FAQ

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In it for the Long Haul: The Investment Behavior of Public Pensions

What are the report findings?

This report finds that that public pension plans exhibit prudent investment in bear and bull markets. More specifically, the data analyzed indicate that public pensions are prudent investors because they:

- Actively rebalance investments in response to price changes.
- Do not get caught up in a "herd mentality," but rather follow the best investment practices in the industry. State plans, in particular, systematically follow the practices of performance leaders.
- Hold higher risk assets when funding levels are higher and assess their financial situation before modifying the plan's asset allocation. If anything, public pensions are somewhat overly cautious following periods of lower funding, indicating they avoid "chasing returns."
- Hold smaller amounts of stocks when employers face higher contribution rates. This trend continued even after the 2000 bear market. This indicates that public pensions avoid pressure to invest more aggressively after experiencing losses.

Why was the report commissioned?

After the stock market downturn in 2000, the vast majority of defined benefit pension plans (in the public and private sectors) experienced a drop in funding ratios largely due to a drop in stock prices. Anecdotal reports by some media outlets fueled concerns that public pension plans might have acted imprudently by "chasing returns" in their investment portfolios after funding levels dropped. Such concerns are being played up again today during the current market plunge.

This study examines whether concerns are warranted based on the investment decision record of public pension plans during bull and bear markets. The analysis draws on the data available before, during and after the last stock market downturn to determine whether public pension plans typically "buckle down" in the face of a crisis by taking prudent steps to protect the interests of beneficiaries and taxpayers. Or, after experiencing investment losses, do public pensions instead pursue more risky strategies in an effort to recoup those losses?

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Does the report make conclusions with regard to the behavior of public pensions in the current market downturn?

At this point, data isn't available that would allow experts to draw conclusions regarding the investment behavior of public pensions in this current market downturn.

However, the past can often be a good guide to the future. Understanding how public pension plans have dealt with challenges in the past offers useful information on how they may be reacting to the current crisis. The data clearly indicate that public pensions consistently "buckle down" and exhibit prudent investment behavior in bear markets.

What factors would indicate prudent investment behavior?

Four factors that would indicate either prudent or imprudent investment behavior are: portfolio rebalancing, tendencies by plans to follow best investment practices by observing the behavior of peer leaders; possible moral hazard; and employer conflicts of interest.

"Moral hazard" would occur if plans, after experiencing losses, took on more risk, believing that taxpayers would underwrite losses. "Employer conflicts of interest" could come into play if plans were pressured by employers to pursue more risky investment strategies when demands for additional contributions escalated.

These four factors taken together – regular rebalancing, learning from peer leaders, and the absence of moral hazard and conflicts of interest influencing investments – provide evidence of prudent investment behavior.

How was the study conducted?

The report was conducted using economic tools such as descriptive statistics and multivariate analysis. The study utilizes U.S. Federal Reserve and U.S. Census Bureau public pension data from 1993 to 2005.

Who are the report authors?

The report was issued by the National Institute on Retirement Security and was co-authored by Dr. Christian Weller and Dr. Jeffrey Wenger, who are nationally-recognized experts in the fields of economics, retirement, and income security. Dr. Weller is associate professor at the University of Massachusetts McCormack Graduate School and senior fellow at the Center for American Progress. Dr. Wenger is assistant professor at the University of Georgia School of Public and International Affairs.