Evolution and Growth: How Public Pension Plans Have Diversified Their Investments Amid Changing Markets

Research Webinar

June 25, 2025

NATIONAL INSTITUTE ON
Retirement Security
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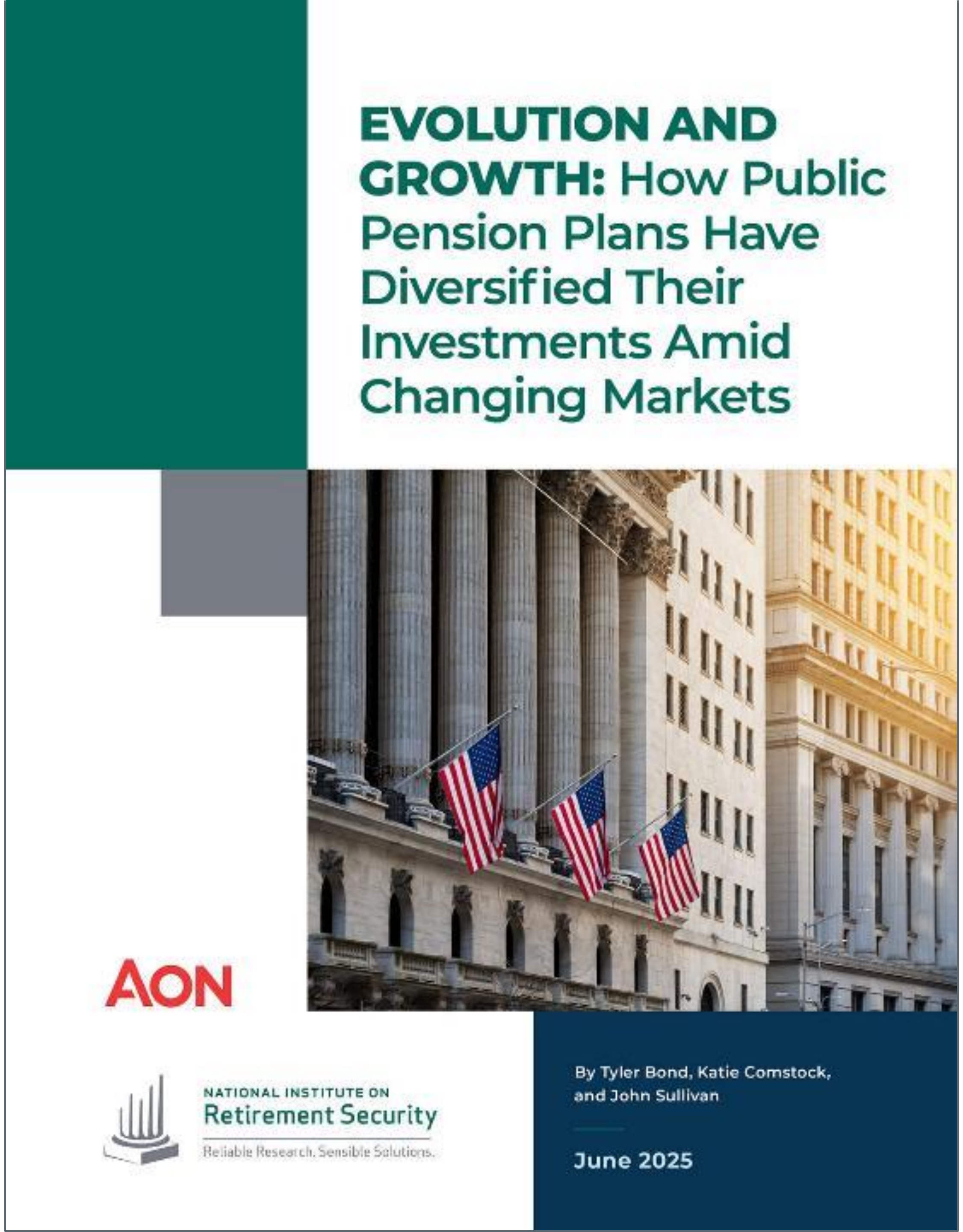
Agenda

- Logistics and Introductions
- Research Review
- Q&A



Speakers

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Associate Partner, Asset-Liability Management at Aon

Why This Research

- Public pension plan asset allocation has changed significantly during the past quarter century. While the fact of this shift is well-known, the broader changes in the economy and financial markets that led to this shift are less well-understood.

- As changes to asset allocations and actuarial assumptions have been occurring, it often has been difficult to measure success.

- Recent economic changes, such as the increase in interest rates, are leading public plans to re-evaluate their investment portfolios once again.

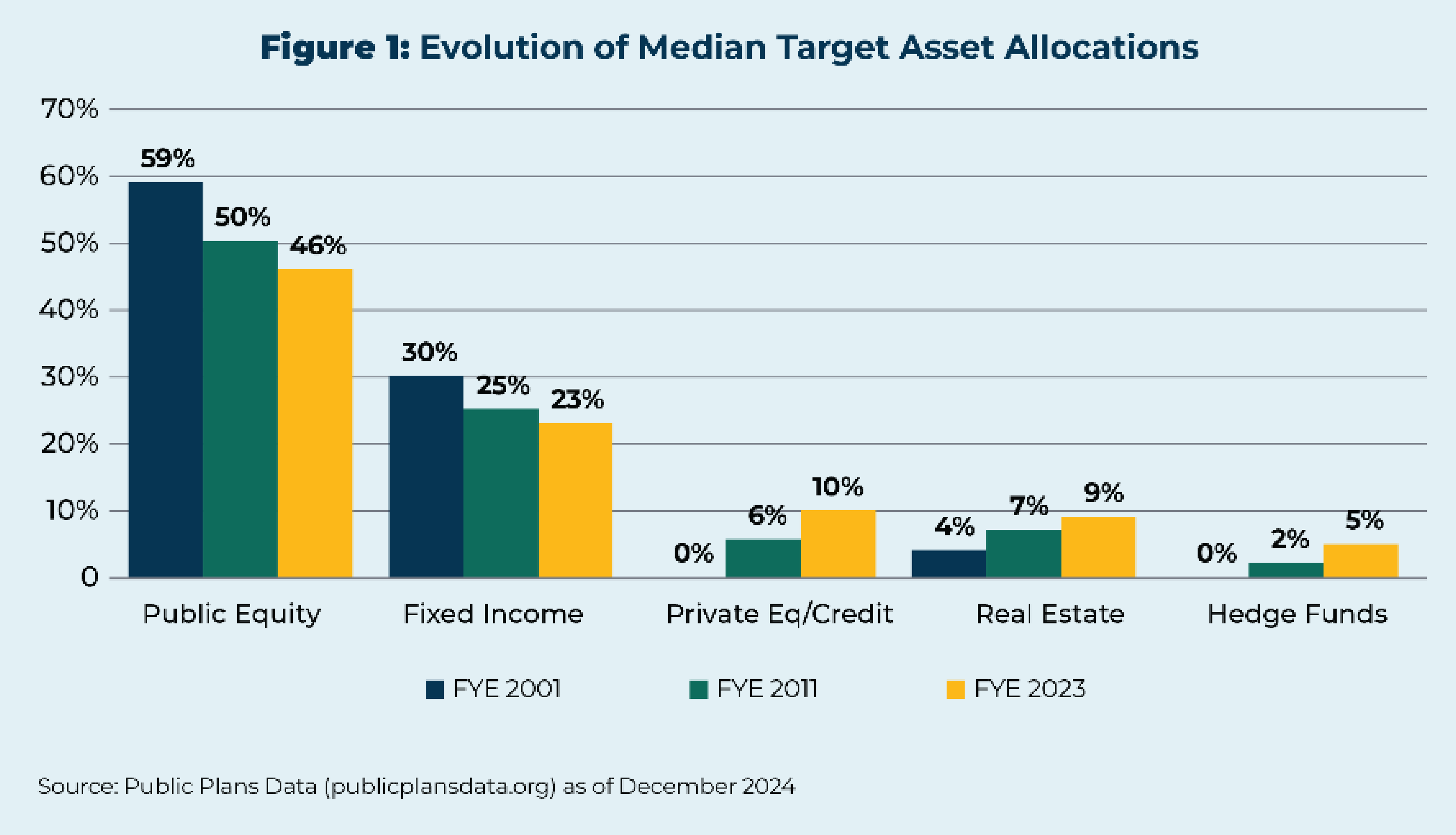
Key Insights and Analysis

- **Public pension plans have significantly diversified their portfolios**. From 2001 to 2023, the average plan reallocated about 20 percent of its assets from public equity and fixed income into private equity, real estate, hedge funds, and other alternative investments.
- **Notable historical events:**
  - During their early years in the 1920s and 1930s, U.S. public pension plans largely followed an investing philosophy known as "fiscal mutualism" in which they invested primarily in municipal bonds.
  - By the mid-twentieth century, most plans had adopted the "prudent investor rule" instead. This shift in investment philosophy opened the door for the more diverse portfolios seen today.
  - The decade of ultra-low interest rates was a notable period of transition and change for public plan investments. This fiscal policy decision following the financial crisis had major consequences for how public plans invest.

Key Insights and Analysis, Continued

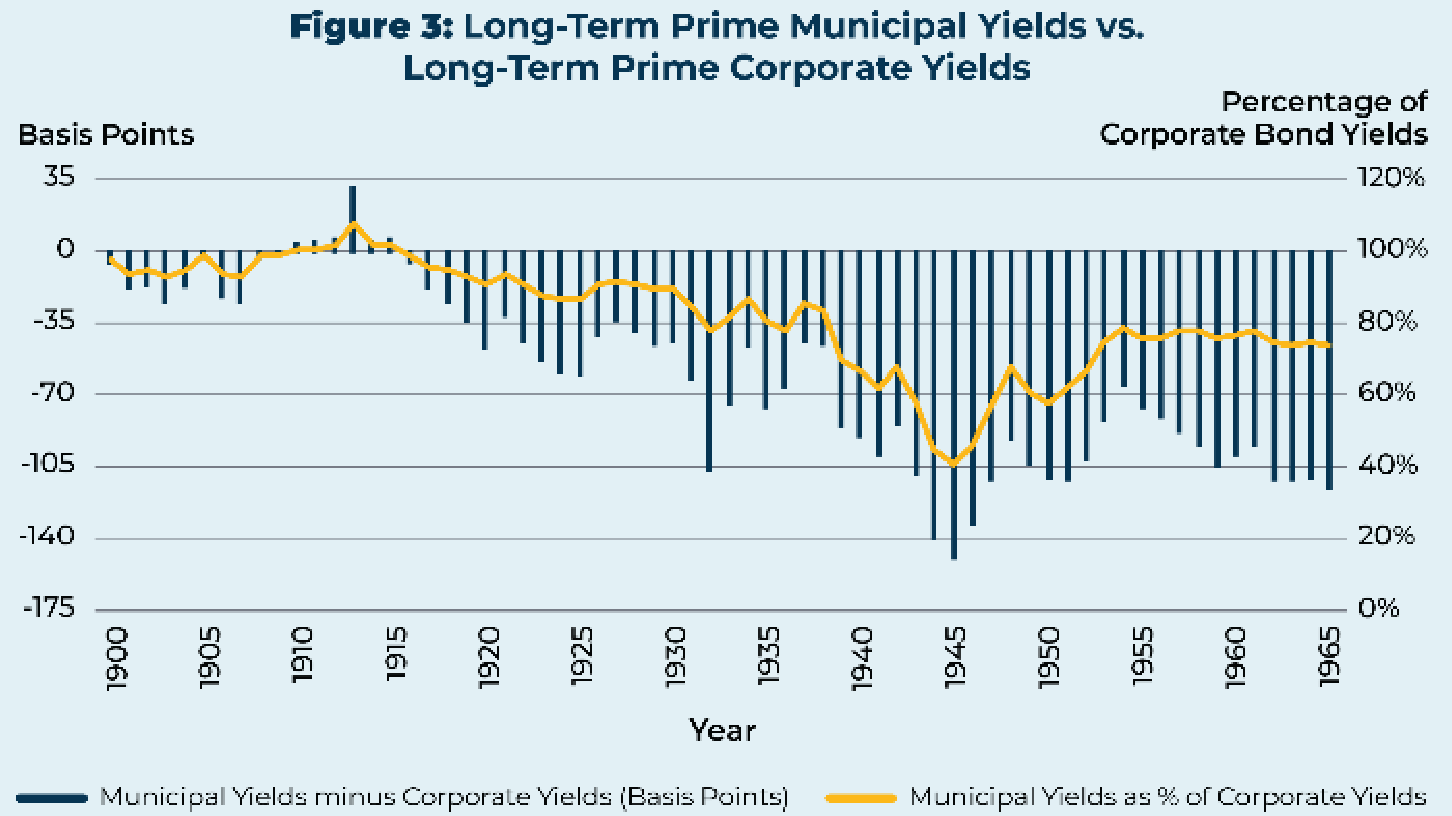
- **Performance Evaluation**
  - **More diverse pension plan portfolios have performed strongly in recent years**. When compared to a "traditional" 60/40 or 70/30 public stock/bond portfolio, the diversified portfolios of public pension plans in the U.S. mostly outperformed following the GFC, measured net-of-fees over rolling five-year periods. Moreover, the diversified portfolio exhibited less volatility and greater upside and downside benefits.
  - **Public pension plans have met their investment return expectations more frequently since the GFC**. When compared to their own return expectations (defined as the actuarial assumed rate of return), U.S. public plans have largely met or exceeded these expectations over rolling five- and 10-year periods that correspond with greater diversification and lower actuarial assumed rates of return. Furthermore, the diversified portfolio met these objectives more frequently than the traditional portfolios.

Asset Allocations Have Shifted Noticeably



One Reason for the Decline of Fiscal Mutualism: Lower Municipal Bond Yields

Fiscal mutualism was an investing approach in which public plans invested almost exclusively in municipal bonds, which was seen to benefit both the plan sponsor and the plan itself.



Source: Sidney Homer, "Factors Determining Municipal Bond Yields," in State and Local Public Facility Needs and Financing: Volume 2, Public Facility Financing (Washington, DC: Government Printing Office, 1966), 269-298 (Glass & Vanatta, 2021, p. 438).

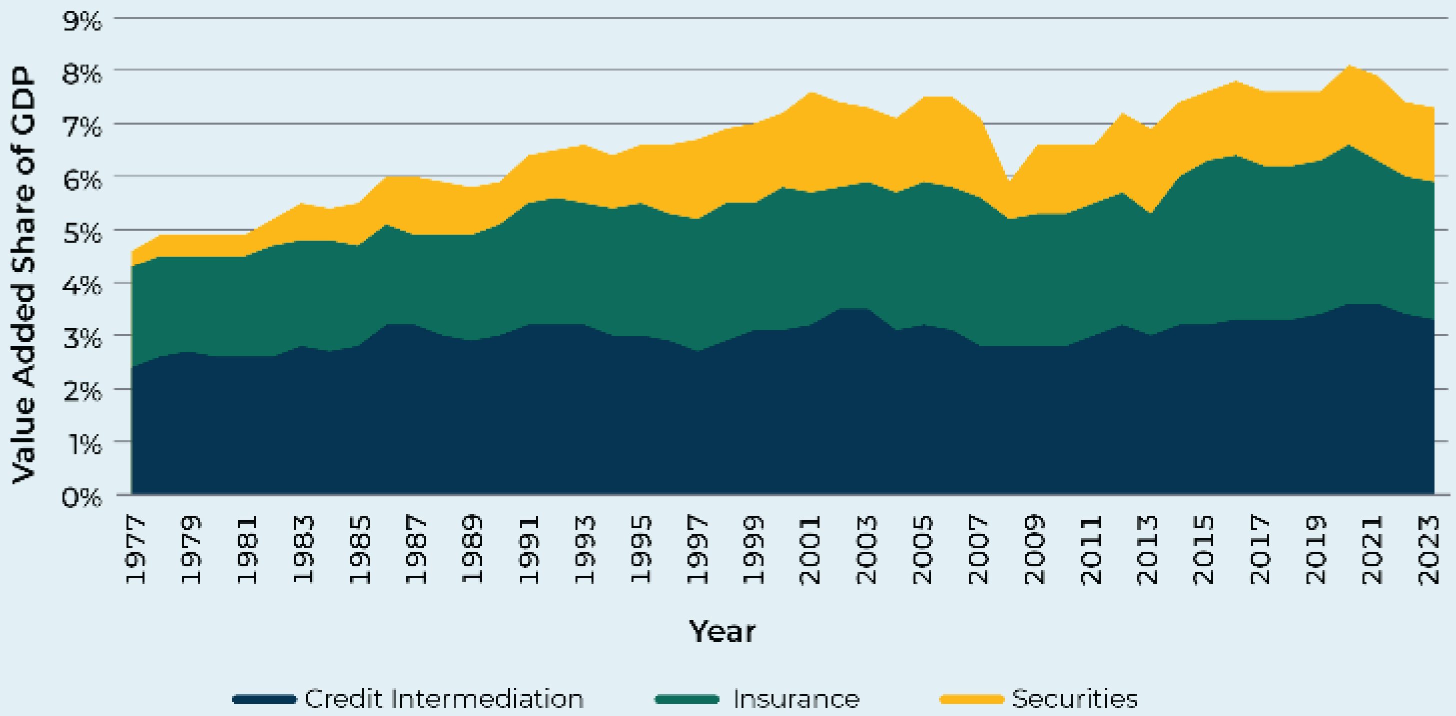
The Prudent Investor Takes Charge

A fiduciary should manage a portfolio 'with the care, skill, prudence, and diligence, under the circumstances then prevailing, that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims.'

- Employee Retirement Income Security Act (ERISA) of 1974

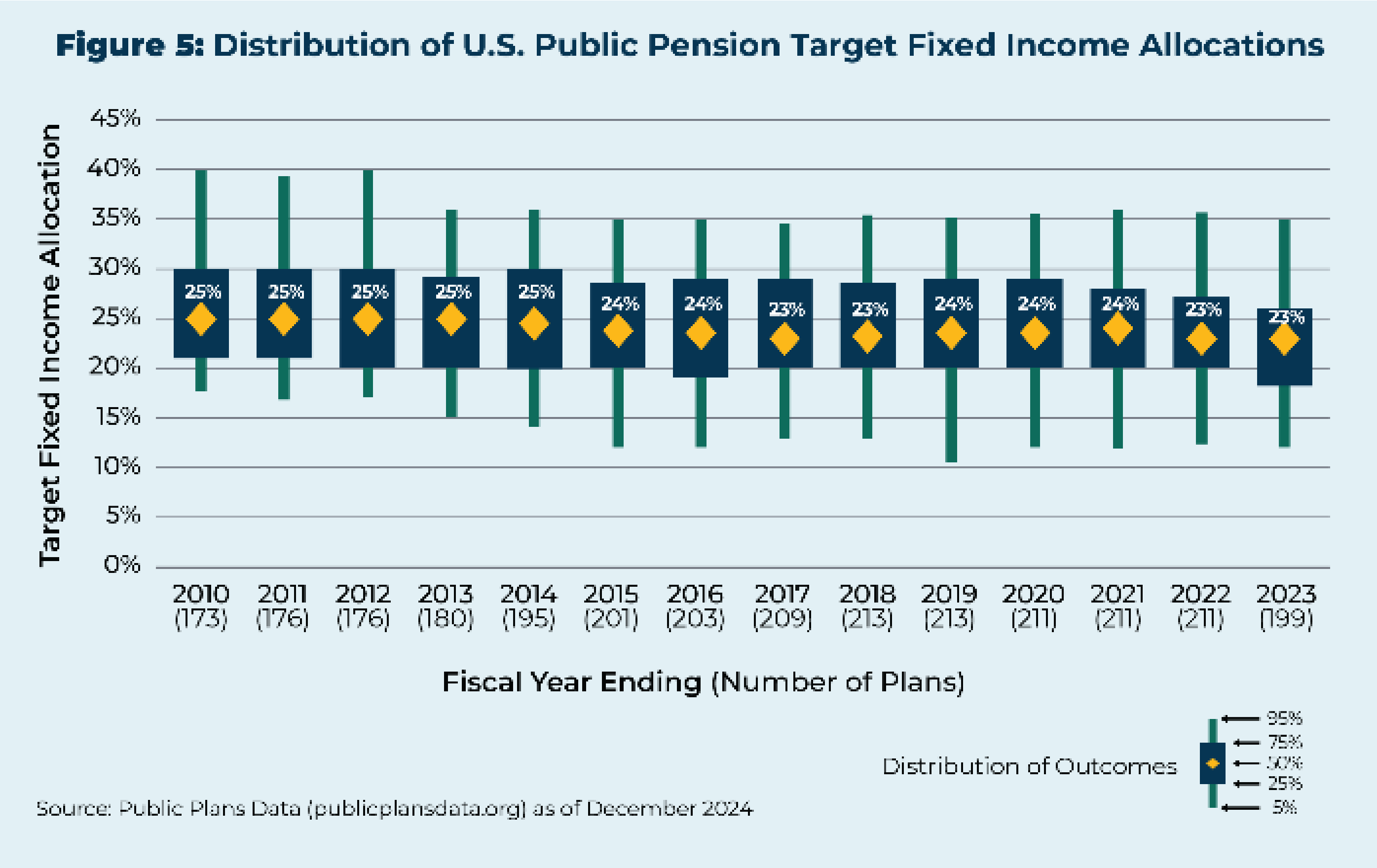
Financial Services Have Grown as a Portion of the Total Economy in the U.S.

Figure 4: The Growth of Financial Services



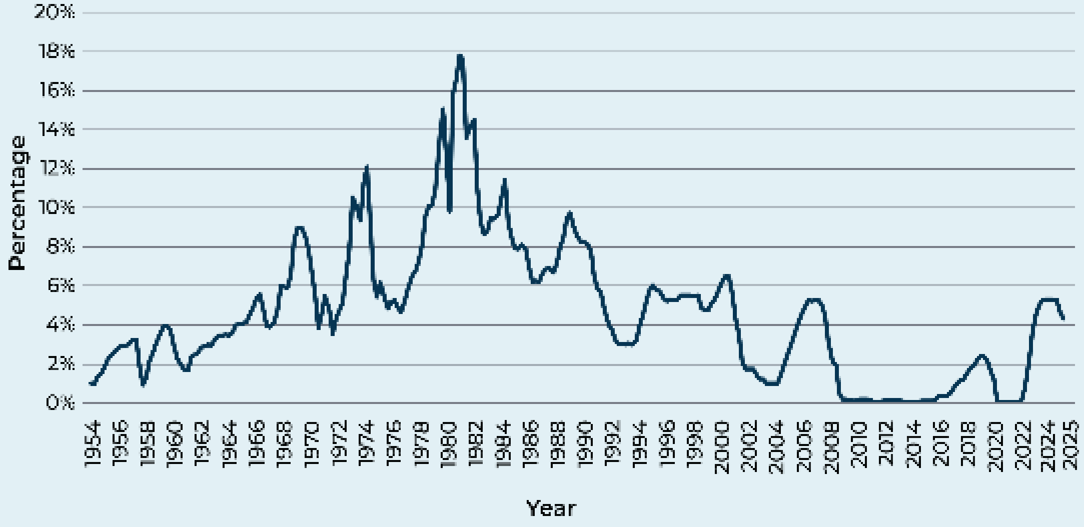
Source: this chart follows and expands upon Figure 1 from Robin Greenwood and David Scharfstein, "The Growth of Finance", Journal of Economic Perspectives—Volume 27, Number 2—Spring 2013—Pages 3–28.

Fixed Income Allocations Declined to About a Quarter of a Plan's Portfolio After the GFC



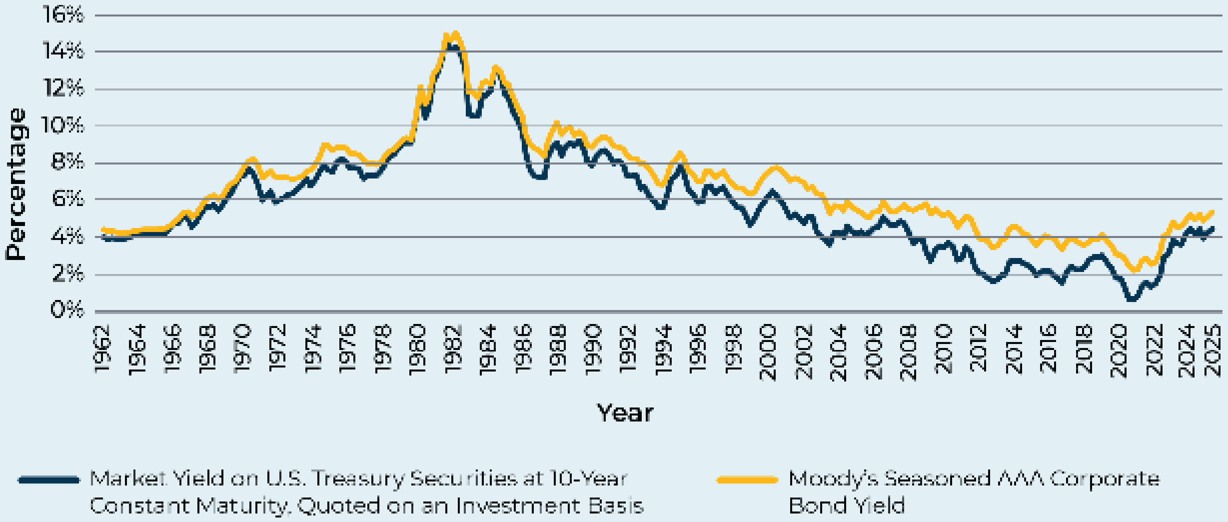
The Long-Term Decline in Interest Rates Has Pushed Down Yields from Bonds and Other Fixed Income

Figure 6: Federal Funds Effective Rate



Source: Board of Governors of the Federal Reserve System (US) via FRED®

Figure 7: 10-year Treasuries and Corporate Bond Yield



Sources: Board of Governors of the Federal Reserve System (US); Moody's via FRED®

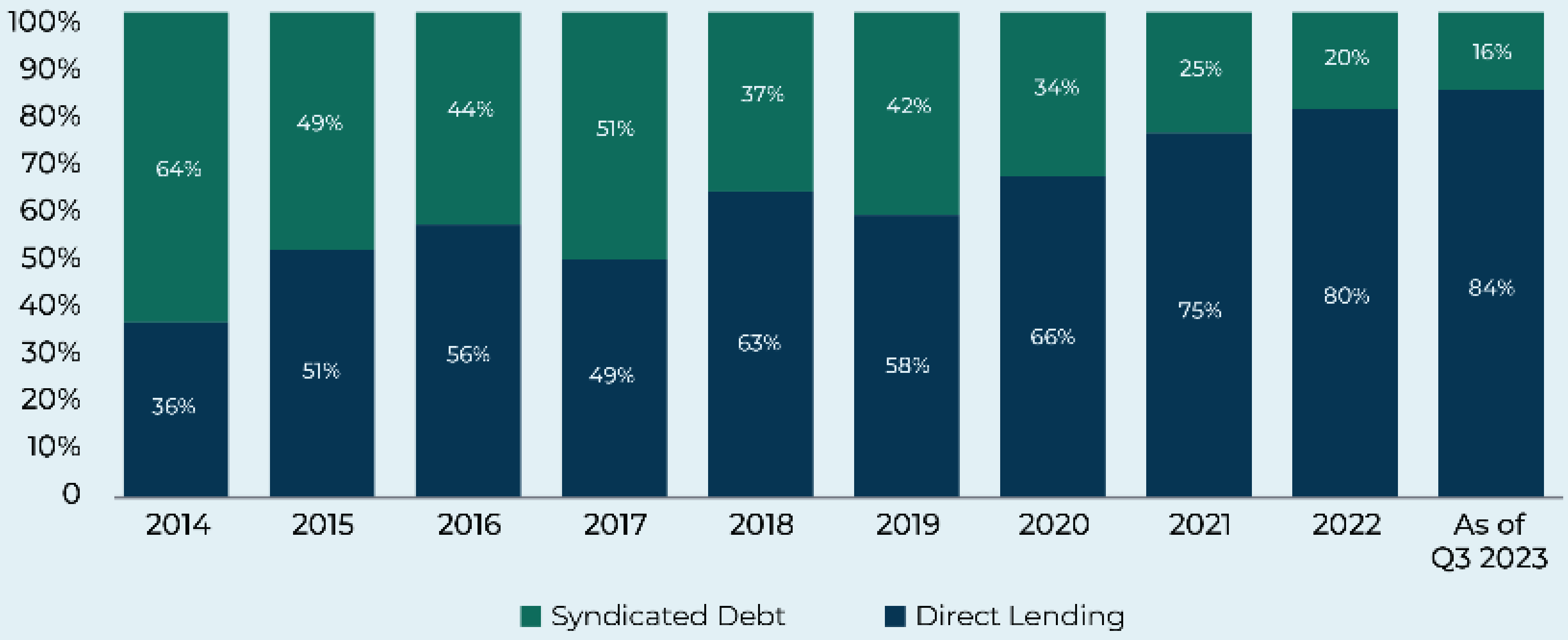
Investors Looked Elsewhere to Lend and Earn Interest

"The emergence of interest to incentivize lending is the most significant of all innovations in the history of finance."

- William Goetzmann, *Money Changes Everything: How Finance Made Civilization Possible*

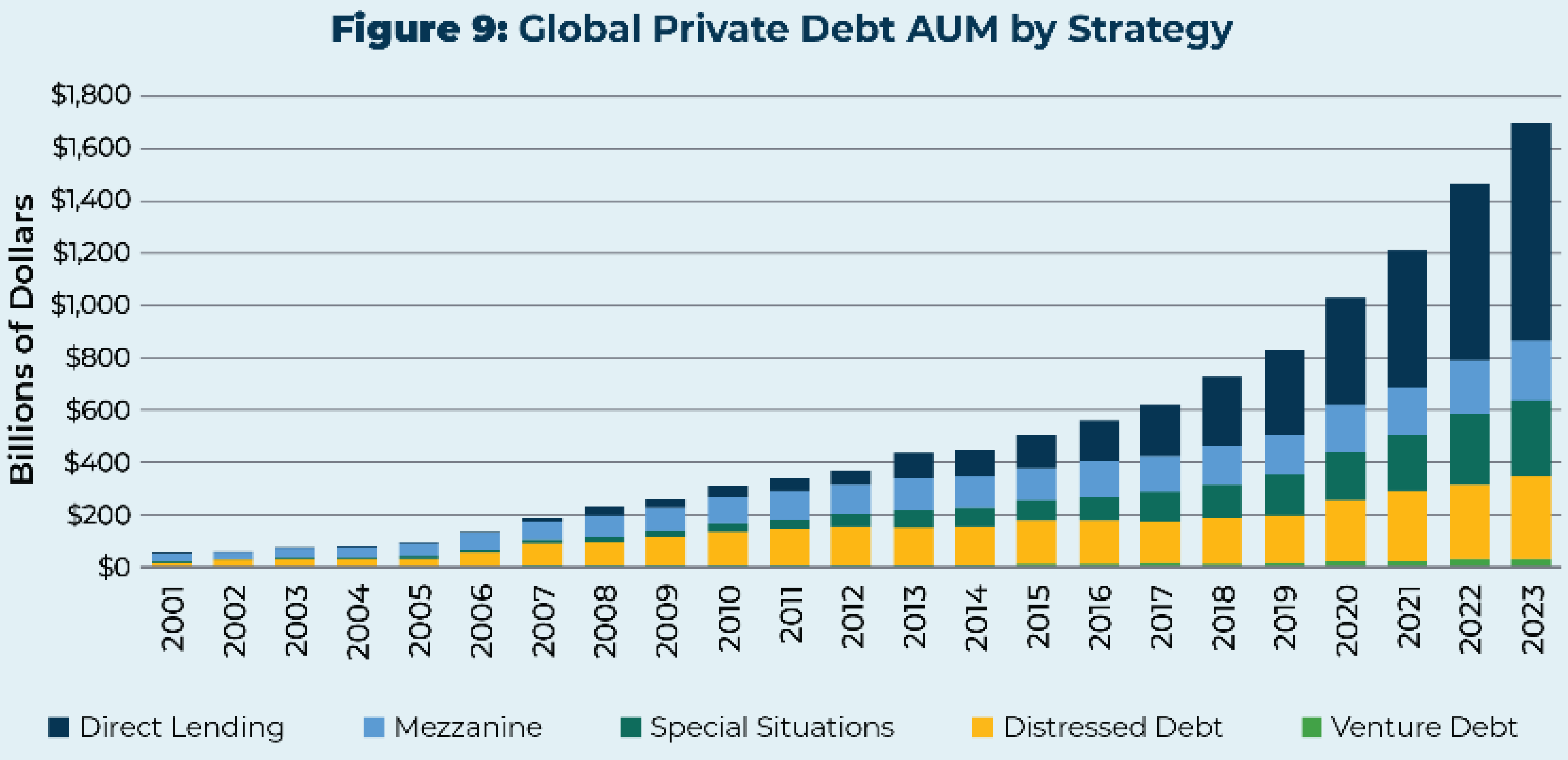
Tighter Banking Regulations Contributed to an Increase in Nonbank Financing

Figure 8: Nonbank Financing of Middle-Market Deals



Source: Young Soo Jang and Steven Kaplan, "Some Thoughts on Private Markets", Presentation to BIS Pension Fund Workshop on Private Markets, March 2024; Figure 10, slide 13.

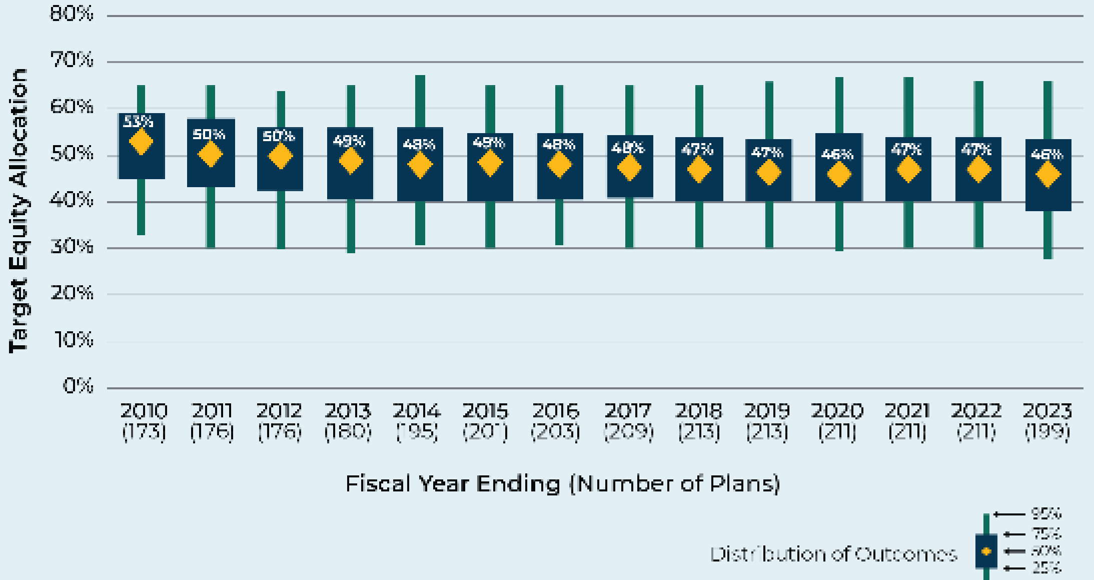
Private Debt/Credit Has Grown Significantly Since the GFC



Source: Preqin Pro

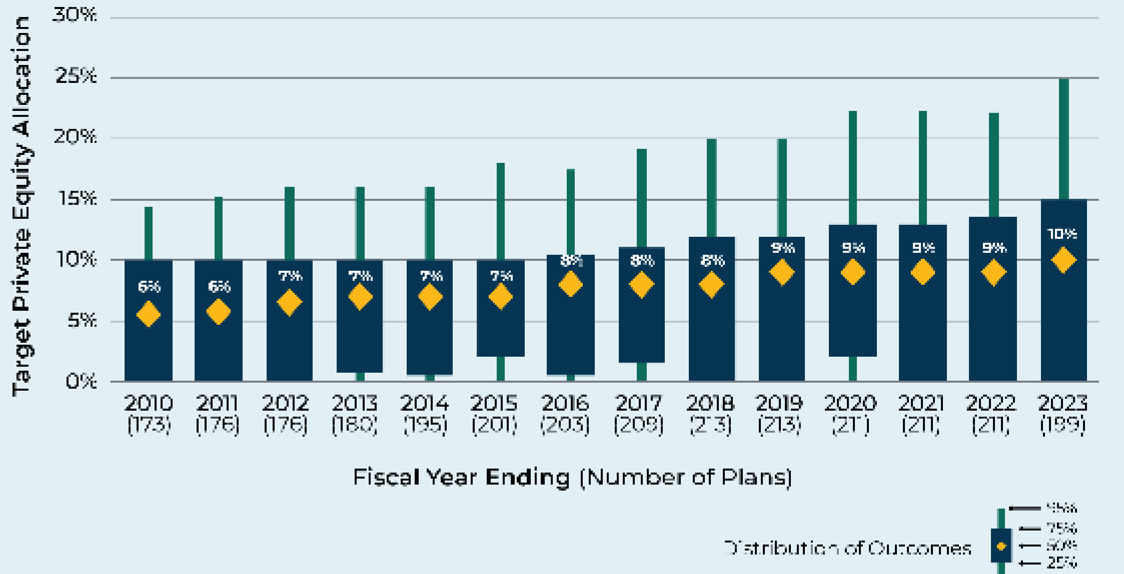
Allocations to Private Equity Have Increased as Allocations to Public Equity Have Decreased

Figure 11: Distribution of U.S. Public Pension Target Public Equity Allocations



Source: Public Plans Data (publicplansdata.org) as of December 2024

Figure 12: Distribution of U.S. Public Pension Target Private Equity/Credit Allocations



Source: Public Plans Data (publicplansdata.org) as of December 2024

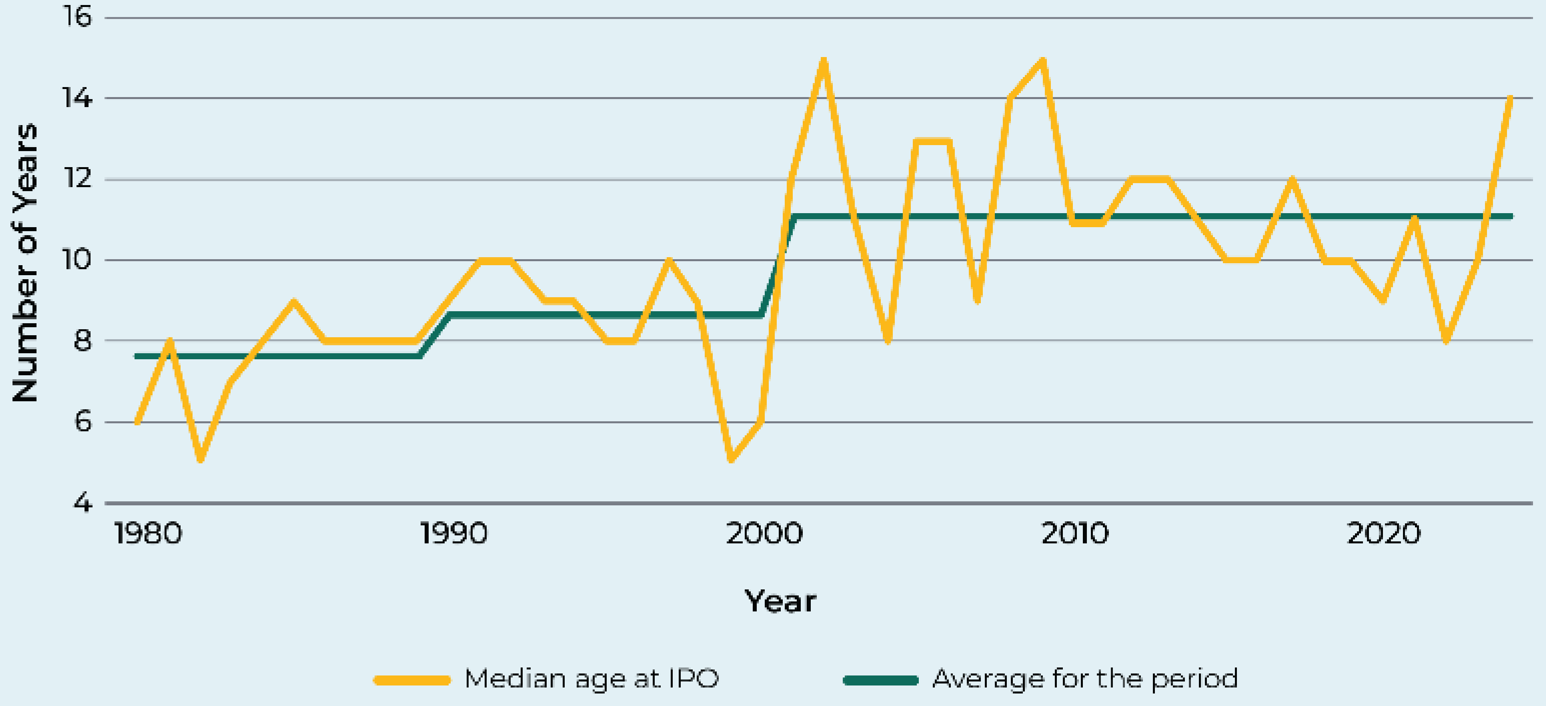
The Number of Public Companies in the U.S. Has Been Cut Nearly in Half Since the Peak in 1996

Figure 13: Number of Listed Domestic Companies

Sources: World Bank, Macrobond

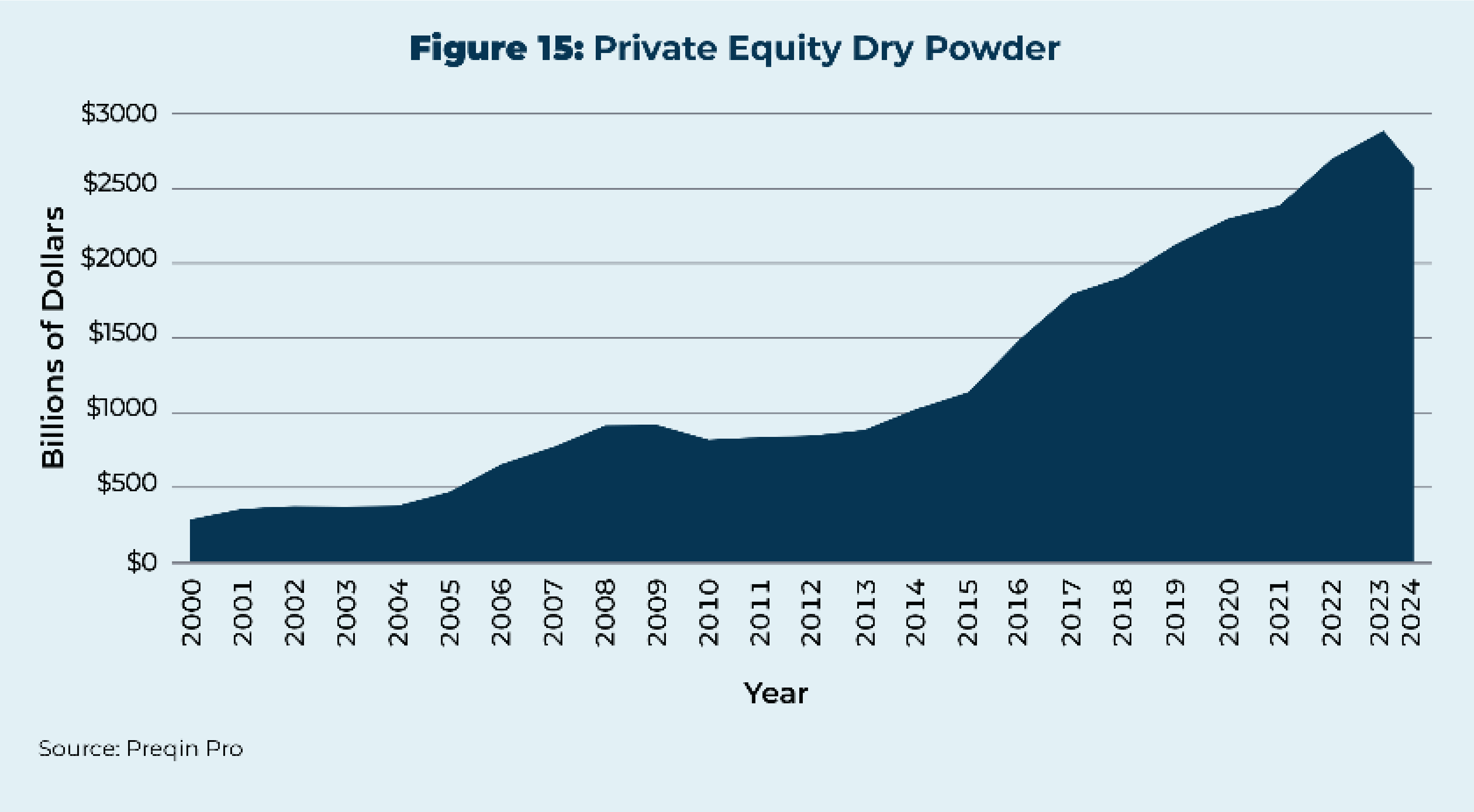
There Are Fewer IPOs and Companies Are Waiting Longer to Go Public

Figure 14: Companies Are Waiting Longer To Go Public



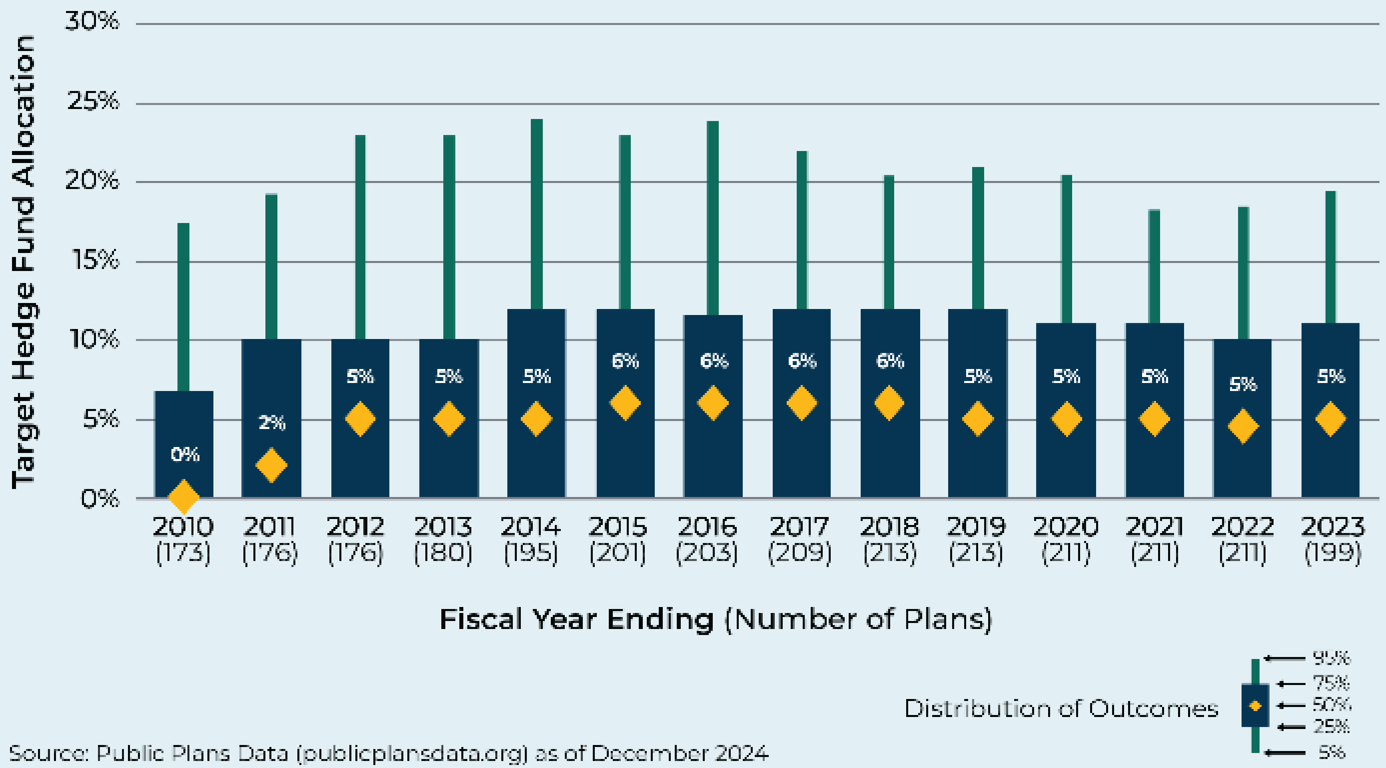
Source: Apollo Global Management: Apollo Chief Economist analysis of data from Jay Ritter

Private Equity Dry Powder Peaked in 2023



Allocations to Hedge Funds Rose and Then Plateaued Following the GFC

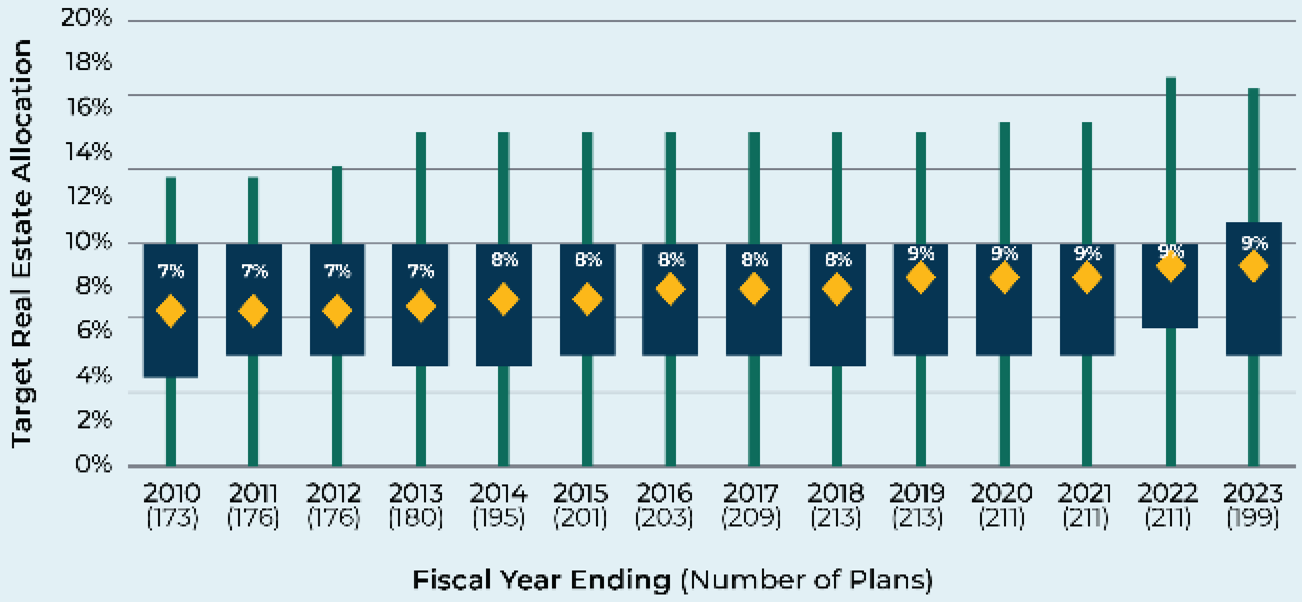
Figure 16: Distribution of U.S. Public Pension Target Hedge Fund Allocations



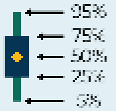
Source: Public Plans Data (publicplansdata.org) as of December 2024

Real Estate Has Become a Consistent Allocation in Many Plans' Portfolios

Figure 17: Distribution of U.S. Public Pension Target Real Estate Allocations

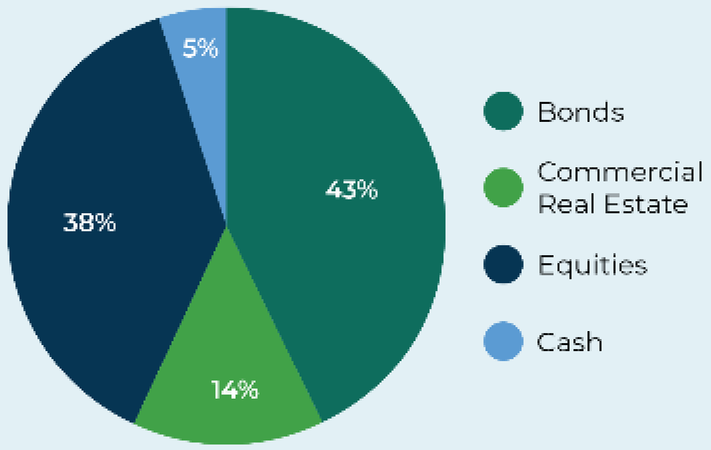


Distribution of Outcomes



Source: Public Plans Data (publicplansdata.org) as of December 2024

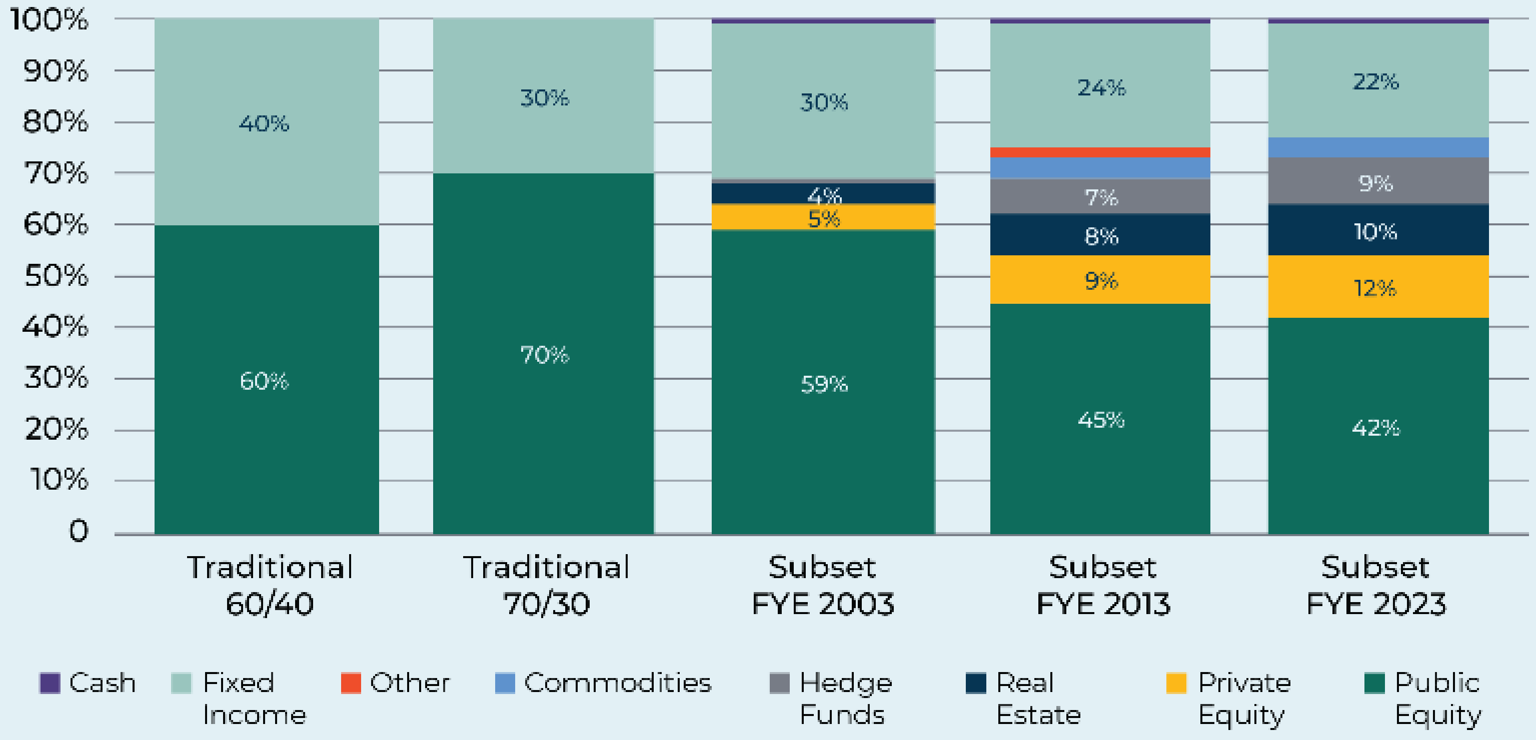
Figure 18: Commercial Real Estate of Investable Market Basket, 2020Q4



Sources: Stock and bond data from Board of Governors of the Federal Reserve, Financial Accounts of the United States, 2020:Q4; commercial real estate market size data based on Nareit analysis of CoStar property data and CoStar estimates of commercial real estate market size.

Asset Allocations Have Moved Away From Traditional 60/40 or 70/30 Portfolios

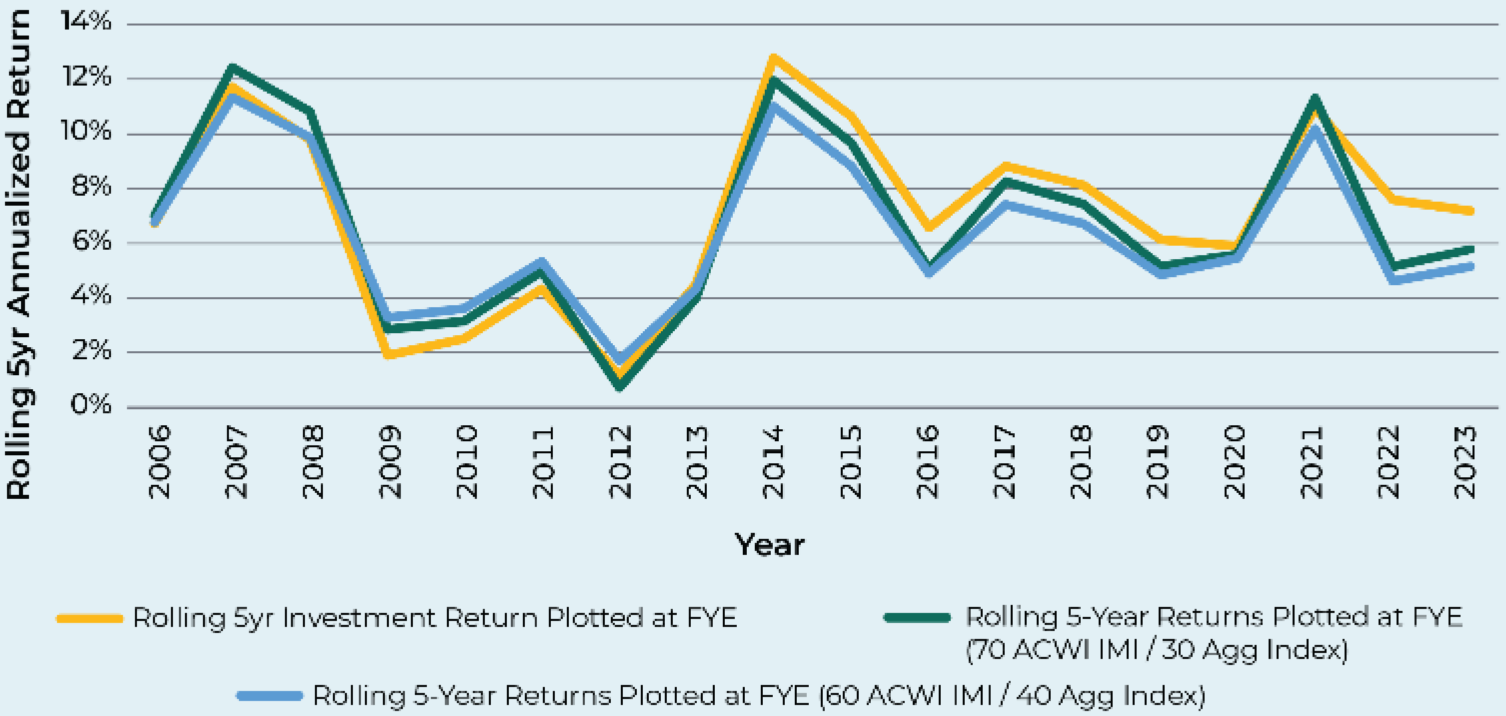
Figure 19: The Evolution of Asset Allocation



Source: Public Plans Data (publicplansdata.org) as of December 2024

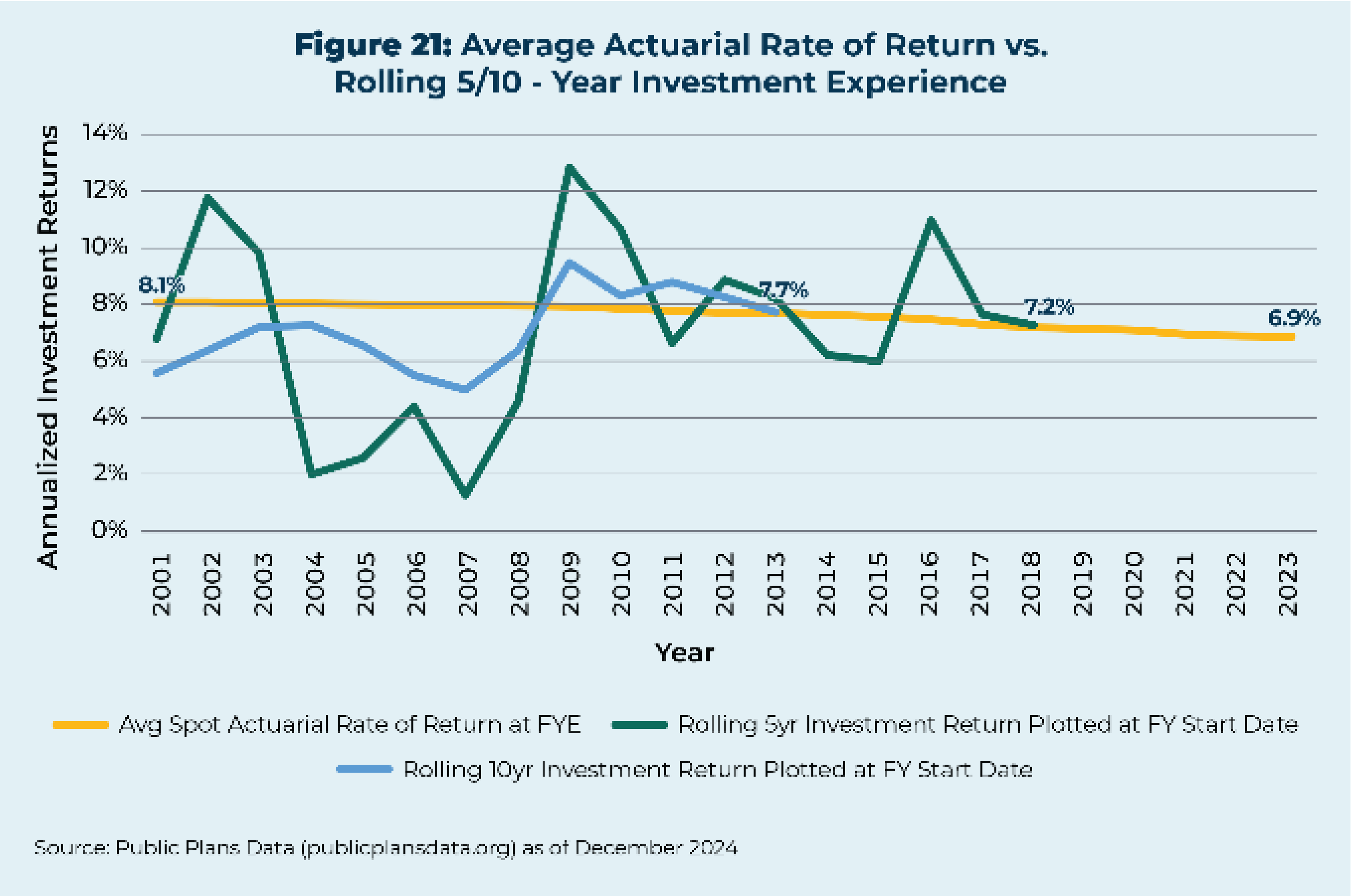
Diversified Portfolios Have Tended to Outperform Simple Portfolios in the Post-GFC Period

Figure 20: Investment Performance: Simple vs. Diversified Portfolios



Source: Public Plans Data (publicplansdata.org) as of December 2024

Diversified Portfolios Have Been More Likely to Meet or Exceed Expectations* than Traditional Portfolios



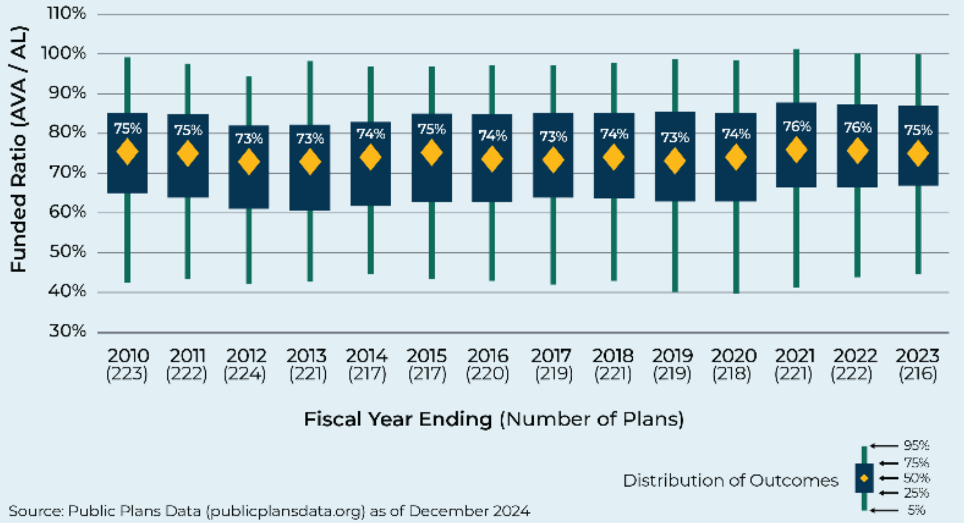
Periods of Outperforming the Actuarial Assumed Rate of Return

	Rolling 5Y Periods (18 total)	Rolling 10Y Periods (13 total)
Peer Average	9	5
Traditional 60/40	5	0
Traditional 70/30	6	2

*Expectations defined as the average actuarial assumed rate of return

Public Plan Funded Ratios Have Remained Mostly Flat for More Than a Decade, Despite Strong Asset Growth

Figure 22: Distribution of U.S. Public Pension Funded Ratios



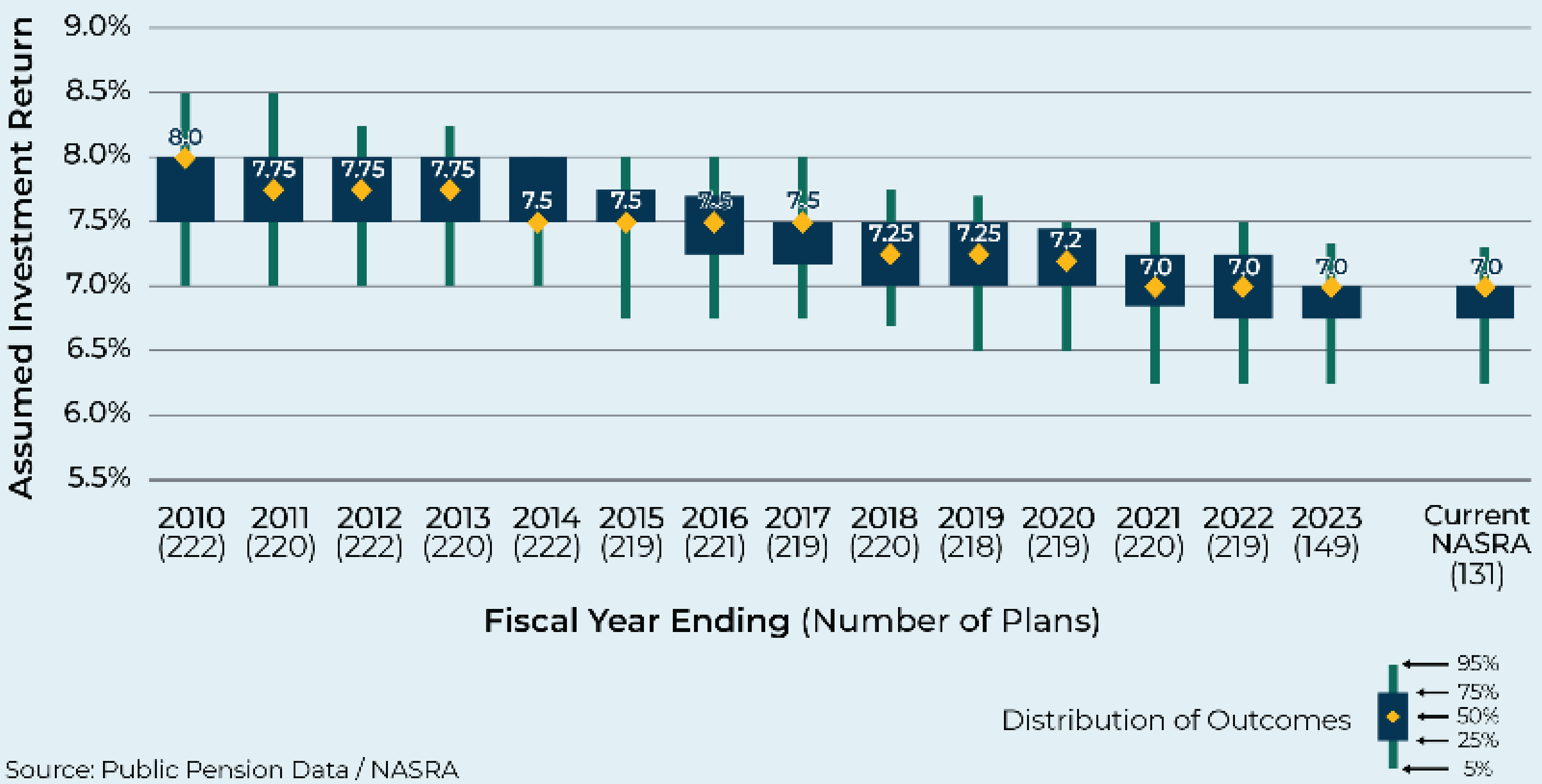
Source: Public Plans Data (publicplansdata.org) as of December 2024

Figure 23: Public Pension Assets (as reported by the Federal Reserve)

Source: Federal Reserve Board as of July 2024

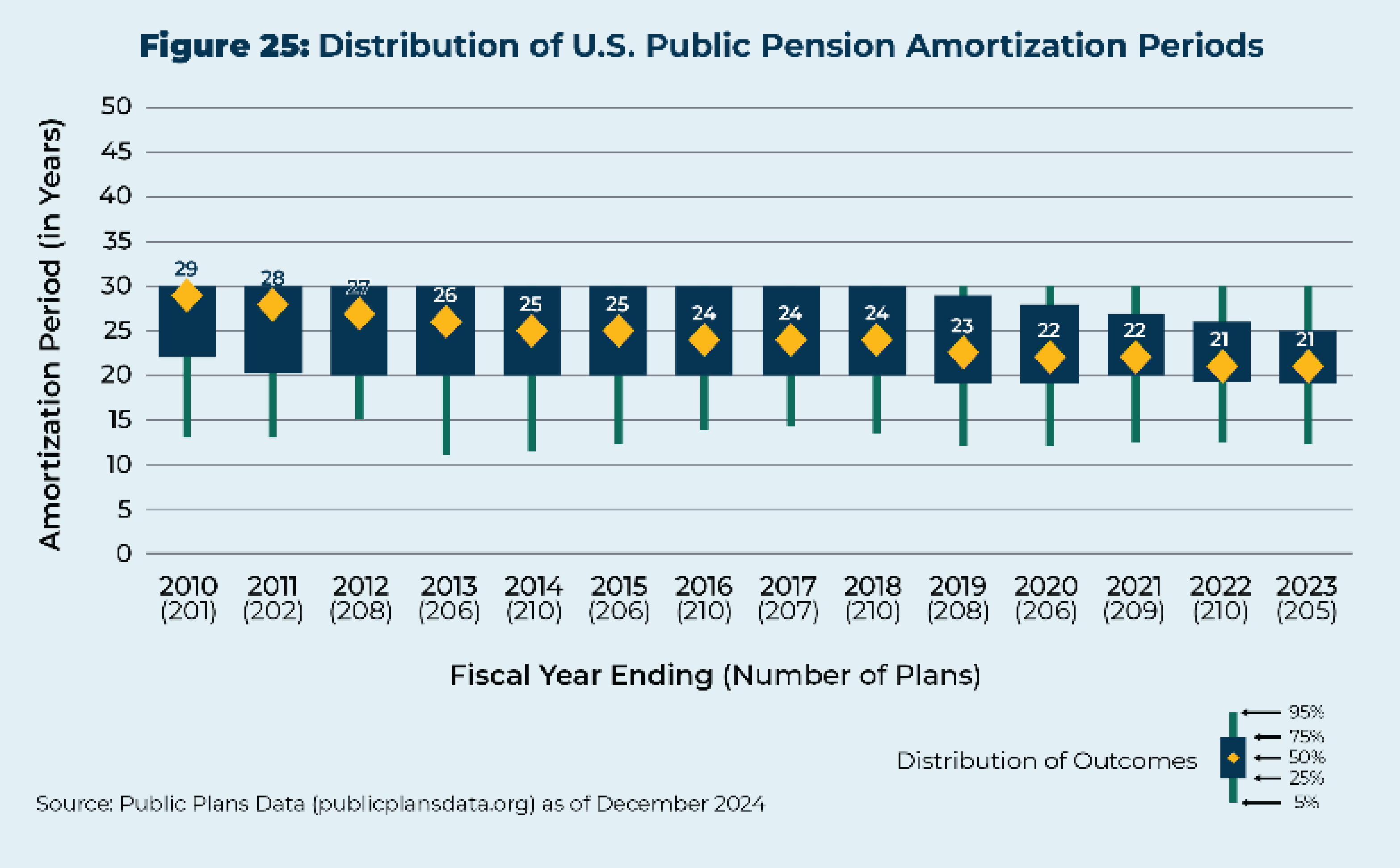
The Assumed Rate of Return on Investments Declined from 8% to 7% After the GFC

Figure 24: Distribution of U.S. Public Pension Investment Return Assumptions



Source: Public Pension Data / NASRA

Public Plans Have Also Tightened Their Amortization Periods Since the GFC



Conclusions

- Changes in the broader economy and financial markets have led public pension plan portfolios to a more diversified investment mix, most notably after the GFC.
- More diversified portfolios, over long-term periods and net-of-fees, have largely offered higher returns with lower risk relative to traditional portfolios following the GFC.
- Given actuarial assumption changes, asset growth, and the current investment landscape, most public plans should be in a healthy position moving forward.
- Looking ahead, public pension plans will need to continue to navigate the evolving investment landscape to secure retiree benefits.

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Questions