Fact Sheet

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

Overview

The National Institute on Retirement Security has released a new research report entitled, *"In it for the Long Haul: The Investment Behavior of Public Pensions."* The report finds that that public plans exhibit prudent investment behavior even during turbulent market conditions. The findings can provide insight as to how pension funds may be reacting to current volatile financial market conditions. The analysis is based on data from the Federal Reserve and the U.S. Census Bureau from 1993 to 2005.

Key Findings

The study concludes that public pension plans 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.

These findings come at a time when the current financial crisis brings increased attention to the issue of retirement security. Employees and retirees today watch their 401(k) savings plans shrivel as financial markets plummet, while beneficiaries of public pensions learn that the performance of their retirement plans are not immune to financial market volatility. The findings also underscore that public pension plans are suitable for employees and taxpayers alike whether financial markets are tranquil or volatile, on the rise or falling.

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Why This Report

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?

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 will react to the current crisis to protect benefit security for public servants at the lowest cost to taxpayers. The answer may provide an indication of how public pensions will respond to the severe financial turmoil we are experiencing.

Evaluating Prudent Investment Behavior

The study focuses on four factors that would indicate either prudent or imprudent investment behavior: 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.

Assessing the Available Data

Using economic tools such as descriptive statistics and multivariate analysis, the study examines Federal Reserve and Census Bureau data on public pension plan investments from 1993 to 2005. The data reveal that public pensions:

- Exhibit prudent investment behavior. Plans regularly rebalanced their portfolios and adopted best investment practices from peer leaders to improve the rate of return for beneficiaries.

- Avoid "moral hazard." Plan stock allocations are larger in the period after higher funding levels, indicating that investment officials wait to know what their financial situation is before they change the risk exposure of their portfolio. If anything, plans may have been somewhat overly cautious in their asset allocation decisions in the wake of past instances of under-funding.

- Avoid so-called employer conflicts of interest whereby increased demands for contributions leads to pressure from employers to chase returns by taking on more risk. Public pension plans tend to hold smaller amounts of stocks when employers are faced with the need to contribute more to their pension plans. This relationship seems to have become stronger after 2000. This means public pension plans avoided employer conflicts of interest because larger demands on employers for additional contributions translated into flights from risk rather than a rush toward more risk.

Conclusion

The analysis of the asset allocation decisions by public pension plans should give taxpayers and employees confidence in how these plans are run. The data show that public pension plans followed prudent investment behavior by regularly rebalancing their investment mix, learning from industry leaders, and avoiding moral hazard and employer conflicts of interests. These results cast doubt on anecdotal reports and claims about investment officials investing imprudently when their funding ratios are on the decline.

The results of the study underscore that public pension plans are suitable for their plan participants and beneficiaries when debt and equity markets are tranquil or volatile, or on the rise or falling. Given the severe market swings in U.S. and overseas stock markets and debt markets, workers and government policymakers should value the prudent and professional asset management that defined benefit pension plans are able to achieve.