

THE CLOSING BELL
Report of Jim Marketti, Public Employee Committee, AFL-CIO
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November 22, 2008

Yesterday (November 21, 2008), the State Investment Council held its first annual public meeting at the War Memorial in Trenton -- a fitting location given the grim news delivered by the Chair of the Investment Council (Orin Kramer) and Director of the Division of Investment (William Clark) to nearly 200 public employees who came to hear and to deliver their concerns about the direction of public pension funding and investments.

First, the bad news. As of the close of business on November 20, 2008, the value of pension assets had dropped to \$57.8 billion dollars, the lowest since 2003. On June 30, 2007, the pension assets were worth \$82.5 billion. The drop in value of \$24.7 billion represents a loss of 30% of assets meant to pre-fund promised pension benefits. This loss comes in slightly more than sixteen months of investment activity.

Second, some more bad news. The funded ratio of pension assets to pension liabilities (how much money they have on hand compared to how much in pension benefits which have been earned and are owed) has dropped from 76% on June 30, 2007 to 49% as of the close of business on November 20. This is my own calculation based on \$118 billion in current pension liabilities owed compared to the \$57.8 billion they have in pension assets. The official report on the current funded ratio will not show up for a couple of years due to time lags in reporting and actuarial sleight of hand used in smoothing the numbers over several years. The funded ratio is the key number to understand in terms of judging the level of security of promised pension benefits.

The reports by Kramer and Clark were full of shock and awe about how poorly the capital markets are performing. Both stated that the stock market declines are far beyond anything they have seen in their lifetimes. Undoubtedly true. But there are aspects of the pension asset investments for which they are responsible and for which they could make improvements but they have chosen not to do so.

For some time I have been concerned about the investments in so-called alternative investment classes. The Division of Investment, with State Investment Council approval, has invested more than \$10 billion in these alternative assets since 2006 (nearly 18% of the total pension assets). These include investments in hedge funds, real estate, junk bonds, venture capital, commodities, emerging markets, startups, leveraged buyouts, the whole range of exotic investments which were invented in the go-go 1980's. I have not believed these were suitable investments for a pension fund. Too risky and sometimes, too complicated to really understand.

The decision to make these alternative investments was based on the expert's view of modern portfolio theory which argues that investments should be spread over the largest number of asset classes as possible. You have no doubt heard the argument of not

putting all of your eggs in one basket. That is what they take from portfolio theory. The problem with the theory is that it rests on many assumptions all of which are not true all the time and most of which may not be true when the capital markets are distressed as they are now. Before I came on the State Investment Council, I argued that if they wanted to go in this direction, they should go slow and make small investments to see whether, in fact, they panned out. Instead they have plunged ahead with full speed.

I have been on the Council since September 26, 2008 and attended two Council meetings. Five proposals to make investments in hedge funds and private equity funds have come before the Council in October and November, 2008. I have voted against all five proposals – the only member of the Council to do so.

I have argued that the results on alternative investments thus far have not convinced me that they will make a positive addition to the value of the pension funds. The Division of Investment's own reports, for example, show that hedge fund investments have lost 14.3% (more than \$500 million) of their value since they started buying them in 2006. Hedge fund investments lost 10% of their value in the month of October alone. Further, the Division of Investments has paid more than \$150 million to the managers of these funds which comes right out of your pension assets.

My arguments against alternative investments have fallen on deaf ears. Their counter argument is that if they had invested the money in domestic equities (the regular stock market stuff), they would have lost more money. True enough, but domestic equities are not the only alternatives. They could have kept the money in cash and would have lost nothing. Over the long run, I believe they would have been better off investing the money in high grade corporate and government bonds.

The twin pillars of pension security are in proper funding of the pension plans and in investment performance. The pension entitlement of public employees is a part of their compensation package, promised to them when they were hired and during many years of collective bargaining. I have participated in bargaining for the state worker contract on three different occasions. In each round of negotiations, the state has always taken the position that they don't have a lot of money for pay increases, but state workers (and all public employees) should consider themselves lucky they have a good pension plan. Good pensions and good health benefits are supposed to be a payback for not getting large wage increases.

For more than a decade, the politicians have either not funded or only partially funded their annual pension obligation. Yesterday, the Governor promised state municipalities that they could take another pension payment holiday this coming year. This lack of funding has weakened the pension funds so that now in a dramatic downturn in the market, the pension funds are plunged into more desperate condition.

Legislators and all political leaders must be delivered a message loud and clear. They will not have the support of public workers unless they fully fund our pension plans and ensure that our pension funds are conservatively invested to protect their value.