members and are often members themselves. Their political independence makes them analogous to independent, outside directors on corporate boards.⁵⁶ Just as outside directors are theoretically able to focus on shareholder interests without undue influence from corporate insiders, member trustees are able to focus on beneficiary interests without undue political interference. They may also serve as a monitor

⁵³ Roberta Romano, *The Politics of Public Pension Funds*, THE PUBLIC INTEREST, Spring 1995, at 43 [hereinafter Romano, *Politics*]. Trustees with political affiliations — appointed and ex officio trustees — do not have direct financial interests in the fund's performance, but may have reputation interests. For example, local political pressure to support in-state, under-financed projects may result in trustees trading off fund investment returns for short-term political advantages. If the effect is to significantly reduce fund performance, then the trustee's reputation may be harmed, which may outweigh the short-term political gain. However, even if the trustees realize that such investments will reduce pension fund returns, they may rationally accept this trade-off, as there will be a lag between their board tenure and the impact on fund returns. Romano, *Activism*, *supra* note 48, at 821-22.

⁵⁴ Romano, *Activism*, *supra* note 48, at 809-11.

⁵⁵ In 2002, the board withdrew its assets from that investment manager after the SEC briefed the board on its investigation of that company for using the pension system's assets to invest in its own parent company. Michael Dresser, *State's Pension Board Dismisses Chapman's Firm*, BALTIMORE SUN, Feb. 9, 2002 at 1A; Jon Morgan et al., *A Record of Paltry Pension Returns*, BALTIMORE SUN, Nov. 30, 2001, at 1A; Jon Morgan et al., *Questions Abound in Pension's Fiscal Skid*, BALTIMORE SUN, Nov. 15, 2001, at 1A. Some members of the board made attempts to sever ties with the money manager, but were unsuccessful. The investment manager involved was later convicted of defrauding the pension system. Stephanie Hanes, *Chapman Draws 7 1/2-year Prison Term*, BALTIMORE SUN, Nov. 2, 2004, at 1A.

⁵⁶ Hess & Impavido, *supra* note 45, at 73-74.

over the politically-affiliated trustees. However, these representatives may also have their own agenda to promote, especially if they are associated with a union. For example, many raise concerns that CalPERS is dominated not only by politically-affiliated trustees, but also by member-elected union representatives who are using the system's assets in an attempt to bring about social change without regard to the direct financial health of the pension system.⁵⁷

In addition to their potential political independence, board members who are also plan members may improve the performance of the fund due to their direct financial interest in the plan's performance. Due to the fact that their personal retirement is at stake, these trustees are analogous to corporate directors with significant equity ownership in their firm.⁵⁸ In both cases, the financial interests of the agent are aligned with the performance of the firm (or the pension fund). In the corporate context, directors with large equity ownership have incentives based on the direct benefit they receive from higher share values. Similarly, the benefit of DB public pension plans being managed by member trustees may come from assurances that the plan will have funding to meet future obligations. Increased performance potentially provides these plan members with a lowered burden as taxpayers or a lower contribution as employees. Poor performance can lead to a loss of current income, as active member employee contributions may be increased to make up for the loss. For example, in 2002, Nevada public employees, who were already required to contribute 9.75% of their pay to the pension plan, faced increased contributions due to the plan's investment losses.⁵⁹ Retired plan members also have an incentive to protect the fund's assets because it is not uncommon for strong investment performance to lead to increased cost of living adjustments.⁶⁰

⁵⁷ Mary Williams Walsh, *CalPERS Wears a Party, or Union, Label*, N.Y. TIMES, Oct. 13, 2002, at 1; *Cronyism at CalPERS*, WALL ST. J., Jan. 31, 2003, at A10; Press Release, U.S. Chamber of Commerce, *Chamber Criticizes Public Pension Fund Tactics Withhold Vote Strategy Targets Safeway Board of Directors* (May 20, 2004) available at <http://www.uschamber.com/press/releases/2004/may/04-69.htm> (last visited Oct. 24, 2004).

⁵⁸ Romano, *Activism*, *supra* note 48, at 820-21. Overall, though, the taxpayers should be considered the residual claimant closest to shareholders in a corporation, as higher taxes will be used to make up any funding shortfall. Hess & Impavido, *supra* note 45, at 58-59. It should also be noted that, in addition to financial incentives, plan member trustees have motivations based on social bonds they have with the other plan beneficiaries who elected them to the board. *Id.* at 67.

⁵⁹ Kara Scannell, *Public Pension Plans Come Up Short*, WALL ST. J., Aug. 16, 2002, at C1.

⁶⁰ Peskin, *supra* note 49, at 200-01.

Overall, member-elected trustees have strong incentives to perform their board-related duties, while politically-affiliated trustees have incentives to shirk and act opportunistically. For example, most of the ex-officio trustees of the Maryland State Pension system drew criticism for missing more than 40% of the board's meetings, many of which were important investment strategy meetings.⁶¹ Most elected members, on the other hand, attended 90-100% of the meetings.⁶² At its March 24, 2000 meeting, the board voted to increase its maximum asset allocation limits to 78% in equities and 30% in international assets, which permitted a very aggressive investment strategy.⁶³ Coincidentally, the day the board approved this policy was the same day the S&P 500 reached its peak and began a long downward trend.⁶⁴ Three ex-officio trustees with a long history of absence from board meetings were absent that day.⁶⁵ The short-term outcome was performance that was among the lowest of any state pension system.⁶⁶ The media accused the politically-affiliated trustees of harming performance by failing to monitor the system's investments and failing to exercise care in setting the system's strategy. On the other hand, when the trustees actually were actively involved in the fund's affairs, they were accused of making decisions based on political favoritism — hiring politically-connected investment managers and giving them a large fee⁶⁷ — rather than sound investment management choices.

II. FUNDING LEVELS AND ACCOUNTING ASSUMPTIONS

The long-term financial health of a pension plan is measured by its funding status. As mentioned above, some trustees have political incentives to reduce contributions to the plan, especially during times

⁶¹ Michael Dresser & Jon Morgan, *Maryland Pension Trustees Are Often Absent*, BALTIMORE SUN, Nov. 18, 2001, at 1B.

⁶² *Id.*

⁶³ Morgan et al., *Questions Abound*, *supra* note 55, at 1A.

⁶⁴ *Id.*

⁶⁵ Dresser & Morgan, *supra* note 61, at 1B.

⁶⁶ The fund lost \$3 billion in the fiscal year ending in 2001 (out of \$29.5 billion in total assets). Dresser & Morgan, *supra* note 61, at 1B. Remarking on the system's poor performance, a professor of finance at the University of Houston – Clear Lake stated, "I don't see how you could deliberately put together a portfolio and get these kinds of returns." Morgan et al., *Questions Abound*, *supra* note 55, at 1A.

⁶⁷ See *supra* note 59 and accompanying text.

when the state or local government is suffering a budget crisis. This contributes to public pension underfunding problems.⁶⁸ Several studies have considered this relationship. For example, studies by both Mitchell and Hsin⁶⁹ and Mitchell and Smith⁷⁰ found that a pension plan's funding status was negatively related to state fiscal stress, as measured by recent increases in the local unemployment rate.⁷¹ Other studies confirmed these findings using other measures of fiscal stress. Schneider and Damanpour measured fiscal stress by per capita debt,⁷² and Chaney et al. used fiscal stress measures such as bond ratings, tax capacity, and per capita debt.⁷³ Chaney et al. further found that funding levels were lower in states with a balanced budget requirement.⁷⁴

The composition of the board of trustees can also impact the plan's funding status. Consistent with the discussion of incentives above, Schneider and Damanpour found that politically-affiliated trustees had a negative impact on funding status.⁷⁵ In contrast, Mitchell and Hsin found that a pension plan's funding status was negatively related to the

⁶⁸ U.S. GEN. ACCT. OFF., GAO/AFMD-93-58BR, *BALANCED BUDGET REQUIREMENTS: STATE EXPERIENCES AND IMPLICATIONS FOR THE FEDERAL GOVERNMENT* 35 (1993) (noting that some states meet balanced budget legislative requirements by reducing contributions to pension systems or using pension surpluses).

⁶⁹ Olivia S. Mitchell & Ping-Lung Hsin, *Public Sector Pension Governance and Performance*, in *THE ECONOMICS OF PENSIONS: PRINCIPLES, POLICIES, AND INTERNATIONAL EXPERIENCE* 92, 102-03, 112 (Salvador Valdes Prieto ed., 1997). The authors used two measures of funding status. First, "stock" funding is the ratio of current assets to liabilities. Second, "flow" funding is the ratio of actual contributions to the fund compared to the required level. The results discussed above refer to the stock funding ratio. Among the factors that did not have a significant effect on either measure of funding were state laws requiring a balanced budget, taxes specifically earmarked to generate revenue for the pension, and state requirements that the pension plan be fully funded. *Id.*

⁷⁰ Mitchell & Smith, *supra* note 25, at 285-86. These results refer to "flow" funding.

⁷¹ In addition, Hsin and Mitchell found that actual government contributions to the plan have a negative relationship with fiscal stress. Ping-Lung Hsin & Olivia S. Mitchell, *Managing Public-Sector Pensions*, in *PUBLIC POLICY TOWARDS PENSIONS* 248, 260-61 (Sylvester J. Schieber & John B. Shoven eds., 1997). The authors also found that government contributions are positively related to being able to carry over budget deficits. *Id.*

⁷² Marguerite Schneider & Fariborz Damanpour, *Public Choice Economics and Public Pension Plan Funding, an Empirical Test*, 34 *ADMIN. & SOC.* 57, 75-76 (2002).

⁷³ Barbara A. Chaney et al., *The Effect of Fiscal Stress and Balanced Budget Requirements on the Funding and Measurement of State Pension Obligations*, 21 *J. ACCT. & PUB. POL'Y* 287, 297, 306-07 (2002).

⁷⁴ *Id.* at 306-07.

⁷⁵ Schneider & Damanpour, *supra* note 72, at 75-76. The authors also found that funding status is negatively related to paying out greater benefits to plan members. *Id.* One interpretation of this finding is that politically-affiliated trustees are seeking short-term political gains by increasing retirement benefits at the expense of the long-term health of the plan.

number of member-elected trustees.⁷⁶ Murphy and Van Nuys found a positive correlation between funding levels and trustees who were active plan members.⁷⁷ Finally, Mitchell and Hsin found that member-elected trustees positively impacted the amount of actual government contributions to the plan, especially during periods of fiscal stress.⁷⁸

The presence and representation of unions on fund boards may also impact funding levels. Just as member-elected trustees may serve as monitors over politically-affiliated trustees, so may the presence of employee unions. Unions can provide effective representation of employee interests through their understanding of the complexities surrounding funding decisions.⁷⁹ Chaney et al. found that the number of unionized employees on the board increased funding status.⁸⁰ Mitchell and Smith, however, found the opposite to be true.⁸¹ They suggested that because unions place pressure on the government to increase wages, this may cause governments to underfund employee pensions.⁸² Moreover, unions may be aware and accepting of this trade-off.⁸³

In order to better understand the relationship between board composition and funding status, it is important to also consider the actuarial assumptions a pension plan uses. The board of trustees must adopt certain assumptions to determine the required funding level and government contribution.⁸⁴ To determine current and future obligations, the pension plan needs estimates of when plan members will retire, how much they will be earning in salary when they retire, and how long those retirees will live.⁸⁵ Because benefit obligations to current employees are

⁷⁶ Mitchell & Hsin, *supra* note 69, at 110.

⁷⁷ Kevin J. Murphy & Karen Van Nuys, *Governance, Behavior, and Performance of State and Corporate Pension Funds 33-34* (Sept. 1994) (unpublished manuscript, on file with author).

⁷⁸ Hsin & Mitchell, *supra* note 71, at 260-61.

⁷⁹ Mitchell & Smith, *supra* note 25, at 283. Approximately 35% of state workers and 42% of local government workers belong to unions (compared to only 10% of all U.S. workers). Tiffany, *supra* note 9, at 4.

⁸⁰ Chaney et al., *supra* note 73, at 302.

⁸¹ Mitchell & Smith, *supra* note 25, at 286.

⁸² *Id.* at 283, 286.

⁸³ *Id.*

⁸⁴ The actuary typically makes recommendations on assumptions to the board, and the board may make reasonable changes to those recommendations before adoption. Edwin C. Husted, *Determining the Cost of Public Plans*, in *PENSIONS IN THE PUBLIC SECTOR* 218, 218-19, 231-35 (Olivia S. Mitchell & Edwin C. Husted eds., 2001).

⁸⁵ Mitchell & Smith, *supra* note 25, at 279-80. For a general discussion of actuarial assumptions that pension plan trustees must make, see Husted, *supra* note 84.

in the future, the pension fund does not need that specific amount of assets currently on hand. Rather, the pension must be funded with an amount of assets whose expected growth will fulfill future obligations at the time they become due (the present value). Thus, the pension plan also must make assumptions on the contributions it will receive from employees over time and the expected rate of return on investing those assets. The remainder of the needed assets must come from the government sponsor of the plan. Overall, the trustees determine not only the investment strategy of the pension system, but also the amount of the government-required contribution.⁸⁶

The political incentives discussed above can influence the board's choice of actuarial assumptions. Thus, focusing on the level that a pension plan is over- or underfunded may be misleading.⁸⁷ By manipulating actuarial assumptions, a board can make a pension fund appear more funded than it would be if it used more accurate assumptions. For example, pension funds can manipulate assumptions on the expected rate of return to simultaneously lower the government's required contributions and make the pension plan appear to be funded at a higher level.⁸⁸ Some commentators state a general rule of thumb that a 1% increase in the expected rate of return (projected over thirty years) creates a 20% decrease in the sponsor's current contribution.⁸⁹ Thus, even changes of just a fraction of a percentage point can have dramatic effects on the government's contribution. This can be appealing to politically-affiliated trustees, especially under certain economic conditions. For example, in the early 1990s, the New York State pension fund raised its expected rate of return from 8% to 8.75% in order to reduce contributions by \$325 million and balance the state budget.⁹⁰ In 1991, the governor of California explicitly stated his desire to raise the expected rate of return on state pensions from 8.5% to 9.5% to reduce the state's contribution to pension plans by approximately \$400 million per year.⁹¹ Some commentators claim that two-thirds of all states have

⁸⁶ Peng, *supra* note 3, at 64.

⁸⁷ Hsin & Mitchell, *supra* note 71, at 256.

⁸⁸ Chaney et al., *supra* note 73, at 307.

⁸⁹ Alan Deutschman, *The Great Pension Robbery*, FORTUNE, Jan. 13, 1992, at 76; see also U.S. GEN. ACCT. OFF., GAO/HEHS 96-56, PUBLIC PENSIONS: STATE AND LOCAL GOVERNMENT CONTRIBUTIONS TO UNDERFUNDED PLANS 4 n.3 (1996) (noting that a 1% increase in the assumed rate of return can reduce required contributions by 20% to 25%).

⁹⁰ Mitchell & Smith, *supra* note 25, at 278 n.1.

⁹¹ Steve Hemmerick, *Groups Take on California*, PENSIONS & INVESTMENTS, Dec. 9, 1991, at 39.

manipulated their actuarial assumptions to reduce government budget deficits.⁹²

To control for such manipulation, Chaney et al. re-estimated their regression using a funding level for each state pension that they determined by standardized assumptions.⁹³ Their new models showed an even stronger relationship between fiscal stress and public pension underfunding.⁹⁴ Hsin and Mitchell considered the effects of economic and political factors on the assumed interest rate and the “spread rate,” which is the difference between the assumed salary wage growth and the assumed rate of return on investments.⁹⁵ A higher spread rate requires a lower annual contribution. Their study found that fiscal pressures in the state led to a higher spread rate.⁹⁶ In addition, the presence of member-elected trustees and an interaction term between member-elected trustees and fiscal pressures led to a lower spread rate.⁹⁷ This is consistent with the view that member-elected trustees serve as a check, attempting to protect the long-term health of their retirement fund and preventing the manipulation of actuarial assumptions.

Eaton and Nofsinger considered the actuarial assumptions on the expected rate of return, the expected salary growth,⁹⁸ and the amortization period.⁹⁹ They found that pension funds were more likely to use assumptions requiring lower government contributions during

⁹² Mitchell & Smith, *supra* note 25, at 278 n.1; Neil Weinberg, *Votes Today, Taxes Tomorrow*, FORBES, June 5, 1995, at 88; *see also* Chaney et al., *supra* note 73, at 293 (citing examples involving Illinois, North Carolina, Virginia, and others).

⁹³ Chaney et al., *supra* note 73, at 302-04.

⁹⁴ *Id.*

⁹⁵ Hsin & Mitchell, *supra* note 71, at 254. An earlier study based on data from the 1980s, but without data on the board of trustees, concluded that pension funds were not manipulating their assumptions for the appearance of full funding. Mitchell & Smith, *supra* note 25, at 281-82.

⁹⁶ Hsin & Mitchell, *supra* note 71, at 257-59.

⁹⁷ This interaction term suggests that member-elected trustees will have a stronger impact on the spread rate during times of fiscal stress than in time periods not involving fiscal stress.

⁹⁸ A higher expected salary growth rate means that the government will have to make a higher contribution to the pension fund for it to remain funded, as higher salaries mean higher expected benefits payouts to retirees in the future. Tim V. Eaton & John R. Nofsinger, *The Effect of Financial Constraints and Political Pressure on the Management of Public Pension Plans*, 23 J. ACCT. & PUB. POL'Y 161, 169 (2004).

⁹⁹ This is the period of time the government has to make up for underfunding with annual contributions. *Id.* at 170; Peng, *supra* note 3, at 64. The longer the period of time, the lower the required contribution by the government. Governments can also issue a pension obligations bond to pay off the underfunding in one payment. This option is used if the interest rate available for the bond is sufficiently low. Peng, *supra* note 3, at 64.

periods of fiscal stress.¹⁰⁰ In addition, they found some evidence that these pension systems using more favorable assumptions continued to be more underfunded than other systems.¹⁰¹

The presence of a balanced budget requirement, which tends to increase fiscal stress pressures on governments, also makes a difference. Chaney et al. compared pension systems in states with a balanced budget requirement to those in states without such a requirement. In states with a balanced budget requirement, the plan's expected rate of return was predicted by fiscal stress.¹⁰²

These studies consistently show that state and local governments use their pension funds as safety valves.¹⁰³ Munnell and Sundén argue that, although underfunding and the manipulation of accounting assumptions for political reasons occurs, it is very rare and when it does occur, it is adequately addressed by state courts.¹⁰⁴ The empirical evidence discussed above, however, exposes government sponsors' systematic abuse of pension funds in times of fiscal stress. To avoid the negative publicity and opposition from plan members faced by open attempts to reduce government contributions,¹⁰⁵ lowering contributions occurs through the less conspicuous and less clearly understood method of altering actuarial assumptions. Not only do these manipulations achieve lowered contributions, they have the added benefit of creating the

¹⁰⁰ Eaton & Nofsinger, *supra* note 98, at 172-75. The authors created fiscal stress variables by considering the state's interest expenses and debt compared to the state's revenue. *Id.* at 171-72.

¹⁰¹ *Id.* at 182-83.

¹⁰² Chaney et al., *supra* note 73, at 305-06.

¹⁰³ See Alicia H. Munnell & Annika Sundén, *Investment Practices of State and Local Pension Funds: Implications for Social Security Reform*, in PENSIONS IN THE PUBLIC SECTOR 153, 174 (Olivia S. Mitchell & Edwin C. Hustead eds., 2001) (using phrase "safety valve," but arguing that it rarely occurs and when it does occur, state typically corrects it).

¹⁰⁴ *Id.* at 175-76. For a review of the challenges public pension participants face to prevent the use of pension assets as a "safety valve," see Darryl B. Simko, *Of Public Pensions, State Constitutional Contract Protection, and Fiscal Constraint*, 69 TEMP. L. REV. 1059 (1996).

¹⁰⁵ For example, in Maryland in 2002, the governor made a proposal to waive a legislative requirement that the state make up for the pension system's investment losses by increasing its annual contribution to the pension fund. To cover the investment losses and move the pension system up to full funding, the state would need to provide \$76 million in addition to the state's existing \$517 million contribution requirement based on actuarial assumptions. Dresser, *supra* note 55, at B1. One trustee, who was elected by the plan members and was himself a plan member, accused the governor of attempting to balance the state's budget "on the backs of teachers and state employees." *Id.* In the end, the board voted against the governor's proposal.

appearance of a greater funding level. Overall, the empirical evidence shows that pension system assets are subject to political abuse. The presence of member-elected trustees or unions, however, may work to prevent that abuse.

III. INVESTMENT PRACTICES AND PERFORMANCE

In addition to its impact on funding levels, many argue that political influence also systematically leads to lower investment returns for pension funds.¹⁰⁶ Currently, there is mixed evidence on the impact of the board of trustees on the plan's investment performance. For example, Romano found that the presence of member-elected trustees had a positive impact on fund performance.¹⁰⁷ Mitchell and Hsin¹⁰⁸ and Murphy and Van Nuys,¹⁰⁹ however, all found some evidence that trustees elected by *retired* plan members had a negative impact on performance, while trustees elected by *active* plan members had no impact on performance. Other studies found that a trustee's status as a plan member or one elected by plan members had no impact on performance.¹¹⁰

Pension funds are the most active institutional investors in terms of their attempts to change the management practices of the companies in which they invest.¹¹¹ The empirical evidence measuring the impact of

¹⁰⁶ Coronado et al., *supra* note 35, at 580; *see supra* notes 54-59 and accompanying text.

¹⁰⁷ Romano, *Activism*, *supra* note 48, at 826. Romano covered the time period 1985-1989 and included 50 state plans, but the study had only limited data. For example, Romano did not have data on plan size or market value. *Id.* at 823-24.

¹⁰⁸ Mitchell & Hsin, *supra* note 69, at 110. Mitchell and Hsin used the PENDAT data for 1990, with performance data for 1986 to 1990. *Id.*

¹⁰⁹ Murphy & Van Nuys, *supra* note 77, at 24-25. Murphy and Van Nuys used a data set of 107 state pension systems from 1988 to 1992. Their data was collected from various sources and included only a limited number of variables. *Id.* at 6-7.

¹¹⁰ Munnell & Sundén, *supra* note 103, at 162-63; Michael Useem & Olivia S. Mitchell, *Holders of the Purse Strings: Governance and Performance of Public Retirement Systems*, 81 SOC. SCI. Q. 489, 500-01 (2000). Useem and Mitchell did, however, find limited evidence that the number of trustees had a negative impact on performance. *Id.*

¹¹¹ MICHAEL USEEM, *INVESTOR CAPITALISM: HOW MONEY MANAGERS ARE CHANGING THE FACE OF CORPORATE AMERICA* 53-57 (1996). There are several reasons why public pension funds are more active in corporate governance issues than other institutional investors are. First, due to the size of some public pension systems and their significant share of ownership in a large number of corporations, pension funds have chosen to attempt to improve the performance of the companies in which they invest instead of simply selling their shares. Second, public pension funds do not have the conflicts of interest with the corporations they invest in that other institutional investors may have. *Id.* at 30-31. Some refer to public pension funds as "pressure-resistant" institutional investors

shareholder activism on targeted firms is extensive and mixed.¹¹² Some argue that there is not a clear indication that activism improves corporate performance because pension funds are not engaging in activism to increase their investment returns, but to further other political goals.¹¹³ For example, in 2004, CalPERS was active in an attempt to remove the CEO of Safeway, Inc. as part of its corporate governance reform efforts.¹¹⁴ Critics, however, point out that CalPERS's president was also the head of the union representing Safeway employees that had recently had contentious labor negotiations with the company.¹¹⁵

If shareholder activism is used to further political goals rather than increase performance, then the use of the board's time and the plan's resources in this manner would seemingly have a negative impact on performance. This hypothesis, however, is not supported by current studies. Romano¹¹⁶ and Munnell and Sundén¹¹⁷ both did not find that shareholder activism affected performance. In addition, Coronado et al.'s study found that shareholder activism actually had positive effects on performance, but the evidence is limited and questionable.¹¹⁸

A second form of political interference that may reduce investment performance is the use of economically targeted investments ("ETIs"). ETIs are investments in which the pension fund managers consider not only the investment's return potential, but also its economic benefits to

because they do not have a business relationship with the firm. Parthiban David et al., *The Effect of Institutional Investors on the Level and Mix of CEO Compensation*, 41 ACAD. MGMT. J. 200, 202 (1998). Thus, they are more likely to speak out against practices with which they disagree or vote against management's recommendation on a proxy ballot. Finally, pension funds are the least regulated category of institutional investor, which has also allowed them to be more active than the others. MARGARET M. BLAIR, OWNERSHIP AND CONTROL: RETHINKING CORPORATE GOVERNANCE FOR THE TWENTY-FIRST CENTURY 155-65 (1994).

¹¹² For reviews, see Romano, *Less is More*, *supra* note 5; Jonathan Karpoff, *The Impact of Shareholder Activism on Target Companies: A Survey of Empirical Findings* 1, tbls.3, 4 & 5 (Aug. 18, 2001) (unpublished manuscript, on file with author).

¹¹³ See *supra* notes 58-59 and accompanying text.

¹¹⁴ George Raine, *Funds to Yank Votes from Safeway CEO*, S.F. CHRON., Mar. 26, 2004, at C1.

¹¹⁵ Dan Walters, *CalPERS Actions: Mere Coincidences or Evidence of Side Agendas?*, SACRAMENTO BEE, May 21, 2004, at A3. The CalPERS president recused himself from decisions relating to Safeway. *Id.*

¹¹⁶ Romano, *Activism*, *supra* note 48, at 824-26.

¹¹⁷ Munnell & Sundén, *supra* note 103, at 162-63.

¹¹⁸ Their findings were based on a sample of all pension funds in the 1998 PENDAT dataset (results only weakly significant) and in a smaller sample of only the largest 25 state pension funds. Coronado et al., *supra* note 35, at 588, 590.

the local community.¹¹⁹ In his 1992 presidential campaign, Bill Clinton encouraged investment in ETIs by pension plans.¹²⁰ Such investments became one of the most controversial issues facing pensions funds (both public and private) in the 1990s. Examples of ETIs include California's investment of \$375 million in single-family homes to increase affordable housing and create jobs, Connecticut's investment of \$25 million in a local company to save 1000 jobs, and Pennsylvania's decision to provide favorable interest rates for home mortgages.¹²¹ Further, common ETI practices involve providing venture capital to in-state companies and involvement in residential mortgages.¹²² Although advocates of ETIs continually claimed that such investments could be structured to obtain a market rate of return, these advocates faced significant opposition.¹²³ Some referred to ETI practices as "politicizing" pension investments rather than "maximizing" them.¹²⁴ In 1994, the Department of Labor Pension and Welfare Benefits Administration stated that the fiduciary duties of private pension plan managers under ERISA allowed investment in ETIs, provided that it had an expected rate of return commensurate to alternative investments of similar risk.¹²⁵ UMPERS

¹¹⁹ U.S. GEN. ACCT. OFF., GAO/PEMD 95-13, PUBLIC PENSION PLANS: EVALUATION OF ECONOMICALLY TARGETED INVESTMENT PROGRAMS 5-6 (1995) [hereinafter U.S. GEN. ACCT. OFF., GAO/PEMD 95-13]; Ronald D. Watson, *Does Targeted Investing Make Sense?*, 23 FIN. MGMT. 68, 68-69 (Winter 1994).

¹²⁰ Brian R. Talcott, *Economically Targeted Investments: Using Public Pension Fund Dollars to Close Capital Gaps in Oregon*, 74 OR. L. REV. 1031, 1032 (1995).

¹²¹ Richard W. Stevenson, *Pension Funds Becoming a Tool for Growth*, N.Y. TIMES, Mar. 17, 1992, at D1.

¹²² U.S. GEN. ACCT. OFF., GAO/PEMD 95-13, *supra* note 119, at 2; Munnell & Sundén, *supra* note 103, at 157.

¹²³ Proponents of ETIs argue that gaps in the capital market leave certain socially desirable projects underfunded. Nofsinger, however, argued that "if capital markets function reasonably efficiently, then the lack of capital for a given project is indicative of its inadequate risk/return characteristics." John R. Nofsinger, *Why Targeted Investing Does Not Make Sense!*, 27 FIN. MGMT. 87, 88 (1998).

¹²⁴ David A. Vise, *A Billion-Dollar Battle Over Pension Plans' Purpose*, WASH. POST, Dec. 6, 1992, at H1. Nofsinger argued:

"[ETIs] are often highly visible projects that attempt to generate a public good in a concentrated geographical region. The claimable political benefits of an ETI policy can be large and the costs of claiming them small. The agency cost taxpayers bear is not visible at the initial investment because the costs are not realized until some distant time when an increase in funding is needed for the underfunded pension plan."

Nofsinger, *supra* note 123, at 89.

¹²⁵ Pension and Welfare Benefits Administration, 59 Fed. Reg. 32,606 (June 23, 1994) (codified at 29 C.F.R. pt. 2509).

adopted a similar standard.¹²⁶

Despite these standards, however, some commentators still raise the concern that any policy including ETIs will unavoidably lead to political interference and have a negative impact on performance. Several studies confirm this concern.¹²⁷ Romano,¹²⁸ Nofsinger,¹²⁹ and Mitchell and Hsin¹³⁰ all found a weakly significant negative relationship between ETIs and performance. Other studies have not found an impact on performance. Munnell and Sundén used different definitions of ETIs and did not find a significant relationship.¹³¹ Due to concerns over the ETI variable in the PENDAT database used in some of the other studies,¹³² Coronado et al., reviewed the annual reports of the largest twenty-five state pension funds to determine if they had a policy for in-state investment. Using the new ETI variable, they did not find a significant relationship between ETIs and performance.¹³³

Overall, the existing studies on the impact of pension fund governance and investment practices on financial performance provide inconsistent evidence. Some of these inconsistencies may be due to limitations in the data used in the various studies. To help resolve these conflicts, Part IV provides new empirical evidence on the impact of pension fund governance on both investment performance and the strategic decisions to engage in shareholder activism or ETIs. This analysis uses the most recent and complete dataset available, as well as variables not previously considered.

¹²⁶ UMPERS § 8(a)(5) states that trustees “may consider benefits created by an investment in addition to investment return only if the trustee determines that the investment providing these collateral benefits would be prudent even without the collateral benefits.”

¹²⁷ Nofsinger, *supra* note 123, at 95-96.

¹²⁸ Romano, *Activism*, *supra* note 48, at 828-29.

¹²⁹ Nofsinger, *supra* note 123, at 92-94. Nofsinger used the PENDAT data from 1991-1993, but he only used those systems for which he had complete data for all years. This reduced his data set to fifty-six systems, with only nine of those systems engaged in economically targeted investing. *Id.* at 90-91.

¹³⁰ Mitchell & Hsin, *supra* note 69, at 109-10.

¹³¹ Munnell & Sundén, *supra* note 103, at 158-59. The authors also re-estimated Nofsinger’s regression models using a larger sample size and found no effect of ETIs on fund performance. *Id.* at 164.

¹³² See *supra* notes 128-30; *infra* note 145 and accompanying text.

¹³³ Coronado et al., *supra* note 35, at 589-90.

IV. EMPIRICAL EVIDENCE ON THE IMPACT OF GOVERNANCE ON
INVESTMENT PERFORMANCE AND STRATEGIES

To understand the impact of the board of trustees and governance practices, this study considered the following variables. With respect to board structure, a variable was included for member-elected trustees. The studies on funding practices showed some evidence that member-elected trustees acted as monitors of those trustees subject to political pressures to prevent actions that could hurt the long-term interests of plan beneficiaries.¹³⁴ To consider the impact of political influence, this study included a variable for the number of trustees appointed by the executive (e.g., the governor). These trustees should be the most susceptible to political pressures. Although other trustees, such as ex-officio trustees, also have political connections or aspirations, executive-appointed trustees are clearly and directly accountable to the executive and most susceptible to political pressures.

Differences in boards' responsibilities, practices, and policies should also have an impact on performance. With respect to responsibilities, the regressions included variables on whether the trustees were directly responsible for investments, and whether the board sets the asset allocations of the fund. With greater involvement in these matters, the board should have a greater impact on the fund's performance.

Next, there was a variable indicating whether the board had adopted a code of ethics. For trustees, these codes cover such issues as conflicts of interest and acceptance of gratuities. A code of ethics should provide guidance to trustees and instruct them to avoid practices that may adversely affect plan performance, such as hiring money managers based on favoritism.

The final policy variable indicated whether the board had minimum education or experience requirements for those involved in investment decisions. A 2001 review of institutional investment practices in the United Kingdom, known as the Myners Report,¹³⁵ found that many

¹³⁴ See *supra* notes 75-78 (stating that studies by Schneider and Damanpour, Murphy and Van Nuys, and Hsin and Mitchell show that member and member-elected trustees improve funding practices and politically-affiliated trustees hurt funding practices, in contrast to a study by Mitchell and Hsin).

¹³⁵ Paul Myners, INSTITUTIONAL INVESTMENT IN THE UNITED KINGDOM: A REVIEW (2001) [hereinafter MYNERS REPORT], available at <http://www.hm-treasury.gov.uk/media/2F9/02/31.pdf> (last visited Oct. 14, 2005). This study was not limited to DB public pensions, but also included DC schemes as well as other types of institutional investors (e.g., private pensions, insurance companies, charities). *Id.* at 27-38.

trustees do not have professional experience in investing, have received only limited training by their pension system, and spend little time preparing before making investment decisions.¹³⁶ Due to these findings, the Myners Report questioned the board of trustees for taking on the role of setting the fund's asset allocation. Trustees' lack of expertise caused them to rely heavily on the opinions of consultants and follow the actions of funds in their peer group without giving adequate consideration to what their fund should have as an investment objective.¹³⁷

The next set of variables reflected potential external controls on the board of trustees. First was a variable indicating whether the trustees were subject to a "prudent person" requirement by state legislation. UMPERS states that trustees should be held to a prudent person standard.¹³⁸ This standard is similar to the duty of care standard that corporate directors and officers must meet. Such a requirement is expected to encourage trustees to follow sound investment strategies, which should lead to better fund financial performance.

Second, there was a variable indicating if any of the employees covered by the plan were unionized. A union provides the employees with a collective voice to air their concerns about the performance of the pension plan and to prevent misuse of the assets. In addition, the financial health of the pension plan is often part of the collective

¹³⁶ *Id.* at 40. For example, in pension systems that invested based on meeting certain benchmarks, 23% of the trustees reported that they could not identify that benchmark. *Id.* In other cases, trustees of the same pension fund provided conflicting answers on the investment practices and strategies that the fund supposedly followed. *Id.* Practitioners have raised similar concerns about U.S. public pension trustees. Some trustees are aware of their inexperience and expect to "learn on the job," while other trustees that have financial experience often find that their experience does not adequately prepare them for the unique experience of managing a pension fund. Ilkiw, *supra* note 2, at 224-25.

¹³⁷ MYNERS REPORT, *supra* note 135, at 59-61. Similar concerns with investment experience and excessive reliance on consultants have been expressed about U.S. public pension fund trustees. Mary Williams Walsh, *Concerns Raised Over Consultants to Pension Funds*, N.Y. TIMES, Mar. 21, 2004, at 1; see also Ilkiw, *supra* note 2, at 227 (noting that reports trustees use to monitor investments may also be "misleading because of an excessive focus on peer-relative performance."). This behavior is referred to in the finance literature as "herding." Russell Galer, "Prudent Person Rule" Standard for the Investment of Pension Fund Assets, FIN. MARKET TRENDS, Nov. 2002, at 58-60, 64.

¹³⁸ UMPERS § 7(3) states that a trustee shall act "with the care, skill, and caution under the circumstances then prevailing which a prudent person acting in a like capacity and familiar with those matters would use in the conduct of an activity of like character and purpose." This standard is less than the "prudent expert" rule, but instead depends on the characteristics of the particular pension system. UMPERS § 7 (comments).

bargaining negotiations.¹³⁹ Unions may also facilitate engagement by plan members by providing them with information on the health of the pension. In general, employees are notoriously uninformed about their pension benefits due to the costs of collecting that information. Unionized workforces are significantly more informed, however, due to the efforts of the union in reducing those information costs.¹⁴⁰

Consistent with the importance of providing plan members with information in a cost-effective manner, the final external control variable indicated whether the pension system had automatically sent an annual report to its members. Similar to the policy behind disclosure in securities laws, forced disclosure of activities may have an impact on the trustees' behavior that leads to better performance. Although more than 90% of the funds in the PENDAT sample have such a report available, half will only distribute the report to those who request it. UMPERS requires that pension funds distribute an annual report to each member within seven months of the end of the fiscal year.¹⁴¹

The final two variables indicated whether the firm engaged in ETIs or shareholder activism — the two investment strategies that have created the most controversy. The ETI variable was a binary variable and did not indicate the amount of the portfolio allocated to ETIs. The shareholder activism variable was based on a survey question asking whether the board was active in corporate governance issues by either encouraging changes in management practices at corporations or voting against management on a proxy ballot. Finally, controls for the size of the plan (in assets)¹⁴² and the percentage of the portfolio invested in equities were added.¹⁴³ Table 1 provides descriptive statistics.¹⁴⁴

¹³⁹ Mitchell & Smith, *supra* note 25, at 283.

¹⁴⁰ See generally Alan L. Gustman & Thomas L. Steinmeier, *Imperfect Knowledge of Social Security and Pensions*, 44 *INDUST. REL.* 373 (2005) (providing an empirical study on employee knowledge about their retirement plans and the role of unions).

¹⁴¹ UMPERS § 14(a)(4). The report should also be available to any member of the public that requests it. UMPERS § 13(c). In addition to financial information, the report should also include information on the actuarial assumptions used. UMPERS §§ 17(c)(10), 18(3).

¹⁴² Due to the wide variations in the size of the plans, plan assets were transformed with the natural logarithm to remove skewness.

¹⁴³ This study included variables for the size of the plan and the allocation of investments to equities because previous studies have found these variables to have an effect on annual returns. With respect to equities, some commentators argue that this asset allocation alone can explain up to 90% of the variance in return on assets. *Determinants of Portfolio Performance*, *supra* note 34; *Determinants of Portfolio Performance II*, *supra* note 34. For public pension funds, several studies have found that a larger allocation of assets to equities had a positive effect on returns. Coronado et al., *supra* note 35, at 588; Romano, *Activism*, *supra* note 48, at 826; Useem & Mitchell, *supra* note 110, at 500-01. The evidence

A. Investment Performance Results

Table 2 shows the results of the regression models where the dependent variable was the pension fund's time-weighted market rate of return for the calendar year. Models 1 and 2 show that ETIs and shareholder activism did not have an impact — either positive or negative — on pension fund performance. It is important to note that Model 2 only used data from 1996 and 1998, as the shareholder activism variable was only available in the PENDAT survey for those years.

The finding of no effect of ETIs on performance is consistent with the definition of ETIs in UMPERS. UMPERS allows trustees to take into consideration the benefits of an investment to the local community, but the investment choice must be prudent even if those benefits are not present. If trustees are following such a rule, then ETIs should not have an extraordinary effect on overall performance. The UMPERS definition was adopted in 1997, and the ERISA definition on which it is based was promulgated in 1994. This is after the time periods of the studies that found a negative relationship between ETIs and performance.¹⁴⁵ One possible explanation is that the practice of ETIs may have changed; before the mid-1990s, trustees made ETI investment decisions without regard to risk/return characteristics, but now they take those factors into consideration.¹⁴⁶

These results are consistent with the findings of Munnell and Sunden¹⁴⁷ and Coronado et al.,¹⁴⁸ which both used alternative specifications of the ETI variable. The exact number of funds investing in ETIs is difficult to determine. A 1995 study by the General Accounting Office of 119 of the largest public pension systems found that 42% of the funds invested in ETIs, which totaled \$19.8 billion (or 2.4% of

on the impact of plan size (in assets) on investment returns is mixed. Compare Nofsinger, *supra* note 123, at 94 (finding a negative relationship between size and performance), and Coronado et al., *supra* note 35, at 588 (finding a positive relationship between size and performance), and Munnell and Sundén, *supra* note 103, at 162-63 (finding mixed evidence of a relationship between size and performance), with Useem & Mitchell, *supra* note 110, at 501 (finding no evidence of a relationship between size and performance).

¹⁴⁴ All tables in this Article can be found in the Appendix.

¹⁴⁵ See *supra* notes 128-30.

¹⁴⁶ Munnell & Sundén, *supra* note 103, at 164.

¹⁴⁷ *Id.* at 161-64.

¹⁴⁸ Coronado et al., *supra* note 35, at 589-90.

assets).¹⁴⁹ In the PENDAT database, only 8% of the public pension systems reported targeting investments for in-state development.¹⁵⁰ Overall, the evidence seems to indicate that ETIs do not systematically lower performance. These investments are typically a small portion of a fund's total portfolio,¹⁵¹ and trustees do not seem to be considering the social benefits of the investment to the exclusion of its risk/return characteristics. In fact, trustees may be paying very little attention to the social benefits. For example, a recent investigation into public pension funds' real estate investments — a commonly cited potential ETI activity — found little evidence of investments being based on serving social objectives.¹⁵²

Further, the finding that shareholder activism had no impact on investment performance is consistent with other studies.¹⁵³ While this does not reject the argument that activism is used for political gain, it does reject the argument that such activities are being undertaken at the expense of investment return. These results are also consistent with research findings that, while shareholder activism may have some impact on the operations of corporations, it does not have a significant impact on overall performance.¹⁵⁴ It is also possible that all investors share any benefits derived from activism.¹⁵⁵

In contrast to the findings on ETIs and activism, governance structures and practices had a significant impact on performance. Model 1 in Table 2 shows that trustees appointed by an executive positively impact performance. Apparently, rather than adopting a conservative strategy that attempted to avoid the possibility of negative publicity associated

¹⁴⁹ U.S. GEN. ACCT. OFF., GAO/PEMD 95-13, *supra* note 119, at 2.

¹⁵⁰ A potential reason for this discrepancy is the PENDAT survey question. The survey asked if funds are targeted in-state for "developmental" purposes. Munnell and Sundén argue that this may have led some funds to not consider residential mortgages and private placement debt, which are two common methods of ETIs. Munnell & Sundén, *supra* note 103, at 157-58.

¹⁵¹ *Id.* at 158.

¹⁵² Mark S. Rosentraub & Tamar Shroitman, *Public Employee Pension Funds and Social Investments: Recent Performance and a Policy Option for Changing Investment Strategies*, 26 J. URB. AFF. 325, 332-34 (2004).

¹⁵³ See *supra* notes 118-20 and accompanying text.

¹⁵⁴ See Karpoff, *supra* note 112.

¹⁵⁵ For example, a motivation to engage in activism to "raise the ocean in order to lift all boats" would benefit all investors. Diane Del Guercio & Jennifer Hawkins, *The Motivation and Impact of Pension Fund Activism*, 52 J. FIN. ECON. 293, 303 (1999). This approach to activism is common for heavily indexed pension funds. *Id.* at 294.

with any investment losses from a riskier strategy, these trustees were able to guide the fund towards superior performance. Although the variable indicating education or experience requirements was not significant, it may be that the trustees selected by executives were more qualified than those elected by the plan members.

The trustees elected by plan members did not have an impact on performance in Model 1. The model may be misspecified, however, and these trustees did not have a linear relationship with performance. Instead, as Romano argued, their relationship to performance may have been curvilinear (i.e., an inverted-U shape).¹⁵⁶ Member-elected trustees may improve the fund's performance due to their independence from political influence and their incentives to perform their duties, but they may also lack the expertise necessary to manage a portfolio worth hundreds of millions of dollars.¹⁵⁷ Thus, member-elected trustees may have a positive impact on performance up until they hold a certain percentage of board seats, at which point they provide diminishing returns.

Models 3 and 4 tested for the possibility of diminishing returns. Model 3 includes a squared member-elected trustee term.¹⁵⁸ The positive and significant coefficient on the original variable and the negative and significant coefficient on the squared-term indicate that member-elected trustees had an inverted U-shape relationship with performance. Solving for the point at which the inverted U begins its downward slope showed that once the board consisted of 47% member-elected trustees, there were diminishing returns to placing an additional member-elected trustee on the board. Intuitively, this figure sounds reasonable, as having a board dominated by one class of trustees may prevent the meaningful input of other categories of trustees. In addition, a board made up equally of politically-affiliated and member-elected trustees gives each group veto power over any decision and forces them to work together.¹⁵⁹

¹⁵⁶ Romano, *Activism*, *supra* note 48, at 827-28. Her study did not find evidence of such a relationship. *Id.*

¹⁵⁷ Hess & Impavido, *supra* note 45, at 67.

¹⁵⁸ WILLIAM D. BERRY & STANLEY FELDMAN, *MULTIPLE REGRESSION IN PRACTICE* 56-58 (1985).

¹⁵⁹ Likewise, due to the Taft-Hartley Act, union pension funds that receive employer funds must have a board made up of equal numbers of union trustees and management trustees. 29 U.S.C. § 186 (2000). The goal of this provision was to prevent abuse of these funds by unions. Stewart J. Schwab & Randall S. Thomas, *Realigning Corporate Governance: Shareholder Activism by Labor Unions*, 96 MICH. L. REV. 1018, 1076-77 (1998); *see also* Stephen

Model 4 tested for the same relationship, but in a different manner.¹⁶⁰ This model included an indicator variable for a board having at least one member-elected trustee on the board and a separate indicator variable for a board having 47% or more member-elected trustees. The results showed a significant and positive impact for having member-elected trustees, but no impact when the board consisted of approximately one-half or more of such trustees. This also supports the possibility of an inverted-U relationship.

Consistent with the concerns raised in the Myners Report, all models in Table 2 showed that pension funds performed worse if the board was directly responsible for setting the portfolio's asset allocation. The surprising results were the negative effects of automatically sending disclosures to members and having an ethics code. With respect to disclosure practices, most commentators would argue that transparency should cause boards to follow prudent investment practices. It may be the case, however, that disclosure works to maintain overly conservative investment practices due to the fear of negative publicity, but without recognition for exceptional performance. Although poor performance may draw significant attention from the media, superior performance may not be noticed.¹⁶¹ Sending annual reports to all plan members may serve to amplify that effect. Alternatively, disclosure may encourage boards to follow the practices of other institutional investors to justify their actions to the readers of the report. Poor performance may result, however, if that strategy is not appropriate for the pension fund or the board does not have the expertise to carry it out correctly.¹⁶²

A possible explanation for the troubling finding on codes of ethics is that boards of trustees adopt codes of ethics for symbolic purposes only.

Fogdall, *Exclusive Union Control of Pension Funds Taft-Hartley's Ill-Considered Prohibition*, 4 U. PA. J. LAB. & EMP. L. 215, 232 (2001) (arguing that the goal of this provision was to prevent use of pension assets "as leverage in advancing a pro-labor agenda").

¹⁶⁰ Anytime a polynomial regression is used there is the possibility of multicollinearity. BERRY & FELDMAN, *supra* note 158, at 58. Although standard diagnostic tests could not rule out the possibility that multicollinearity was creating artifactual results, attempts to determine the impact of a multicollinearity problem by using alternative specifications of the model and random samples of the dataset produced qualitatively similar results. Standard diagnostic tests of Model 4 in Table 2 did not show any indication of a multicollinearity problem for that model. *See infra* Appendix.

¹⁶¹ John M. Conley & William M. O'Barr, *The Culture of Capital: An Anthropological Investigation of Institutional Investment*, 70 N.C. L. REV. 823, 832-34 (1992).

¹⁶² As discussed, the MYNERS REPORT noted the problem of trustees following the actions of their peers without considering its appropriateness for their fund. *See supra* notes 135-36 and accompanying text.

That is, these codes are adopted to satisfy the demands of outside stakeholders, but the codes are not meaningfully implemented. This would be consistent with the symbolic management perspective of corporate governance developed by Westphal and Zajac. They argue that “top managers can satisfy external demands for increased accountability to shareholders while avoiding [l]oss of autonomy by adopting but not implementing governance structures that address shareholder interests.”¹⁶³ If that is the case, then pension plans that are consistently poor performers will adopt ethics codes in an attempt to maintain legitimacy with external groups, such as plan members, government officials, and taxpayers, but without having to change their practices.¹⁶⁴ Although ethics codes are now almost universal for public pension funds, these findings provide a cautionary note for future practices that a fund may adopt with the ostensible purpose of promoting accountability.

B. *Determinants of Shareholder Activism and Economically Targeted Investments*

The two models in Table 3 tested for the determinants of ETIs and shareholder activism. The results of Model 1 did not show any systematic impact of board structures on the use of ETIs.¹⁶⁵ The use of an ethics code was negatively related to ETIs, which suggests codes are limiting the use of such investments. However, this finding was only weakly significant. The only significant finding was that larger pension

¹⁶³ James D. Westphal & Edward J. Zajac, *The Symbolic Management of Stockholders: Corporate Governance Reforms and Shareholder Reactions*, 43 ADMIN. SCI. Q. 127, 128 (1998). In one study, they found that firms were adopting long-term incentive plans for CEO compensation but not actually implementing the plans. However, if these firms used the appropriate agency theory rhetoric of aligning CEO and shareholder interests, they would still have been able to enjoy the benefits of a positive stock market reaction and lowered external pressure for further reform. *Id.* at 146-47.

¹⁶⁴ Similar arguments have been made with respect to ethics codes and corporations. See, e.g., LINDA KLEBE TREVINO & GARY R. WEAVER, *MANAGING ETHICS IN BUSINESS ORGANIZATIONS: SOCIAL SCIENTIFIC PERSPECTIVES* 127-31 (2003) (noting “decoupling” of ethics programs from day-to-day operations to create only the appearance of compliance); John M. Stevens et al., *Symbolic or Substantive Document? The Influence of Ethics Codes on Financial Executives’ Decisions*, 26 STRATEGIC MGMT. J. 181 (2005). Another explanation is that boards were not implementing ethics codes properly and were unnecessarily restricting their practices. Finally, it may be that, in this dataset, the ethics code variable served as a proxy for some other characteristic of a pension fund that was not directly captured by a variable in this study’s model.

¹⁶⁵ Using a limited dataset, Nofsinger also did not find any determinants of the use of ETIs significant at conventional levels. Nofsinger, *supra* note 123, at 94-95.

funds were the ones engaging in ETIs. The underinclusive definition of ETIs used in this study may explain the limited results.¹⁶⁶

The results of Model 2 in Table 3 showed that pension systems were more likely to be shareholder activists when the board was directly responsible for investments, there were more member elected trustees,¹⁶⁷ and at least some of the plan members were unionized. These findings provide some support for the critics of CalPERS, who claim that the pension fund is using its assets to further union political goals. It is important to note, however, that the definition of activism used by the PENDAT surveys includes pension systems that simply voted their proxies against management, as well as those more active in corporate governance reform, such as CalPERS. Thus, it is also possible to argue that the combination of determinants of activism is consistent with a motivated board that is conscientious about performing its duties. Member-elected trustees have incentives to attempt to improve the fund's performance due to their accountability to plan beneficiaries and their own financial interest.¹⁶⁸ Being directly responsible for investments increases the likelihood that the trustees are actively involved in and knowledgeable about investment strategy, which could also lead to more activism. From this perspective, unions could simply be seen as placing pressure on trustees to perform their duties.

The determinants of shareholder activism also included the size of the pension system and its investments in domestic stock. Both findings were as expected. Larger pension funds are likely to have more resources than smaller pension systems, and thus can be devoted to being more informed and active shareholders. In addition, due to their large holdings, the voices of larger pension funds were more likely to be heard by management, which gives them more of an incentive to use it. Likewise, if a pension system has more of its assets devoted to equities, then it has a greater incentive to actively exercise its shareholder rights.

V. CONCLUSION AND DISCUSSION

The future success of DB public pension plans depends upon their governance. The board of trustees must be able to prevent the political misuse of the fund's assets and have the expertise and motivation to

¹⁶⁶ See *supra* notes 146-50 and accompanying text.

¹⁶⁷ This confirms an earlier finding by Useem & Hess, *supra* note 17, at 146.

¹⁶⁸ See Hess & Impavido, *supra* note 45, at 58-59, 67.

ensure successful investment performance. Similar to the role envisioned for independent directors in corporate governance, there is a role for member-elected trustees. These trustees are motivated, accountable to plan beneficiaries, and independent of political influence. A growing body of empirical evidence suggests that they are potentially good stewards of the pension assets.

The political problems affecting public pension fund performance are not shareholder activism or social investing, as the critics of public funds suggest, but that governments are using pension assets as a safety valve against other budgetary problems. This misuse of pension assets does not always occur through overt actions, but often through the manipulation of poorly understood accounting assumptions. Trustees who are elected by plan members, however, may be able to reduce or prevent such misuse.¹⁶⁹

Member-elected trustees' dedication to their duties also appears to be beneficial to plan financial performance. Empirical evidence on these trustees' positive relationship with shareholder activism may be one indication of this dedication. The Myners Report encouraged funds to actively vote their proxies and intervene with companies when it could improve the fund's performance.¹⁷⁰ The report also encouraged trustees to adopt the U.S. Department of Labor's position on the appropriateness of private pension trustees engaging in active monitoring of corporate management.¹⁷¹ The Department of Labor requires trustees to vote their proxies on matters that may affect the plan's investments. In addition, the Department of Labor approves cost-effective attempts to influence corporate management when it is expected to improve the fund's investment value in the company.¹⁷² The presence of member-elected trustees seems to help ensure that the board dutifully performs this role.

In 1993, Romano called for boards of trustees to adopt more member-elected trustees,¹⁷³ but from 1990 to 2000 the structure of boards remained unchanged. The average pension system in the PENDAT dataset has consistently had approximately one-third of its trustees consist of member-elected trustees, and one-third of the systems do not

¹⁶⁹ Hsin & Mitchell, *supra* note 71, at 257-59.

¹⁷⁰ MYNERS REPORT, *supra* note 135, at 93.

¹⁷¹ Interpretive Bulletin Relating to the Employee Retirement Income Security Act of 1974, 29 C.F.R. § 2509.94-2 (2005).

¹⁷² *Id.*

¹⁷³ Romano, *Activism*, *supra* note 48, at 840-41.

have any such trustees. There may be limits, however, on the optimal number of member-elected trustees on the board. That is, there may be a curvilinear (or inverted-U shape) relationship where an increasing proportion of member-elected trustees have a positive impact on performance, but after crossing a certain threshold, it has a decreasing impact. Presumably, there are benefits from the independence and motivation of member-elected trustees, but at some point their non-technical expertise may work against those benefits. This suggests that there is a need for a well-balanced board and not a board dominated by any particular class of trustees. This is further reflected in the positive association between trustees appointed by an executive (who perhaps are more likely to have investment expertise) and plan performance.

The empirical evidence presented here also provides insights on different board governance practices. In the United Kingdom, the Myners Report recommended several practices to improve the performance of institutional investors. These recommendations included ensuring that trustees have the necessary investment expertise required before making any decision,¹⁷⁴ that the board use a subcommittee for investments comprised of qualified individuals,¹⁷⁵ and that trustees receive adequate training and in-house support staff.¹⁷⁶ Although my indicator variable for expertise requirements was not significant, the negative relationship between the board setting the asset allocation and investment performance does suggest that the board does not have the capability to perform this task appropriately. This supports the Myners Report's concerns on trustees overseeing asset allocation decisions¹⁷⁷ and demonstrates the potentially negative consequences.

The Myners Report also recommended, and UMPERS requires, that

¹⁷⁴ MYNERS REPORT, *supra* note 135, at 44-45. If they cannot acquire the necessary expertise, then the decision should be delegated to those who possess the necessary skills. *Id.*

¹⁷⁵ *Id.* at 47.

¹⁷⁶ *Id.* at 49. The report concludes by providing ten proposed principles for defined benefit pension plans that include the above-mentioned recommendations. *Id.* at 148-49. These recommendations apply to both private and public pensions. *See id.* at 199. In December 2004, the United Kingdom HM Treasury issued a report on the progress of institutional investors in complying with the recommended principles and recommended amendments to those principles. HM TREASURY, MYNERS PRINCIPLES FOR INSTITUTIONAL INVESTMENT DECISION-MAKING: REVIEW OF PROGRESS 21 (2004) (U.K.), available at http://www.hm-treasury.gov.uk/documents/financial_services/securities_and_investments/fin_sec_mynfinal.cfm (last visited Oct. 14, 2005) [hereinafter HM TREASURY].

¹⁷⁷ *See supra* note 137 and accompanying text.

the board send a detailed annual report to all plan members.¹⁷⁸ My study shows that using transparency to improve governance may have unintended consequences. Likewise, ethics codes also had a negative impact. The cause of these results are in need of future research, but these findings — along with the asset allocation findings — point out the direction where future research and policy discussions on public pensions need to head: that is, whether improving the level of expertise on the board will improve fund performance. For example, one explanation of the findings on the annual report is that disclosure pushes boards to adopt the investment strategies of their peers (so they can more easily justify their actions to an external audience in the case of investment losses).¹⁷⁹ Presumably, a more qualified board would consider the needs of its particular pension and not adopt an off-the-shelf strategy used by others.

In 2004, the United Kingdom passed the Pensions Act of 2004, which requires trustees of occupational pensions to meet certain knowledge requirements.¹⁸⁰ Likewise, the debate on the appropriate qualifications of trustees should move beyond debates on “prudent person” versus “prudent expert” requirements¹⁸¹ and toward a discussion of how we can ensure that a board of trustees has the expertise to perform its duties — whether it is making investment decisions directly or simply overseeing the implementation of the fund’s strategy by others. This requires additional research on how trustees make decisions, what training trustees currently receive, and if knowledge requirements can improve that process. For example, a 2002 study by an ERISA advisory council found that most education options for private pension fiduciaries were directed at professional fiduciaries.¹⁸² This finding suggests that non-

¹⁷⁸ Myners Report, *supra* note 135, at 16, 46, 147.

¹⁷⁹ See *supra* notes 160-61 and accompanying text.

¹⁸⁰ HM TREASURY, *supra* note 176, at 21.

¹⁸¹ See Galer, *supra* note 137 (providing an overview of the prudent person standard in pension investing in the United Kingdom and United States); Willborn, *supra* note 15, at 146-48 (stating that UMPERS rejected the “prudent expert” rule because “[f]iduciaries should be evaluated, not against a single prudent expert, but in terms of the actions of prudent fiduciaries for other similar systems facing similar circumstances”).

¹⁸² U.S. DEP’T OF LABOR, REPORT OF THE WORKING GROUP ON FIDUCIARY EDUCATION AND TRAINING (2002), available at http://www.dol.gov/ebsa/publications/AC_1108b02_report.html (last visited Sept. 8, 2005). In addition, these training programs were typically sponsored by investment firms, as opposed to independent organizations. The advisory council also considered and rejected mandatory training for private pension fiduciaries. Although the advisory council made various recommendations on ways to improve and support fiduciary education, including appointing a national coordinator of fiduciary

professional, member-elected trustees are not getting the training they need. This finding is especially disappointing because the trustees that are the most likely to be independent of political influence and have the strongest incentives to perform their duties are also the least likely to have the necessary investment expertise.

As the debate over the governance of public pension funds continues to evolve and governments consider new reform measures, it is essential that we take into account the growing body of empirical evidence on these matters. This evidence shows that pension funds are being abused for political reasons but that careful consideration as to the composition of the board of trustees, especially the role of member-elected trustees, and their investment practices can lead to a positive improvement in performance. There will not be a one-size-fits-all solution to pension governance, as the size of the fund, the presence of a union, and other factors will make a difference. Our understanding of the impact of the board must continue to develop, however, to ensure that pension funds can reduce their unfunded liabilities and continue to meet the needs of retirees.

education and outreach to coordinate these efforts, the educational needs of the various fiduciaries involved in a private pension plan were too different to mandate a knowledge requirement. *Id.*

APPENDIX

Table 1: Descriptive Statistics

Independent Variables	Mean	St. Dev.
Board		
Trustee appointed by exec. (% of bd)	.11	.24
Trustee elected by members (% of bd)	.36	.24
At least one trustee elected by members (yes/no)	.72	.45
Trustee elected by members are majority of board (yes/no)	.32	.46
Policies/Practices		
Board responsible for investments (yes/no)	.56	.50
Board sets asset allocations (yes/no)	.87	.34
Ethics code (yes/no)	.60	.49
Education/experience requirements (yes/no)	.44	.50
External Controls		
Prudent person (yes/no)	.86	.34
Union (yes/no)	.69	.46
Disclosure sent to members (yes/no)	.46	.50
Economically-targeted investments (yes/no)	.08	.26
Shareholder activism (yes/no)	.19	.39
Control Variables		
Total Equity Investments (% of portfolio)	46.5	18.1

Assets (in \$ millions) 4090.7 12380.8

Table 2: Regression of Rate of Return on Fund Characteristics

This table includes four ordinary least squares regression models. The dependent variable is the rate of return on the pension system's assets for the calendar year. Each model contains year indicators not shown here. The standard errors are reported below the coefficients in parentheses and use the Huber-White correction.

Independent Variables	Model 1	Model 2	Model 3	Model 4
Board				
Trustee appointed by exec.	2.30*** (.80)	2.55** (1.10)	2.67*** (.85)	2.70*** (.86)
Trustee elected by members	1.05 (.80)	1.10 (1.06)	5.06** (2.13)	
Trustee elected by members (squared)			-5.37** (2.13)	
At least one trustee elected by members				1.30** (.60)
Trustee elected by members > 47%				-.54 (.35)
Policies/Practices				
Board responsible for investments	.25 (.36)	-.02 (.47)	.21 (.35)	.19 (.35)
Board sets asset allocations	-1.77*** (.53)	-1.77** (.70)	-1.82*** (.51)	-1.79*** (.49)
Ethics Code	-1.37*** (.39)	-1.05* (.63)	-1.40*** (.38)	-1.39*** (.39)
Education/experience requirements	.50 (.33)	-.03 (.50)	.42 (.38)	.41 (.34)
External Controls				
Prudent Person	.36 (.39)	-.28 (.65)	.41 (.39)	.41 (.38)
Union	-.06 (.34)	.39 (.50)	-.17 (.35)	-.19 (.35)
Disclosure Sent to Members	-1.08*** (.38)	-1.19* (.65)	-1.04*** (.38)	-1.02*** (.39)
Economically-targeted investments	-.71 (.46)	-.86 (.81)	-.59 (.44)	-.56 (.45)
Shareholder activism		.07		

	(.50)			
Control Variables				
Total Equity	.06***	.14***	.06***	.05***
Investments	(.01)	(.02)	(.01)	(.01)
Assets (log)	.14*	.25*	.17**	.16**
	(.08)	(.13)	(.08)	(.08)
Constant	11.92***	7.11***	11.92***	11.51***
	(.96)	(1.26)	(.96)	(1.01)
N	514	241	514	514
R-sq	.72***	.34***	.72***	.73***

*p<.10; **p<.05; *** p <.01 (two-tailed tests)

Table 3: ETIs and Activism

This table reports the results of three logit regression models. In Model 1, the dependent variable has a value of one if the pension system invested in economically-targeted investments. In Model 2, the dependent variable has a value of one if the pension system engages in shareholder activism. Each model contains year indicators not shown here. The standard errors are reported below the coefficients and use the Huber-White correction.

Independent Variables	Model 1: ETI	Model 2: Activism
Board		
Trustee appointed by exec.	1.10 (1.19)	-.55 (1.27)
Trustee elected by members	2.14 (1.35)	2.70** (1.13)
Policies/Practices		
Board directly responsible for investments	.77 (.54)	1.01** (.56)
Board sets asset allocations	.06 (1.07)	-.36 (1.02)
Ethics Code	-1.05* (.59)	.41 (.80)
Education/experience requirements	.15 (.50)	.73 (.56)
External Controls		
Prudent Person	-.36 (.59)	.63 (1.14)
Union	.68 (.70)	1.12** (.59)
Disclosure Sent to Members	.38 (.56)	-.52 (.45)
Control Variables		
Total Equity Investments	.04*	.08***

	(.02)	(.03)
Assets (log)	.58***	.73***
	(.16)	(.16)
Constant	-10.62***	-15.01***
	(2.27)	(2.70)
n	567	268
Pseudo R-sq	.21***	.38***

*p<.10; **p<.05; *** p <.01 (two-tailed tests)