Article from

Risk & Rewards

August 2016
Issue 68

Should Public Pension Plans Hold Equities?

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Before considering the title question of this article, begin with a brief exercise. List the services that you believe a state or municipal government can perform more effectively than its private citizens. Most everyone would start with fire and police protection, with sanitation close behind. Education would be on most lists, as would infrastructure. Libertarians would likely stop there, or earlier; left-leaners could go on a bit longer.

Now we turn to the management of public pension funds. In a recent article,[1] I argued that public plans' use of high investment return assumptions (anything above riskless or very low-risk rates) and equity investments gives current taxpayers the full benefit of hoped-for risk premiums by passing all the risk to future taxpayer generations. Here I present some additional arguments against equity investment in public pension plans.

Irwin Tepper's classic paper[2] analyzed corporate pension plan investment strategy by observing that a shareholder's investment portfolio includes his share of the corporate pension fund. It is most efficient to use the corporate pension fund tax shelter for the shareholders' more highly taxed investments—bonds—than for the more favorably taxed equities. Therefore shareholders will gain if the corporate pension fund exchanges its equities for bonds, while the shareholders compensate by exchanging their own unsheltered bonds for equities. The shareholders' overall pretax returns will not change, but their taxes will drop. Though Tepper was addressing corporate pension plans, the same strategy can benefit the taxpayers who fund public pension plans.

So tax considerations favor public plan investment in bonds, leaving equity investment to be managed by the taxpayers themselves. The Tepper strategy also enables taxpayers to determine their own risk levels and choose equities or alternative investments without putting future taxpayer generations and plan members at risk.

But shouldn't public plans manage equities or select equity investment managers more successfully than individual taxpayers?

Not necessarily. A taxpayer can buy a low-cost index fund, which should match the median return of public pension funds. His expenses would be only a few basis points higher than even the most exemplary public plans and probably lower than most, particularly those paying for active management and using alternative investments.

For readers who remain unconvinced that public pension funds should confine their holdings to bonds, please return to the list you compiled at the start of this article—services that government can manage more effectively than private citizens. How high on your list was "seek equity risk premiums"? ■

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ENDNOTES

1 Bader, Lawrence N., "How Public Pension Plans Can (and Why They Shouldn't) Ignore Financial Economics," Financial Analysts Journal, September/October 2015, pp. 14–16.

2 Tepper, Irwin, "Taxation and Corporate Pension Policy," Journal of Finance 36-1, March 1981, pp. 1–13.