GENERAL ASSEMBLY OF NEW JERSEY

ALAN J. KARCHER, SPEAKER

SPEAKER'S PENSION INVESTMENT POLICY FORUM

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APPENDIXES

ALAN J. KARCHER (SPEAKER): First, let me welcome you to this Pension Investment Policy Forum, which is sponsored by the Office of the Speaker of the General Assembly. As I am sure most of you know, this is the first such event of its kind that has been sponsored by the Speaker's Office, and I don't think it could be more timely.

The purpose of this Forum today is to examine the investment policies of public employee pension funds in other states and to look at how such investments have been diversified to bring a competitive rate of return and also benefit those respective states' economies.

I hope that this Forum, which will be transcribed, will help the Legislature and the Administration in considering whether New Jersey's pension investment policies should be reexamined.

Capital formation and capital allocation will be important issues for policymakers throughout the 1980's. A greater proportion of this country's national income must be channeled into productive investment to overcome the economic stagnation of recent years.

We cannot talk about capital formation or capital allocation in today's economic climate without considering pension funds. According to a recent article in the National Journal, public and private pension funds are worth $800 billion. They own more than one-fifth of the country's corporate stock and, last year, produced about one-fourth of all new capital generated throughout the economy. More than $200 billion of pension fund assets are held by states and localities.

I don't have to tell you that the days of unlimited government spending have ended. We can no longer rely on Federal or State tax revenues to supply the resources necessary to revitalize the economy. Instead, we must assess the resources available to us and develop bold and imaginative strategies for deriving the maximum benefits from existing resources. I must admit that this is by far not a novel concept, nor a new approach. In fact, it was Governor Kean in his inaugural address this past January who said, "We must change the way we do things and the way we view government's role in our rapidly changing society."

"We must turn to ourselves," the Governor said, challenging his listeners to join with him in "summoning up those resources -- both human and natural -- which our State possesses in abundance, and applying them to the tasks we all know await us."

Governor Kean reminded us also that, in this climate, "The untried can no longer be viewed with fear, but must be viewed with interest. The new and the innovative must attract our attention, not divert it. We can no longer shrink from the imaginative; rather, we must nurture and encourage it. We must turn away from a reliance on Washington and focus our energies on a renaissance here in Trenton."

It is in that same spirit and in the direction set by Governor Kean that I have convened this Forum to discuss whether the economic power of our State's public pension funds can be harnessed to strengthen New Jersey's economy and provide a better life for our people. Let me stress that the purpose of this gathering is not to promote a particular point of view or any specific or special proposal. I simply want to review the experience of other states and localities, and begin a discussion as to whether those of us in New Jersey can benefit and learn from those experiences.

Let's look briefly at what's happening elsewhere. According to a recent survey by the National Conference of State Legislatures reported in the April, 1982 issue of the New Jersey Legislature's Magazine, in an article by Ken Kirkland, a member of our Forum who you will meet in a few minutes, 27 states have attempted or were considering some form of targeted, or strategic, investment of pension funds. These involved programs which would bring a market rate of return, but also above and beyond bringing a market rate of return, would also offer other economic or social benefits. The most common targeted investment focuses on increasing the capital available to the housing industry through the purchase of mortgage pass-throughs or certificates of participation.

Other popular forms of targeted investment have included an emphasis on in-state investment to stimulate the State economy. Our panelists will describe a variety of State pension investment policies.

New Jersey invests its pension assets under a "Prudent Man" statute with no further limitations. The State Investment Council, which by law is responsible for overseeing the investment of pension funds, is required to conduct itself faithfully and exercise sound discretion in investment decisions. There are no statutory barriers to developing a diversified portfolio which earns a competitive rate of return.

Preliminary figures for Fiscal Year 1982, as reported by the New Jersey Division of Investments, show close to $8.1 billion in the six State pension funds in various forms of securities (bonds, notes, mortgages, stocks, warrants, options, etc.). The average rate of return on our portfolio here in New Jersey on the pension investments is in the vicinity of 8.7%. Part of today's Forum will focus on where and how pension funds are invested in the State today.

The sheer magnitude of New Jersey State pension assets warrants careful attention to investment policy options, including whether we can target investments in New Jersey to positively affect our economy. This is especially vital to the taxpayers in New Jersey, whose taxes provide between 60% and 70% of the money in the six State pension funds and who serve as the ultimate guarantors of the retirement benefits.

The question we must ask at day's end is whether the "strategic" investment of pension funds in businesses that provide jobs and income in the construction of new and affordable housing stock, in alternative energy development, and in designated economic sectors vital to New Jersey -- such as high technology -- is possible without compromising the security of the fund's benefits.

To discuss this timely issue, we are fortunate to have a panel with a wealth of experience in pension investment policy options. They are: Ken Kirkland of the National Conference of State Legislatures, who will speak on pension investment techniques in other states; Allan Emkin, an investment consultant in the Pension Investment Unit of the California Governor's Office of Planning and Research, who will speak on innovative pension investment policies in California; John Chenoweth, Executive Director of the Minneapolis Employees' Retirement Fund, who will speak on the fund's investment policies; and, Gerry Silliphant, the New Jersey Legislative Budget Officer, who will describe New Jersey's pension systems and the investments in New Jersey as we handle them today.

At 12:30 we will break for lunch, to which everyone is invited. It is going to be next door in Room 348. As your program which I know all of you have received indicates, we will reconvene after lunch and that will be an open session for discussion, questions, etc.

Let me start this morning's program by introducing to you Gerry Silliphant and, if he'll indulge me, and if you'll indulge me, just let me tell you, for those of you who are not familiar with his background -- let me give you a little synopsis of the experience that Gerry brings to his present position.

Gerald Silliphant was appointed Director, Division of Budget and Program Review and also as Legislative Budget Officer of the New Jersey Legislature in May, 1981. Prior to that time he had served as Director, Division of Budget Review and Program Analysis, and Director, Division of Program Analysis in the Office of Fiscal Affairs. Most recently, he has served as Executive Director of the Senate Minority. All of these positions, obviously, were within the New Jersey Legislature.

Mr. Silliphant's professional career in government and governmental management spans 25 years, beginning with service as a Budget Analyst, both in the Ohio and New Jersey Executive Budget Divisions, as well as service as a Research Associate with the New Jersey Taxpayers Association. In 1956, he was appointed to the newly created post of Chief Budget Analyst in the New Jersey Legislative Budget Office, in which capacity he served until becoming Director, Division of Budget Review and Program Analysis in 1972. In 1971, Mr. Silliphant was on leave from his legislative post to serve with the Cahill Tax Policy Committee.

Mr. Silliphant holds a B.A in History and Government from the University of Buffalo and a Master of Public Administration from New York University. Gerry.

G E R A L D   D.   S I L L I P H A N T: Thank you very much, Mr. Speaker. One of the advantages of being around here 25 years is that you can peer into the past and make some comparisons between the way things were then and the way things are today. And, because we're looking at a topic which is so vast in scope and has such enormous fiscal implications for the State, government, the taxpayers, and business and industry, I thought that you would be interested, as I was, to look back in time 20 years and to draw some comparisons between where we were then and where we are now. Speaker Karcher referred to the fact that we have at the present time $8.1 billion of investments of pension funds in this State. Twenty years ago that figure was only $800,000,000. The aggregate investments of all funds under management by our Division of Investment in the Department of the Treasury now is $9.5 billion. Twenty years ago there was only $1.2 billion.

But the source of these enormous funds in the pension systems comes from the employee and the contributory systems, and from the employer, namely the State, in the other half of the equation. Going back 20 years, and I think these figures will put the whole thing in perspective and may surprise, if not shock you -- going back 20 years the employer costs, the State government's cost of the Public Employees' Retirement System was $7.8 million. In this current year, the same cost is $87.5 million, an even more spectacular increase and, although this is not related directly to the pension investment portfolio, it certainly indicates the enormous growth in employee benefits. The employer's share of the Social Security tax 20 years ago for State employees was $4.5 million. This year that figure is $103 million.

Now, an even more dramatic increase is in the Teachers' Pension and Annuity Fund. Twenty years ago, about $28 million was the employer's share, and bear in mind that the employer here is the State of New Jersey. The local school districts make no contribution as the employer for the teachers. That figure of $28 million has grown in 20 years to a current level of $220 million, and here again it was the teachers -- the Social Security employer's share has grown from slightly less than $10 million to a current level of $149 million. So, whereas in 1963 we get a State budget of $510 million, we're currently spending about $820 million this year in employee benefits alone, that is for both the Public Employees' Retirement System and the miscellaneous systems we have in the Teachers' Pension and Annuity Fund.

I should add, at least parenthetically, that in 1963 the State budget was a shade over $500 million and this year it's $6.2 billion, so 20 years has not only aged me a great deal, but has shown some enormous changes in the expenditure of State funds.

I want to thank the Speaker for inviting me to participate in this Forum today on behalf of my Division of Budget and Program Review, which is the fiscal analytic service to the Legislature. This is an extremely timely and important subject. It is obviously one of the fastest growing areas in State government. It is one that probably has grown without the kind of attention paid to it by government executives, legislators, taxpayers, the public at large, and certainly the private sector represented by business and industry. So this is particularly important at this time and the use and the return on those enormous investment funds is a topic which, in my judgment, is exceeded by none other in the level of importance in the State's fiscal future.

My comments today are designed to try to put into context the framework of pension investments in New Jersey, and I'll be relating primarily background information on this State's pension systems and investment policies. In pulling together the material for this presentation, I was struck by two rather contradictory discoveries -- namely, that there has been a real explosion of interest in today's subject matter, along with a lot of surveys, a lot of position papers and a lot of conferences, and yet there is a lack of a clear consensus on what we actually mean by "strategic" investment opportunities and, perhaps more importantly, a dearth of the hard data that policymakers need and can rely on in attempting to formulate an investment policy strategy along the lines of the concerns expressed by Speaker Karcher.

I think this dichotomy is one of the reasons why the current debate over "targeted" or "alternative" investment is often carried on at a subjective level, resulting in premature and perhaps totally unwarranted fears being instilled in pension system members, taxpayers, the investment community and public policymakers. I am delighted, therefore, to see a panel of this quality invited to this Forum, including participants with actual experience in facing the issues that we're discussing today. Their expertise should be valuable for all of us. We met over dinner last night, and I was absolutely amazed and fascinated by the wealth of knowledge and background that these gentlemen have in this subject area today, and I'm sure that you will find their remarks extremely informative and helpful in formulating policy for New Jersey's future investment strategy.

Let me begin by briefly describing the structure and size of public pension systems in New Jersey. Unlike many other states, almost all public employees in New Jersey, regardless of the level of government, whether it's State, county or municipal, are members of one of seven retirement plans administered at the State level. One of those plans is more or less dormant; we actually have six active plans. New Jersey has had a long history of consolidating small, actuarially unsound local pension plans so as to ensure the payment of guaranteed, promised retirement benefits to public employees throughout the State. New Jersey has therefore managed to avoid many of the financing problems being experienced in states where smaller municipal or school plans are the rule, rather than the exception. I indicated to you before, and I'm sure that most of you are well aware, that the Teachers' Pension and Annuity Fund -- all of their members are covered not by local property taxes or by anything generated at the local level, but purely and simply from State-generated funds.

Today, 365,000 active employees are enrolled in State-administered systems, as compared roughly to 10,000 in the few remaining local systems, which operate primarily in Essex and Hudson Counties.

The two largest systems by far, of course, are the Public Employees' Retirement System (PERS), with 214,000 State and local employee members, and the Teachers' Pension and Annuity Fund (TPAF), with 111,000 members, most of whom, of course, are teachers and other professional staff in the local school districts. These two systems are both over 60 years old and have developed in roughly parallel fashion and with equivalent benefit structures. I'd just like to digress for a moment -- we're talking, of course, about investment policy and strategy today. I think in order to fully grasp the big picture -- the entire story about this whole area, it is necessary to gain some pretty deep insights into the pension systems themselves and, if you'll forgive me a little bit of unconcealed pride -- about seven years ago, the Division that I headed, the Division of Program Analysis, did a comprehensive study of the Public Employees' Retirement System and a companion study of the Teachers' Pension and Annuity Fund. They distilled a lot of material into a few pages. But what I think is valuable about this study, and we do have a limited number of copies that we would be glad to loan to any of you on request, is the incremental growth of these retirement systems over the years -- the passage of ten, twenty or more pieces of legislation each year which have incrementally added to the structure and scope of the pension systems.

So we have a vast system now with a vast array of benefits and provisions, and regulations certainly, and I think that to look at this whole thing, to get an idea of where we're going, and you'll find in this study projections up to the year 2000, and in some cases beyond, that we are going to have to make some hard choices within the very near future about the scope of our pension systems. The basic question -- can we afford to maintain two separate retirement systems, namely Social Security and the Public Employees' Retirement System, the TPAF and the other systems. In 1966 when the systems were deintegrated and we set up a program whereby employees were entitled to full Social Security benefits as well as full pension benefits, I don't think anyone believed or realized that Social Security would grow to the extent that it has. So we now have this enormous liability of over $800 million that I referred to before, and we need to look very closely at this whole subject. Now, this is not to suggest in any way that there should be a return to 1966, or that there should be any tampering with the systems as they now stand. What is required is very close and intensive study, within the very next few years, because the numbers are growing very, very rapidly and I'm sure that if we all came back here 20 years from now, the numbers we're talking about today would seem just as unreal as the numbers I gave to you before about 20 years before this date.

These two systems I referred to are both over 60 years old, as I indicated, and have developed in a parallel fashion. We also have the Police and Firemen's Retirement System (27,000 members), the State Police Retirement System, which is a separate system (2,000 members), and the Judicial Retirement System (300 members) for State and county judges. Two remaining funds, one for police and firemen and one for prison officers, have been closed to new employees for many years and exist primarily to finance retirement benefits for pensioners from these systems.

All of New Jersey's State-administered plans require employee contributions and all except the small Prison Officers' Pension Fund are funded on an actuarial reserve basis. The cost to maintain the systems at a high level of actuarial soundness is substantial, of course, and continues to grow every year, but the regular employee and employer contribution schedule has given us stable and well-funded pension systems. Our "funded level" for the older and larger systems is in the 80 to 85% range, a rate that compares quite favorably with similar systems in other states. So there is no question that our major pension funds are healthy when measured by standard actuarial and accounting criteria. When we say they're funded in the 80 to 85% range, what we're saying essentially is that if one of the pension plans were to terminate today, really go out of business, there would be assets in the funds sufficient to pay 85% of the total actuarial liabilities for now and into the future covering every member of the system.

I'm sure that many of you were shocked a few years ago to discover the situation in New York City, where the mayor and the council head rated the assets in several of the city's pension systems and reduced the level of funding down as low as 1 or 2% in some cases, and in most cases around 10%. You are probably also aware that until a few years ago the State of Massachusetts, for example, had no funded public employees' retirement system. Benefits were paid out each year from general funds. All of a sudden the same incremental growths occurred in Massachusetts, and the annual appropriation was staggering to support these systems so they went to a funded system. So, ours is a very healthy system. It has been well cared for over the years and certainly should give every public employee a great deal of reason to feel safe and secure.

The age, size and funding schedule of our pension systems have produced a combined asset base estimated at $8.1 billion, as the Speaker mentioned, as measured by book value as of this past June 30. Five years ago pension fund assets stood at $4.4 billion. So you see what has happened in five years, from $4.4 to $8.1 billion, an enormous increase. Thus, the asset base, benefiting from high earnings and contributions, has been growing in recent years at an annual rate of almost 13%. Extrapolate that out for the next 20 years and see where it takes you. The magnitude of this growth, reflecting what one recent article in the Institutional Investor termed the "inexorable expansion" of public pension funds, lends further credence to Speaker Karcher's remarks about the enormous capital investment pool represented by these funds.

While interstate comparisons can sometimes be tricky and get you into an apples and oranges situation, based upon information reported to the U.S. Census Bureau for Fiscal Year 1981, New Jersey ranked sixth among the states in the value of its State-administered pension funds, and eighth in rank if both State and local funds are considered.

New Jersey's position is further magnified when we consider the centralized investment responsibility for the State pension funds. The State Investment Council, a policy-making body, and its executive arm, the New Jersey Division of Investment, were created by statute over 30 years ago to centralize all functions related to securities holdings on behalf of the State's diverse pension, trust and reserve funds. Prior to that time, the boards of trustees of the various funds were responsible for investments for each of the funds. Allegations of inefficiency, incompetence and political favoritism by those bodies in handling these funds were the direct cause for the establishment of the Investment Council and the Division of Investment as we know them today.

Today, this Division of Investment in the Department of the Treasury is widely regarded as a highly professional organization, fully capable of participating in the complex financial markets that are the stage for large-scale institutional investing. Besides the six active pension funds, the Division is managing the investment of 70 other State investment funds under the Investment Council's jurisdiction and an additional 166 public authority and agency funds on a service basis. The Division also operates the five-year old New Jersey Cash Management Fund, which is a short-term money market fund open to all governmental units in the State, and this has grown enormously since its beginnings.

As a portfolio manager, our New Jersey Division of Investment ranked fourth largest among public entities nationwide, and forty-ninth largest overall, according to a recent survey conducted by Institutional Investor magazine, forty-ninth largest overall. This includes all of the private funds. I, and you are aware how enormous many of those are. In view of this enormous amount of money and the enormous responsibility that goes with it, I think it is useful to briefly review the policies and guidelines under which the Division of Investment currently operates.

As a governmental entity, the State of New Jersey is not subject to the fiduciary standards of the Employment Retirement Income Security Act of 1974, which is commonly known as ERISA. Whether or not State and local pension plans should be subject to federal regulation is an issue now being considered in the Congress. It is the official position of the National Conference of State Legislatures, as well as my own personal belief, insofar as New Jersey is concerned, that such intervention is unnecessary and ill-advised. However, the real point to be made is that the fiduciary standard specified in most versions of federal pension legislation, which is the "prudent man" rule, is similar if not identical to New Jersey's own statutory requirements for State investments.

The "Prudent Investment Law" of 1975, and it has been recodified since then, repealed years of previous statutory restrictions on legal investments for trust administrators in New Jersey. The law now states simply that in investing money and property, a fiduciary "shall exercise care and judgment under the circumstances then prevailing, which persons of ordinary prudence and reasonable discretion exercise in the management of -- property and affairs of another, considering the probable income as well as the probable safety of capital." The law also directs that if a fiduciary has special skills or expertise -- such as the Director of the Division of Investment is required by law to possess -- he is under a duty to exercise those skills. Finally, within the limitations I have just noted, a fiduciary may invest "in any investments whatsoever."

In a recent survey conducted by Ken Kirkland of NCSL, who is on the panel today, New Jersey was listed as one of only eight states that has a "prudent man" statute with no further limitations -- one of only eight. To those who are interested in "strategic" investment opportunities, this broad grant of legislative authority is really a two-edged sword. It allows the fiduciary -- in this case, the State Investment Council -- to explore and implement these options, but it does not require them legally to do so.

The State Investment Council and the Division of Investment, as well as previous administrations, have interpreted their fiduciary responsibilities to preclude a specific interest in "targeting" the investment funds under their jurisdiction for any of the usual purposes associated with this concept -- be it instate or localized economic development, promotion of new industries, or avoidance of certain investments on social policy grounds. Certainly you are all aware of many of the controversies in the involvement by the public and special-interest groups about investment in corporations and businesses which are carrying on international commerce and trade with nations and governments that are really not acceptable to their thinking, or perhaps even the American way of life.

The Council, which includes among its membership representatives of five of the six State-owned pension plans, apparently feels, as do many others, that such targeting is either inimical to its clear primary goal of seeking to maximize investment yields at an appropriate level of risk for the ultimate benefit of pension recipients and taxpayers, or that suitable alternative investment vehicles that do not compromise this goal have not yet appeared.

I will return to this in a minute or two, but first I would like to provide you with a few facts and figures concerning the investment of New Jersey pension fund assets. In the absence of specific legislative mandates, the State Investment Council has published 111 pages of administrative regulations governing permissible types of investments, volume of investments, and, in some cases, approved lists of corporations for investment. For instance, the approved list of common stock holdings includes 145 corporations of "Fortune Top 500" caliber that meet the Council's size and dividend standards. Not more than 25% of the book value of any single pension fund can be invested in common stock at any given time. Other authorized investments, each of which must meet certain criteria, include corporate debt obligations, commercial paper, government-insured mortgages, such as the FHA and VA mortgages, State and municipal government general obligation bonds, public authority revenue bonds, U.S. and Canadian government obligations, mortgage-backed securities, repurchase agreements, and certificates of deposit.

The actual composition of the pension fund portfolio is extremely complex and detailed and is changing rather slowly as the Division of Investment responds to market conditions and risk perceptions. For ease of comparison, I have grouped the holdings of the three largest pension funds, which represent 96% of all pension fund assets -- of the $8.1 billion we referred to before -- into three categories -- stocks, mortgages and non-mortgage fixed-income securities. At the close of Fiscal Year 1981, these funds held about 19% of their book value in stocks, this as opposed to the 25% authorized level, 14% in mortgages or mortgage-backed certificates, and the remaining 67% in fixed-income securities, which encompass all types of corporate and government debt, as well as bank deposits. Comparable figures for Fiscal Year 1982 are not yet official, but the Director of the Division of Investment estimated them to be 22% in stocks, up from the 19% in '81, 15% in mortgages, and 63%

in other fixed-income securities. In recent years, the Division has gradually increased its holdings of stocks and mortgage instruments at the expense of fixed-income securities, in line with national trends among pension fund managers.

The weighted average rate of return for all of the State's pension funds has increased gradually from 6.28% in 1977 to an estimated 8.7% in 1982. Differences among the individual pension funds are becoming less important now that they participate, through a system of share-holding, in common investment pools for stocks, bonds and short-term securities. Incidentally, the rates of return reported by the Division are based on book value or amortized cost, and not on current market values of those securities. There is currently considerable debate going on in financial circles around the country over this issue and whether or not it misrepresents actual investment performance. The Division of Investment does report total rates of return, which include income and market price changes for its investments, in its annual reports. A summary page from the 1981 Annual Report, giving such information for the past five years, is available for distribution. There is an attachment, I believe, to the handout you have, but we have other material available.

Unfortunately, for purposes of this Forum today, we were not able to obtain a geographic distribution breakdown of pension fund investments, with particular emphasis on New Jersey. The Division of Investment simply does not maintain its records in a manner conducive to tracking and, judging from a 1981 National Pension Study conducted by the Urban Institute, this is the rule rather than the exception. Only 17% of the systems surveyed in that study reported tracking local or instate investments. This, of course, is simply a method whereby the investments held by the fund can be traced to where the business is located -- where it does most of its business -- where most of its employees are.

What is frustrating about this situation, aside from the lack of information itself, is the absence of any clear guidelines about what constitutes investments which are ultimately beneficial to a state's economy. This brings me back to an issue I raised at the beginning of my remarks and one I will use also to close my remarks.

In an interview with the Director of the Division of Investment, staff of the Division of Budget and Program Review raised the issue of pension fund investment "in New Jersey." The response was that the Division did not collect this information, but that the percentage of investment in New Jersey business could possibly range from 10% to 90%, depending on what investment criteria were selected. For instance, perhaps 9 or 10% of the assets were invested in corporations headquartered in New Jersey, but many of them have national or worldwide operations. On the other hand, perhaps 90% of the "Fortune 500" companies actually do business in New Jersey, regardless of where they are headquartered. A similar example was cited for national trading of mortgage pool participation shares, regardless of where those mortgages originated.

This kind of ambiguity doesn't help the cause at all, but it does suggest that further clarification of what is meant by strategic or targeted investment may be in order. Speaker Karcher's opening remarks have set the stage for this discussion today, and I am hopeful and certainly confident after my discussions last night with our guest panelists, that they will be offering some extremely valuable insights for your general consideration. Thank you very much.

SPEAKER KARCHER: Thank you very much, Gerry.

M A R K   N E M I S E R (from audience): Mr. Speaker.

SPEAKER KARCHER: Yes.

MR. NEMISER: Mark Nemiser -- I was just wondering, since Gerry addressed himself to the Pension Investment Council, you mentioned the Council in your opening remarks, and I suspect other speakers will be speaking about the Council or how it functions, I'm wondering if perhaps you could advise us if the Pension Investment Council is represented here today, or another question might be where is Roland Machold?

SPEAKER KARCHER: First of all, let me just say that we are not going to take too many other questions, because we have a whole afternoon set aside for that discussion, but we'll consider that to be a procedural question rather than substantive. He was invited, and the information I received was that he will attend.

MR. NEMISER: Thank you.

SPEAKER KARCHER: Okay?

MR. NEMISER: (Inaudible)

SPEAKER KARCHER: -- that response to that. Let me first say that, as a member of the Legislature, after hearing Gerry Silliphant, that it is gratifying to know that the Legislature -- sometimes we do not act as wisely as we should, but in our appointment of Mr. Silliphant, I think that that was one of the better things we did. I want to say that as a legislator, and I want to thank you. I also want to clarify that after the presentation this morning, there will be the luncheon, and after that we have set aside literally the whole afternoon for the panelists to answer questions and to engage in a broad-ranging discussion of the subject matter that has been presented this morning.

Let me now present to you, Dr. Kenneth Kirkland. Before I do, let me give you a brief biography of Dr. Kirkland, and also let me express my deep appreciation, not only to him individually, but to the NCSL which really made this conference possible by way of their cooperation and financial support. As to Dr. Kirkland personally, he is presently the Associate Program Director for Fiscal Affairs of the National Conference of State Legislatures, and he is headquartered in Denver, Colorado. He has been with the NCSL for almost five years and is its chief specialist on pension policy. He is a former staff member for the Oklahoma State Legislature and frequently writes and speaks on pension topics to national audiences.

Dr. Kirkland graduated from Stanford University. He received his M.A. from the University of Oregon and his doctorate from the University of Michigan. He formerly taught at the University of Michigan and also at the University of Oklahoma. With that I present to you Dr. Kenneth Kirkland.

K E N N E T H   K I R K L A N D: Thank you, Mr. Speaker. I trust that your gratitude to the NCSL will be remembered when we come around and ask for our annual appropriation.

You've heard a couple of references to some surveys that I did on behalf of the NCSL, and what I want to do in my presentation today is to spend some time talking about what has happened in the last couple of years. I think you have in your packets the paper that I wrote on An Overview of Recent Changes in Investment Policy of the State Legislatures. This is not a comprehensive view of what all state pension systems are doing, but it is an attempt to catch up to where the kind of concerns begin.

We took this up because I noticed as I was answering requests for information, responding to telephone calls, and things like that from people around the states, there were probably more requests about, and concerns expressed about, investment policy than all the other areas of pension policy combined. So we took a couple of surveys to look at what the states have been doing. There were no shortages of them. Indeed, as is mentioned in the article and as mentioned in this, just in the last year alone 13 states have set out House legislation, signing into law, which broadens their investment policy options. Seventeen states -- and there are some of those you can count twice because they're trying to do both, have set out in the last 18 months alone to target investments in one particular way or another.

It's been our impression that there are really two good reasons behind this, and perhaps that one source of the change has been two very diverse groups of people looking to investment policy at the same time. One of them has been the managers of the money themselves, and pension funds, whether they're public or private, traditionally are fairly conservative, risk-aversive kinds of investors. But in the economic environment of the last few years of high interest rates, high inflation, -- that kind of thing, it has been extremely difficult for professional money managers, whether they were enthralled with part of the investment or loathed the concept, to be able just to demonstrate the legal rate of return on assets, so that after inflation was statured out, they had something to show for the year. That being the case, many of them, since so few states operate under the "prudent man" statute, turned to their Legislatures and asked for greater flexibility for being able to put more tools in their kit, as it were, so that they could have as broad a range of investment possibilities available as the human mind could conceive, in order to hope that at least one or two of them would be the ones that would enable them to beat inflation and bring back a real rate of return.

At the same time, there has been an increasing amount of concern about both the social and economic investment impacts of what pension funds do. As you've heard from Speaker Karcher and Mr. Silliphant, the size of pension funds alone compels attention to them. They are just simply too big to ignore. One measure of that size is that in Fiscal Year 1980 around the country, the receipts of state-administered pension funds were over $18 billion -- that's one year's net inflow to those funds. That's larger than the total assets of all public pension funds in 1960, and they are expected to keep growing at this kind of rate. Nationally, the return rate of growth is somewhere between 13% and 16%. Most state pension funds, because they are making up for earlier shortfalls in their funding, take in enough employee contributions alone to more than cover all their withdrawals and the investment earnings just keep growing and growing on top of that. And they are a big cost item for states. You don't have to be told that personnel costs are the largest single item in state budgets, when you break them down. Pension funds typically run between 15% and 25% of payroll as an employer contribution. There is a rule of thumb on the actuaries that a 1% improvement in long-term investment performance, that is if you could over a 10 or 15-year period raise the rate of return on investment from 6 to 7%, you would cut your employer contribution by about 20% and still keep at the same level of funding, or you could increase benefits commensurably.

Whatever the case, obviously the fact that some states put in about $12 billion just as employer contributions last year makes it clear that any kind of change in investment policy that may let you adjust that figure is going to be of considerable public interest.

When we looked at the investment policies of states, we found that there were certain patterns. Since, as we mentioned, that as of a couple of years ago there were only eight states, New Jersey being one of them, which had an actual "prudent man" rule, the rest have some kind of a "legal list" of investments. It may be very short, and it may be very long. The range is as diverse as the states themselves. For example, we have Minnesota, and you'll hear a little bit more about it from Mr. Chenoweth, which has probably the longest legal list in the country. It doesn't have a "prudent man" rule, but its legal list includes American and Canadian public and private bonds, corporate stock, international securities payable in dollars, such as those of the Inter-American Bank for Development, covered call options, securities lending, repurchase and reverse repurchase agreements, commercial paper, bankers' acceptances, mortgage participation certificates, mortgage pass-throughs, limited partnerships in venture capital funds, limited partnerships in oil and gas drilling funds, commercial real estate purchases, and certain other kinds of obscure investment vehicles.

At the opposite end is probably Wyoming, which has this Fall in the general election a constitutional amendment which will permit, if approved, the pension fund to invest in stock for the first time. The entire Wyoming investment portfolio is in U.S.government and corporate bonds. So you can see that there is a broad diversity of interest.

Most attempts to broaden investment policy are indentations of the legal list. I don't think I am going to go through it in too much detail, but to say just in general, since you have this information in your packets, that mostly its a case of states sitting down and looking at their particular legal list and deciding whether to add certain options. Only two states, Nebraska and Illinois, in the last year adopted the "prudent man" rule and dropped their earlier restrictions. Just for your information, the states that operate under the "prudent man" rule now are Delaware, Idaho, Illinois, Kentucky, Maine, Nebraska, New Jersey, Oregon, South Dakota and Washington.

A number of other states, including New York State, have considered, but for one reason or another, have not adopted the "prudent man" rule -- . There has also been considerable interest in targeted investment, and I want to spend a little more time explaining how states have attempted to do this. Basically, what has been called targeted investment, or social investment, or strategic investment, or development investment, and indeed one thing in this field is that there is a new name for whatever the concept might be, about every six months or so -- one of the common concerns of that has been to look at ways in which pension funds invest their assets and try to take into account the sudden spill-over effect. Everyone knows, for example, that the pension funds are trust funds. They are funds that are held solely for the benefit of the participants in the systems. Since they are a form of deferred compensation, the money that is in the funds actually does not belong to the taxpayers of New Jersey, for example, or the State of New Jersey. It belongs solely to the current and retired employees of that particular fund and is meant to guarantee their retirement.

That being the case, it is the primary duty of the trustee of the fund to invest those funds in ways that are solely for the benefit of the participants, and not for the benefit of anyone else. The most common problem in the past has been a few trustees who on occasion confused their personal benefit with the benefit of the participants in the system. I probably don't need to mention the Central States' Teamsters

Fund as an example of ways in which the trustees sometimes have trouble distinguishing between those two interests -- you recognize the kinds of abuses. Because of the sources of abuses, Congress passed a writ in 1974 that regulated the private funds and emphasized in there that the sole duty of the plan trustee is to invest in the beneficiaries' interest. Every state has a similar kind of requirement in its laws. But having recognized that you can do that for the benefit of the participants in the system, you need to recognize that investments have other impacts besides the rate of return to the system. The concern with targeted investment comes from the fact that some investments may have indeed negative economic investments and at the very least it might be possible to have a pension fund do things that do not actively contradict what the rest of the particular jurisdiction is doing. For example, several years ago the New York City staff discovered that the teachers' retirement system in New York City had, as one of its investments, made a private placement, that's a loan made directly by the pension fund acting almost as a banker -- a very good investment, which at that time was earning about two and a half to three points over the prime rate. The problem was that the loan was made to the Merchandise Mart in Atlanta to help them build themselves up as the center of the garment industry. As Mayor Koch said, "The New York City administration is quite capable of strangling the economic life of the city without any help from the pension fund, and at the very least we could expect that the pension funds, if they're not going to invest in New York City because they think it's a bad deal, they might at least refrain from making the kinds of investments that actively undermine the economic future of New York City and the New York City employees who are the beneficiaries of that economic activity."

So that kind of concern, I think, is one area that has led people to wonder about the impact of these pension investments. The secondary concern is in wondering whether or not, as we approach an era of somewhat limited economic growth, since the pension funds are clearly the largest single source of capital in the United States and will become more so over a period of time, it is important to look at their policies not only in terms of what rate of return they make to the system, but also what kind of impact they may have on the economic growth -- where is their capital going. And that's necessary, not only for the health of the pension system, but also for the health of the economy as a whole. And that's where states have turned their attention.

Mr. Silliphant mentioned that it is very difficult to find clear criteria for instate investment and, indeed, that has been my experience as we look at this. A number of the states that have passed targeted investment legislation have had more than a little trouble implementing it, and that may explain why certain kinds of targeted investment have been particularly popular among states. One of the problems has been that once you put money into an institution, it's a little hard to tell where that money sort of comes back out. As well as the debate over instate pension investment, there have been debates in many states over the last few years about where the state ought to deposit its funds, or where a municipality ought to deposit its funds -- which bank should it do business with. Bankers have been fond of saying, "If you don't put your money in the local community, if you send it off," -- I don't know what the equivalent is out here, but I know that out in the part of the country where I live that the contrast is usually made between sort of local in-the-community bankers and the sort of evil money centers of the East. While we live on the evil money centers of the East, I don't know where people send your money away, probably to the hungry energy-gulpers in Denver. But, obviously, one of the problems today is that it is sort of hard to tell where the dollar you put into a bank is, opposed to where the dollar that somebody else puts into a bank goes. And it is hard to tell if you invest in a corporation whether your particular investment is the one that benefits New Jersey, or whether its actually the investment they use to open another new plant in Bangladesh, for example. So it's a little hard to distinguish what constitutes an instate investment, except for certain kinds of investment instruments. That's probably why the single most popular targeted investment on the part of states has been to add mortgage pools and mortgage participation as a permitted investment and to find ways to encourage that kind of investment. I am not going to preempt Allan Emkin, who will tell you a great deal about housing and real estate investment, but let me just sketch out briefly what the effect of that has been.

Basically, pool mortgages and participation certificates, which are only two examples of the infinite variety of mortgage investment, are some of the few things that you can look at that actually focus in on states. You can assemble first mortgages on the most common -- the one to four-family residential owner-occupied homes, have those pools put together by the person at the savings and loan or bank that originates the original mortgage, have them insured against default, and have that package in turn sold to the pension fund, which is a large investor and doesn't actually have the time or the resources to make individual mortgage loans. That type, emphasizing that that has to be in the state, is one of the few investments that can be clearly identified as an instate investment. To some extent venture capital partnerships, to the extent that they invest in young growing -- solely in one state, are also clearly identifiable instate investments, and certain other kinds of things, private placements, loans made directly to corporations, can be considered instate investments, but it is difficult to tell. Alabama's pension system, for example, has a strong predilection for instate investments and has a strong program, but of course one of their private placements which they point to as an example of instate investment was a loan made to United States Steel Company. Now that happens to be one of the largest employers in Alabama, but I'm not sure all of us would think of U.S. Steel as being an Alabama corporation.

So I would suggest, just as a personal observation, that part of the interest in mortgage pass-throughs, mortgage participations, mortgage certificates, whatever the case may be, on the part of states has been, not necessarily because that's an ideal targeted investment, although you will hear more from Allan about that, but because at least it has the advantage of being clearly identifiable instate investment, and unlike the sort of slippery nature of other kinds of money, you can see where it is going and you can see what it is doing.

One problem, of course, in the mortgage area has been the lack of intermediaries. Typically, fund names -- and I have never been able to understand why mortgage bankers, who are fairly dull people otherwise, manage to think up so many cute names such as "Fannie Mae," "Ginnie Mae," and "Freddie Mac" as the nicknames for their particular secondary market trading institutions. All of those federally chartered corporations have always in the past pooled investments morttages from around the country, and it is often difficult to find ones that are focused on a particular state. The state should have taken an interest in and a long look to some other kind of intermediary, either a private corporation -- the Mortgage Guarantee Investment Corporation, or MGIC as it is known for short, is the largest and most active in that area, or set up some kind of state-administered or some kind of a corporation that the state participates in to package mortgages for their state. Connecticut has its "Yankee Mac," Michigan has its "Maggie Mae," the Mortgage Corporation of Colorado, which has its entire issuance in mortgage securities sold to the Public Employees' Retirement Association of Colorado, and the North Carolina Mortgage Investment Corporation, which sells part of its securities to the public pension funds and part of its securities to private pension funds in North Carolina. All of these represent attempts by the states to find a useful intermediary package mortgage form.

Still other states, such as Indiana, have attempted to use the state's Housing Finance Agency as a primary packaging mechanism. That has been, by far, the most common instate targeted investment program. Some of the other investment programs that states have taken up to look at have either been to direct investments in general in the state -- Ohio, Pennsylvania and Michigan have all set up legislation that gives preference for instate investments and offers, in some cases, what is known as a "basket clause." Pennsylvania is a good example of that, and says after specifying a long list of legal investments, up to 5% of the assets of the system may be invested in any other investment not otherwise permitted by this particular legislation provided that, in the case of the Ohio law for example, investment is in a corporation that has either its headquarters, half of its assets or half of its employees in Ohio.

Kansas, which is one of the more interesting targeted investment areas, has set up a number of ways of specifying investment in Kansas. They invest in Kansas corporations, they invest in certificates of deposit in Kansas financial institutions and allow those financial institutions to bid, and they invest in packages of residential mortgages, in many cases often giving preference to state employees who are members of the system and obviously have an interest in seeing how their money is invested. I mentioned parenthetically that a number of states have considered this, California being one that has recently enacted it, but of all states the one that pioneered the use of pension funds for mortgage loans to members of the system is the Hawaii Public Employees' Retirement System. Hawaii is unusual in that it has a large population and a small land area, and there is very little really developable land, so that mortgage costs are very high. Right at the moment, over 35% of the assets of the Hawaii State Public Employees' Retirement System are in mortgage loans to either active or retired members of that system. And they intend to keep that policy up for the future, because its the one source in Hawaii that has enough money to be able to make those kinds of loans.

Mortgage investment programs popular around the country, in addition to the ones I have already mentioned with the various intermediary corporations, are Oklahoma, Texas, Utah, Vermont, Virginia and New York, which have all set up programs of mortgage investment. The most recent one has been Idaho, which is operating under its "prudent man" rule and set itself a goal earlier this year for 10% of its state's assets to be in mortgage investments. There is more. In fact, after I had written this thing and made all the changes up through the past week, and I managed to talk to Allan about seven days ago and told him that I had this terrific report, and sounded like the Johnny Carson show, "Everything you want to know is right here in this report," and Allan said, "No, the California Legislature passed three more pieces of legislation last Friday." So as soon as I get back to Denver I'll have to add that to this particular study.

One other area that states have shown an interest in, and I predict you will see more of them, has been in looking at investment policy in a comprehensive way. Most of the changes in California came out of the Governor's Study Commission, which was appointed to take a comprehensive look at the state's investment policy. Texas has both a Governor's Study Commission and a Legislative Study Commission looking at the state's investment policies in pension funds and in other funds. Illinois' recent changes came out of the Study Commission there. In Wisconsin this year they passed a law which merged all the existing pension systems into one, but that law also had a provision which requires the Legislative Council to carry out a study on investment policy and report back to the Legislature in January. North Carolina just passed a resolution last week which sets up a permanent -- not permanent, but a two-year Study Commission on investment policy.

So, what I said in the study, and I think holds truer than ever, whether or not it is a useful idea, or whether or not it is an idea that needs to be considered by every state, clearly the course of investment policy is something that has come to the attention of the Legislatures. It is no longer purely the prerogative of trustees, of treasurers, or other investment things, but it is out in the open as a public policy issue. One of the trustees in the California Teachers Retirement System is quoted in Business Week as saying, "It used to be such a nice quiet thing to be a trustee for a public employee system. Now I am as much in the public eye as the Governor or anyone else." And perhaps that's a good thing. Whether or not the particular actions taken by any state are necessarily not in the public policy, it is clearly an area where there is interest on the part of the state Legislatures, where there is interest on the part of Governors and, in general, if an elected official is going to perform his function and hold appointed officials accountable to the public, then indeed this is an appropriate area of inquiry, just as are other areas of state government. Thank you.

SPEAKER KARCHER: Thank you, Mr. Kirkland -- I should say Dr. Kirkland. I think after hearing Dr. Kirkland -- his remarks put into perspective what I said initially that certainly this is not a new or novel idea in New Jersey. Over half the states in the nation have already moved in doing something in this regard. We're going to hear the next two speakers before we break for lunch, who are going to speak to us about their specific experiences in their states. The first is Allan Emkin, who is from California, and who will talk about their experience, and then Mr. John Chenoweth, who is Executive Director of the Minneapolis Employees' Retirement Fund.

Let me tell you a little bit about Mr. Emkin. As you already heard, California, having taken some initiatives in this area, is now into it with a vengeance we might say. Allan Emkin represents the California Governor's Office in the area of Public Pension Fund Investment Policy. He has been with the Public Pension Investment Unit since its inception one year ago. The PIU in the Governor's Office of California was authorized by legislative appropriations in 1981 and reauthorized in 1982 to implement the recommendations of the Governor's Public Investment Task Force Final Report. It is staffed by five full-time professionals including experts on labor, real estate, business and social policy.

Mr. Emkin received his bachelors degree from Antioch College. He has lectured at UCLA, USC, and the University of California at Irvine on land use and housing issues and has served as a private consultant to developers and financial institutions. Mr. Emkin -- and by the way, I should tell you he was born and raised in Lakewood, New Jersey.

A L L A N E M K I N: --and being here at this time of year and not being in Seaside Heights is very difficult for me.

We in California are somewhat unique in just the size of the public funds. The combined assets of public funds in California exceed $40 billion. The two largest funds, the State Teachers and the Public Employees, have combined assets -- jointly-managed combined assets approaching $28 billion. That makes them, after AT&T, the second largest pension fund in the country and one of the largest economic units and investors in the country. In relationship to our targeting -- and I'm going to leapfrog off from my friend over here, we are now targeting Pittsburgh. The Public Employees, as the State of Alabama has done, is looking at buying and leasing back the U.S. Steel corporate headquarters, to the tune of $250,000,000, and I am defending that investment. I'm here initially to try to show you that targeting might mean more than one thing. If it's a good investment and it's in Pittsburgh, I think the fund should do it. And I'm having to deal with people in my Governor's office in the State Legislature to justify that particular investment.

To give you some idea of the size, the Public Employees' Retirement System has $19 billion, the State Teachers over $9 billion, the University of California $4 billion, LA County, which is a county fund, has $3 billion, and there are approximately 30 other funds varying in size from $40 or $50 million to the average being around $200 million going up to a billion.

In every discussion, anyone who works with pension funds will go back to the key, and the key is that the pension funds' trustees' and managers' sole obligation is to the beneficiaries, and that is an open and shut case. Anyone who argues with that is not talking within the framework of existing statutory and constitutional law. That is their sole legal obligation. What we do in California is we put a comma and we say, and all other things being equal, let's invest in California. But the key is the first word of the phrase, not the second word of the phrase. It has to be in the best interest of the beneficiaries.

In 1980, the Governor appointed a task force. The intent of the task force was to develop policies in a framework for changing and analyzing the investment policies of the public pension funds in the State of California. It was very broad based. It included organized labor, it included managers and trustees, it included experts from investment banking and it included experts from mortgage banking, and the result was this final report. I don't urge you to do another final report -- it's an awful lot of work, and I think that the research has already been done. But there were a number of recommendations, and the recommendations, I think, are what is crucial because they are beginning to be implemented in California.

The Legislature in California, bipartisanly, supported the creation of the unit that I work for, and funded $400,000 in the first year and $400,000 this year to keep the unit working with public pensions funds, including the small county funds, special district funds and the two state funds. Just to give you a little bit more on the size, the PERS and STRS, the two big state funds, are number four stockholder in the B of A, number five in Chase, number nine in Citicorp, number eight in Crocker, number six in Seafirst, number nine in Trans-American, and number five in IT&T. In Pennsylvania, we're number two in Heinz; in Minnesota we're number four in General Mills; in Georgia we're number five in Georgia Pacific, we're number two in Motorola, and I can go down the list. And that's only a small percentage of the amount of investments that they have.

The task force broke the recommendations into three areas, the business sector, the housing sector and the social sector. I am going to initially deal with the business sector, because I think in many ways it is the most fascinating, although my background is on the real estate side.

The business sector was chaired by an investment banker and included a number of people from the small-business and big-business communities. The recommendations were very broad, but we're beginning to see implementation. There is an existing program called the SBA 503 Program, and that program basically enables smaller businesses to get loans which are guaranteed by the instrumentality of the federal government for plant and equipment which is a fixed asset in real estate. These loans are made with a commercial bank and part of the proceeds come from the federal government. In California every year, $250,000,000 is generated in 503 loans. Recently, and let me be more specific -- they have the ability to be very flexible on the terms. Currently, it is no problem getting a 503 loan with a three-year bullit that is a variable. That means that it is all due and payable in three years and the rate floats, with prime or some other index. The need for the small-business community, at least in California, and I assume here, was for longer term, fixed rate paper, and they wanted to get a commitment, even if it was a high rate but a fixed rate so that they could do some financial planning. And that was the sated request from the business community and Chamber of Commerce across the board.

Our pension funds in California, particularly state funds, have committed themselves in a letter to all financial institutions in the state, to a set of criteria where they will buy the guaranteed portion of every single SBA loan that is sold in the state that meets their requirements. And the requirements are very stringent relating to yield, and maybe no one will ever take them up on their criteria, but it's there. And if the lenders start originating paper that meets the criteria of both the small business person and the pension fund, they have made a commitment of $250,000,000 a year to buy that paper. And that paper is high yielding. It's fully guaranteed by an instrumentality of the U.S. government and is a hugh secondary market, so it's not illiquid. It is a program that can be done with absolutely no risk, in my opinion, no concession on yield -- and have a direct and positive impact on the state's economy, and it can be done tomorrow in California. It may not be able to be done here -- I'm not familiar with your regulatory scheme.

We're also working with the business community and private insurance industry on trying to take care of one of the biggest concerns pension funds have, and that is, as they make an investment they are concerned about the concept called "pre-payment," and that mainly deals with mortgages, and that is when an investment pays off prior to maturity, planned maturity. What that does is it throws off your yield and throws off your reinvestment rate. You have to reinvest that money, possibly at a rate that is not as beneficial to the fund. Let me give you an example. If I made a mortgage today at 16% and rates went down to 3%, the person who paid that mortgage off and then I as the investor have to reinvest at 3%. I've lost 13% reinvestment rate over the term of that mortgage. We've gotten a mortgage insurance company and a regular insurance company ready to insure against prepayment, so that the pension fund will be totally secure in knowing that if they make a ten-year investment, it will be out there for ten years, and that way that small business can get the loan that they are looking for.

One of the major issues that confronted the state Legislature was the fact that our regulatory scheme for public pension funds is in the state constitution. The state constitution can only be amended by a vote of the people. Toward that end the Legislature has proposed, and on the ballot this November will be Senate Constitutional Amendment 21. The purpose of that is to give pension funds more flexibility, because they need the flexibility to address changes in the economy. Currently, the California funds that are regulated by the constitution can vest no more than 25% of their portfolio in common stock, and that stock has to be in companies having assets over $100,000,000, having shown a dividend in eight of the last ten years, and having earnings to pay for that dividend in the last three years. Basically that means that California public funds today cannot buy General Motors.

Now, to me that doesn't make very much sense, to have the second largest company in the world being on a restricted list because of minor historic changes in the marketplace. It also means that they can't buy Digital Equipment, which next to IBM is the number two computer company in the world, growing on a compounded rate of 30% a year. Yet they can't buy it, because they don't give dividends, they reinvest it all. The value of the stock has gone through the roof, but they don't show any dividends. They can't invest in that stock -- it's ridiculous, it really is ridiculous. So the Legislature is going to increase to 50% the percentage of -- if the voters approve it -- the portfolio that can be in common stock. They are going to allow, for the first time, 5% of the stock portfolio to be in equities that don't meet that strigent criteria, which is less than $100,000,000 without the dividends, such as Digital Equipment and, what is most unique, and what I think from a manager's point of view, and from an investor's point of view is the most fascinating -- one-half of 1%, which is not a giant number, in venture capital. And the beauty of venture capital is that that is where ideas come from, that's where growth comes from, that's where growth in the economy comes from. As a small company, IBM didn't always have billions of dollars, it started small, and those people who got in at the ground floor of IBM increased with it. And I think one-half of 1% is a very, very small number, but a venture capital firm needs a very small amount of capital to get started and there are pools and professionals in this area who do nothing more than create venture capital pools for funds to participate in.

In the housing sector, which I have been most involved in, California in some ways is unique. The two state funds have 25% of their total portfolio in mortgages and mortgage-backed certificates. They are the largest single holder of Ginnie Maes in the country. Some of our county funds have been extraordinarily innovative. The County of San Bernardino, using an outside real estate adviser, is buying dilapidated apartment buildings, refurbishing them, converting them into condos, and doing the take-out loans. They are going from one end to the other end, and they are estimating an internal rate of return of 19% on that particular transaction. They built a 300-unit student housing project in Chino, and their return on that is 16½%, guaranteed over 30 years. They are buying shopping centers, both new and existing, and then leasing them back to developers. The County of Los Angeles, with $3 billion in assets, is involved in FHA/VA mortgages, home loans, and they are actively participating in the secondary market with Fannie Mae and Freddie Mac, and for the first time they bought a privately-insured mortgage pass-through. It's the first time that happened in the State of California. And what's different there is that they impose their criteria, and their criteria were all Southern California loans, no loan higher than $150,000, and loan value ratio of 80%. The mortgage insurance company, in this particular instance PMI, which is based in San Francisco, pooled those notes, turned them into a security, guaranteed them and insured them, and the rate to the fund was 16½%. Now, that is a very, very healthy mortgage yield. That's a mortgage yield, not a bond yield. If it was a bond yield, it would be closer to 17% because you have monthly compounded. And that could be done by minor changes in your regulatory scheme here in New Jersey almost immediately.

The big state fund, and I think this is the most fascinating, recently purchased $180 million of Freddie Mac PCs from Home Savings and Loan. Their yield was approximately 16% on that and how that works is, it's $180 million on face value, in shares it's probably $100 million that Home Savings got. That gives that institution the ability to relend that money, that $100 million, in California. And we're doing that with small and large institutions. We did it with a small institution in Bakersfield, and here it was a $16 million yield, with Fannie Mae 8½ paper, and the president of that institution has publicly stated he is going to relend our money in Bakersfield. Now it might not go for home loans, it might go for home improvement loans or some other type of investments, but they are going to relend that money in Bakersfield.

We are currently investigating a program which was initially instituted in Minnesota by the Minnesota state fund, not the city fund, but the state fund, and basically what it does is, it allows pension funds to use their assets as security to make a forward commitment to purchase something well into the future. In this case, they are making a forward commitment to buy approximately $75 million worth of mortgages ten years in the future. Now, why are they going to buy these ten years in the future? Because, for the first ten years, the financing for those mortgages is tax-exempt financing and the rate to the home owner -- the home buyer for the first ten years is less than 12%. Gradually, over the term of the ten-year period, the payments go up, so by the time the ten years have elapsed, those mortgages are yielding a market rate in today's market. On top of that, the fund is getting an annual commitment fee, when they haven't put out a dime. So, for ten years, just by putting aside X amount of securities, which you can move in and out at your discretion, they get 25 base points, which is a quarter of a percentage point commitment fee, which they can reinvest for ten years just from making a forward commitment. Now, in the event all of those mortgages pay off, they will never have a dime of that forward commitment taken down, which means they'll never have to put any of it out. It allows a public pension fund to make a very, very positive impact upon the state's housing market, without one dime on day one, and tying up what I feel are today's high yields ten years into the future. There are more creative ways which we are now investigating of doing this with multi-family apartments and creating a participating mortgage in year ten to hedge against inflation, so that what they're getting not only is a high coupon or an interest rate, but also participation in equity position so that as rents go up or as it is converted to condominiums or sold, the investor -- the pension fund investor participates in that.

In California, the two big funds are currently investing in shopping centers, not just in California but in Texas and Michigan, in office buildings and in industrial buildings, and the structures vary. On the newer buildings, almost all of the transactions are either sale-leasebacks or participating mortgages, and

I prefer the participating mortgage. The concept of a participating mortgage is really rather simple, and that is the interest rate appears to be below market. That is, in today's market you might have an interest rate on a mortgage of 12% and to compensate for that the upside will be increases in rent and half the future profit goes to the investor and that provides the hedge against inflation. So if we have another period like the period we've just gone through, and real estate values go crazy, you're not stuck with just your 12% interest rate, but as the value of the property goes up your investment increases in value and that provides you the safety against inflation which most pension fund managers wish they had the opportunity to do ten years ago, so during those recent recession, inflation, stagnation periods they would have had a real rate of return that would have made their funds whole.

I think this afternoon we will be dealing with a lot of the specific questions you have, hopefully not too many about the legislation, since I can honestly tell you the Legislature broke almost two weeks ago and they voted 900 bills out the last day of the session. Three of those bills were pension bills, and not one of them is still in print. We have not seen the amendments, and I'm as worried about what they are going to look like as I'm sure anyone else is. I know what the intended amendments were, but anyone who knows the legislative process will tell you that you're not sure that's what the bills are going to end up looking like. And so we're waiting for it to come out of Council and out of the printer's office before I can give it to Kenneth so he can report about it. Thank you.

SPEAKER KARCHER: Thank you, Allan. It's so delightful to know that a state like California -- that those people there are, as reputed, crazier than us. We're also delighted to know that you were Jersey born and bred, and we have an abiding conviction that we breed some smart people in New Jersey, the shame is that you leave. Once again, let me emphasize that after lunch everybody here will be available for a discussion and specific questions to be answered. The only thing I would mention is that I hate to think about all those billions of dollars invested in a state that is going to fall into the sea pretty soon -- it's kind of unnerving. I guarantee you have a -- we've invested in England.

Let me now introduce to you John Chenoweth. Mr. Chenoweth is, as you know, from the State of Minnesota. Let me just give you some brief background. John C. Chenoweth is presently the Executive Director of the Minneapolis Employees' Retirement Fund. In that capacity he manages $350 million in assets of that particular municipal fund. He is a member of the Investment Advisory Committee to the Minnesota Workers' Compensation Re-Insurance Association, the Managers' Selection Committee of the State Board of Investment, and is also a member of the State Board of Directors of the Minnesota Seed Capital Fund.

Mr. Chenoweth is a former Minnesota State Senator, and Chairman of the Senate Governmental Operations Committee. He also served as Chairman of the Minnesota Legislative Commission on Pensions and is a former member of the Minnesota State Investment Board Advisory Council. By way of background also, apart from all that, he was an investment broker. Mr. Chenoweth.

JOHN C. CHENOWETH: Thank you. It is a pleasure to be here in New Jersey. Some years ago I got a good idea from you; in fact, it was on pensions. You had a problem of a plant closing and the loss of some pensions for certain employees here and I read an article how the Legislature here in New Jersey passed a law to insure and protect those private pension benefits and we looked at that law in Minnesota while I was still in the State Senate and drafted a law that was similar, and yet different, to ensure or guarantee vesting for private pensions in our state. I think we were one of the first states after New Jersey to do something along those lines. In fact, as a result of it, Senator Williams who was very active in pension reform in Congress, was able to secure passage of the ERISA Act and, as I understood it, one of the reasons the national lobbyists changed their position from opposing national legislation was when they saw the Minnesota law after the New Jersey law, they became frightened that they might have to deal with 50 different Legislatures passing 50 different laws protecting private pensions, so they decided to get smart and do something about it on a consistent national basis. So I'm indebted to New Jersey for some good ideas that we took home to Minnesota and maybe we might bring one or two here today to share with you.

I'm here as a representative of the Minneapolis Employees' Pension Fund, where I serve as the Executive Director. What we are is, we're an independent public corporation. We're not a part of the city government in the sense of an agency or a department, if you will. We are established by state law, which gives us some unique status in the sense that pensions are our only business. We have 10,000 employees who work for the City of Minneapolis, the school district, some colony and some metropolitan agencies. We're governed by a seven-member board consisting of four employees elected by the employees, and three elected officials designated by statute as our governing body, and we have assets of approximately $350 million.

That is sort of a capsule of the entity and our involvement. We operate under a Minnesota state law that governs us, and I am somewhat envious of the New Jersey situation in the sense that you are unique in that your Legislature has not tied the hands of your investment people. Your investment people have tied their own hands. It sounds to me as though the only restrictions you have are the ones that your own investment people impose on themselves by way of their own operating procedures. So that really you have ultimately, you might say, the best of all worlds. You have the potential to do what you want so long as it's prudent. And that, unfortunately, is not the norm across the country.

As you may know, or may not know, the record in terms of public pension funds in this country is miserable, to say the least. Public pension funds as a group underperform the private sector in terms of the rate of return on invested assets. When I speak of rate of return, I'm talking about the total rate of return time-waited. There needs to be in every jurisdiction a true accounting of what in fact your investment performance is. In fact, as a starting point I would suggest that, as we have in Minnesota, you start with finding out where are you and where have you been before you can determine where you are going.

In Minnesota, we've had a controversy, and I have been a part of that controversy, involving just how well are we doing, because so often when we talk about investment policy and strategy, there is an implication on the part of some that when you start talking about considerations other than economic, and you start interjecting considerations that may be social or strategic, or whatever you wish to call them divergent, that somehow you discussed those issues as though you are going to be giving up something. Well, my position is that the record of public pension funds to begin with is pretty miserable and that you're really not giving up much when you start to look at new alternatives for investment because the record, and I don't know anything about New Jersey, but I can tell you as a group nationally, the record of public pension funds is poor. They have not invested their assets in a manner that has given them a real rate of return on the average over the past decade relative to inflation. In fact, one could say that the purchasing power of the dollar invested in public pension funds has declined. The one exception to that is the current year that we have just finished on June 30, 1982. The median, according to Becker, which is one of the national independent investment performance firms, has indicated that the composite private and public pension fund declined in value by 1.2%. Now you won't read a report that will probably tell you that your pension fund declined by that, because they'll probably state it in the form of a yield number marking their assets to book, and as you know, that is a very controversial issue with GAP, in terms of the accounting practices as to how these reports should be made.

I would say, that rather than getting into an argument of which way they should be made, because for actuarial purposes there is good reason to use yield, but for investment performance evaluation, there is good reason to use time-waited total rate of return -- rather than argue, I think you should request that you get both, then there is no argument at all. You've got both, and you can use both for whatever they're intended to be. But I think you should know where you stack up, because when you get into these issues of how you should direct pension investments, I think the bias is that somehow everything is wonderful and that to talk about new ways is somehow going to give up something. I submit that entering into a discussion on investment objectives on something other than economic may actually improve your performance, vis-a-vis, mortgages. There is such a thing as disintermediation that takes place in the investment capital markets. In other words, the markets move and they change, and opportunities change, and sometimes they lag other opportunities. For example, you can get a higher rate of return today investing in mortgages than you can in corporate bonds. So I submit, what is more risky -- to put all of your assets in one particular corporation's future, or in a portfolio of individual mortgages?

The other thing is that the cash flow from mortgages is monthly, giving you an opportunity for reinvestment of your assets and also for cash flow to meet your various obligations. There are a number of reasons why mortgages provide a very nice vehicle for pension funds in terms of meeting their liabilities, and at the same time to get a higher rate of return. And yet why don't pension funds buy mortgages? I can't answer that for everyone, but for the most part I find that you have institutional problems, and this is in the public field as well as the private field. You have a sort of mediocrity -- an institutional mediocrity that exists, in that most institutions are lazy and don't really like the extra work of going out of their way to package things that are not easily marketable. For example, you buy a stock, or you buy a bond -- you have a pretty known method of value determination and just by a phone call you can transfer hundreds of millions of dollars if you want to, whereas if you start looking at mortgages, you know maybe you have to go to a little extra work. Now, of course, that is no longer an excuse, because there are a lot of programs that institutions are being offered to package mortgages as securities, so that they have the legal composition of a bond. On the other hand, you give up a certain amount of yield for that, but it also deals with the problem that some people complain about in the institutions, and that is the ease of making commitments.

In terms of investment objectives, and that's really what I want to talk about today, investment policy, I might tell you that we got interested in investment policy beginning with the issue of looking at what our rate of return on our investments were. We were not happy with our rate of return on our investments. We had a portion of our assets managed by the State of Minnesota by statute. They managed a part, we managed a part, and we did an analysis and, if you can believe, we never had a public discussion on what the total rate of return on investments really was in the state. So we got an independent investment analysis based on the total rate of return time-waited, which is the accepted standard, and we found that year in and year out the assets that were under our independent management produced a higher total rate of return than the assets under state management, and that if we took those together we had an opportunity loss of over $40 million in a seven-year period of time. Since that is a lot of money for a fund that is $350 million in total size, we thought that if were going to be prudent that we should manage the assets ourselves. So we embarked on a program to secure the passage of legislation withdrawing our assets from state management. That was a two-year legislative struggle that we finally achieved last year. We just completed our first year of independent investment performance on June 30, and we out-performed the State Board of Investment by 300% in the first year. So it has been a very positive change for us.

At the same time that we achieved that change, we strongly advocated that investment policies must, and should, include objectives other than merely economic objectives. In other words, there is no conflict between sound economic investing and social investing. I want to underscore at the outset though that we are not a social welfare agency, and it is not our objective to utilize our assets as a primary means of accomplishing social change. It is not our primary objecttive -- I want to underscore that. Our primary objective as a public pension fund, and it is a social objective, is to secure a competitive rate of return that produces over time a real rate of return relative to inflation to provide for our retirees an adequate pension and that it is safe and it is secure. That is our primary objective. But insofar as we can achieve a satisfactory economic rate of return, we think good economic investing should also include good social investing. In other words, to my way of thinking a good economic investment is a good social investment. A good social investment is a good economic investment. In other words, rather than talk about conflict between the objectives, that the two shall meet, and I think that mortgages provide an excellent example of that where you can in fact secure a higher rate of return at the present time on those than you can on corporate bonds, with less risk.

In evaluating investment policy and in attempting to determine a strategy for investment, we prepared an outline of objectives that is similar to what most public funds and private funds do, and that is you determine what the purpose of your pension fund is and what your long-term objectives are, and you devise an asset allocation strategy, and you provide ranges for investment. In doing that, we looked at the record and I have a saying that says, "learn from the mistakes of others, because you won't live long enough to make them all yourself." And God knows, there have been enough mistakes made in investment management. In fact, there are more examples of what not to do than what to do.

The history over the past decade is that the average institution invests in the big capitalization stocks, and the fact of the matter is that those companies have produced in total no net increase in total employment opportunities in this country. The growth in jobs and economic development has been coming from small and intermediate-sized corporations, and not the big companies. It seems like the only thing the big companies know how to do is buy out, merge, consolidate or close plants, or play some fancy NBA games of leverage. But in terms of getting down to the basics of getting this country's economic base moving in terms of increased productivity, in innovation they have lagged the small companies, and yet as a matter of investment policy all institutions invest most, if not all of their money in the big smokestack corporations of America. Little has been done to provide any kind of creative investment opportunity. Most of that has come from the individual, in terms of the venture capital approach.

Now, most institutions like New Jersey and Minnesota are not geared up really for venture capital type of investments and I think, therefore, you'd sort of have to look outside of the normal internal framework and look for ways in which to participate, and what we decided to do was to allocate a portion of our assets, in this case 3%, or up to 3%, of our active employees' assets into the area of venture capital. As a result of that policy decision, we have made an investment in a fund called The Minnesota Seed Capital Fund, which I believe is unique. It is a venture capital fund of sorts. However, it is distinguished from most private venture capital funds in that it involves itself at an earlier stage of investment and, therefore, could be deemed to be a higher risk. This fund is unique in that it beings together a partnership of private corporations and private pension funds and public pension funds in the state. We have an investment in there by such companies as Control Data, Dayton Hudson, Honeywell and other private companies, as well as the public pension fund assets of the Minneapolis Employees' Fund, and soon commitment to be made from the Control Data pension fund. And what we are doing there, we are looking for opportunities in the field primarily of technology for new companies, or start-up companies, that are in the Twin Cities area or in the State of Minnesota that we can invest in that will provide future economic growth for the state which we believe to be in the interest of existing private businesses, because if we are going to talk about issues like -- I know everybody here spells issues of the business climate, the tax climate, and the rest of it, I submit that it is in the interest of every private company to have an economic climate where capital is available for new ideas that are going to provide new job opportunities to in essence broaden the tax base, so that the existing companies don't have to bear a larger burden in the future. A healthy economic base is in the interest of everyone, including the public employees providing the services, so that we don't have to be faced with cutbacks and so forth. If we can provide a healthy economic base, we can better provide a higher quality of public services. And that, incidentally, is the philosophical basis for the public employees who are in our fund and who represent the majority of the board control in their commitment to a social investment policy, if you will, as an ingredient in our overall investment philosophy. They believe that if they are not going to be part of the decision-making process at the opening end of things -- in other words, if they're not going to be carving out these opportunities and looking for them, that someone else is going to be directing them later on, and they would rather be providing the direction rather than reacting to someone else's ideas on what they should be doing. And I think that is an important philosophical point. In fact, if you look at history, there are a lot of cases where if you look at the monarchy in France as opposed to England, and why it survived in one country and not the other, the monarchy in England was a lot sharper in the sense that when they saw the winds of change coming, you know they got in tune with them, and they were a part of the change, rather than resisting it. And I think that public employee leadership should recognize that there are winds of change out there and that they should be part of them -- they should take the leadership in that direction and I think that would be the more enlightened course. Otherwise, they may find themselves reacting to it. And that's been the philosophy of our public employee leadership.

I might say that I believe -- I think I work for a very enlightened board, which helps a lot, because a lot of administrators have to deal with difficult boards sometimes that are not enlightened, but the best of all worlds, of course, is to have an enlightened Legislature, enlightened pension boards and enlightened administrators, and then you get a lot done. So, it is a team effort.

In terms of meeting our investment objectives, which is to produce a higher rate of return relative to inflation, we have gone into a number of areas that are a little untraditional. In the Twin Cities area, the cities of St. Paul and Minneapolis decided to join together and to do something to create affordable family housing opportunities. So they, in conjunction with a large private foundation, formed a corporation called the Minneapolis-St. Paul McKnight Family Housing Fund. So we brought a consortium of a private foundation and two city governments together to do something in that area, and we brought private pension funds and public pension funds into the picture. What we did was, we used the assets or the taxing authority for tax exempt bonds of the two cities to provide industrial revenue bonds for housing to provide long-term low interest financing from their role. The McKnight Family Housing Fund provided foundation money to provide down payment money for individuals to buy homes. Then we used a combination of equity participation and other things where pension funds were able to participate in that, in the sense that they could invest money and get a rate of return on the mortgage, plus an equity in the house. It was a great idea. We made a large commitment to it initially, which was used to leverage some UDAG money from the federal government to be used as part of the overall program.

Soon thereafter the Labor Department looked at it and got nervous and told the private pension funds that this was too new and too controversial, and we don't think you should get into it, so they backed out and we were left standing alone. And we felt uncomfortable -- how were we going to explain to our constituency that as a public fund we were going to move in a direction that the Labor Department told the private funds that they couldn't move. So we had to back out of the direct participation ourselves. However, that has since been resolved in terms of some new changes in the legislation at the federal level that allow more flexibility for pension funds to invest in mortgages.

What we are doing in that area in addition to that is, we're providing construction loans for housing projects that are being financed, that is long-term financed, by that money, where we have made arrangements with a bank to be a partner, if you will, in the sense that we take down a portion of the loan and provide the construction funds for those housing developments and we're making those usually at one or two points over prime. So we're getting a better than market rate of return. If we were to put our money in the CD, of course, we'd never get a bank to pay prime rate on a CD; after all, a bank has to make money on your money. So we are getting more than just a competitive rate of return, we're getting a very large rate of return. At the same time we're increasing the competition in the banking place, because we're dealing with a smaller bank that doesn't have the asset base to make these multi-million dollar loans itself and, since they are willing to do it at one or two over prime, you make the other bigger banks have to be receptive to how many points they're charging over prime, and I think overall we increase competition in the marketplace. That's another thing that we're doing. We're also involved in purchasing mortgage commitments. We committed $32 million in the past year to conventional mortgages because we felt that with the monies being made available from the Family Housing Fund that enough money was being channeled to moderate cost housing and we wanted to do something to improve the social economic mix, if you will, of the city, in the sense that we wanted to see more upper income housing going in. So we're using our direct assets to provide a conventional rate of financing for mortgages up to $350,000, so there is a source of capital for that.

In the course of doing that, we are selling mortgage commitments to private banks and mortgage companies in which we receive, usually, two points for our commitment fee, which is 2% of the principal for the amount committed and then we put restrictions on those commitments. For example, the first ones we made we directed that those mortgages must be made, the first batch, all in the City of Minneapolis, if they wanted our money. Secondly, we said we don't want any conversion of existing apartments to condominiums. We'll convert warehouses to condominiums, and we're involved in that. We'll build new condominiums, we'll build new townhouses, we'll build multi-family, we'll build single-family, but we don't want to exasperate the tight rental market. So we're using in essence social policy, you might say, within our investment strategy, and I might add without sacrificing our return.

We're also using as part of that policy a program where we're concerned about the quality of the buildings that go up where we're providing the financing, and because we believe that union-built housing on average tends to be better than nonunion-built housing. That's a value judgment, but I think there is some experience in that we would rather see union contractors involved in the construction, so we also require that the contractors utilize union labor.

Now, a lot of people told us you can't do these kinds of things, but I submit to you that if there is a will there is a way. There's really no limitation on what creative, imaginative, innovative people can do if they make up their minds to do it. All you have to do is exert the effort and those things can be done, and they can be done without sacrificing investment quality or performance.

There are risks, however, and I submit you must be careful, because there is a tendency I have found on the part of some private institutions to look upon public pension funds as captive investment clients, and once they find out that you're socially concerned -- first of all, if you're in the public sector they think you're stupid; they don't think you're as smart as they are in the private sector, so there is a bias, if you will, about your competency level and they seem to be more than willing to try to take advantage of you. They are going to play on your social commitments so that when you want to put money in mortgages, they are always going to offer you a lower rate of return than maybe you might be able to get. One way they do it is that they build in high fees for servicing, some of them want ridiculous rates. I've seen situations in this country where they're paying, in some cases, as much as one point, but that is the extreme in terms of a servicing fee. That's because it was a small deal. But it's not unusual to be paying half a point as a standard fee for servicing, which in my opinion is high. The cost of servicing does not justify that and the consumer is paying it. So, when we negotiate a deal, we negotiate the rates that the institution is going to charge on the servicing fee. In fact, we've even stipulated which institution gets the servicing fee, in our own instance on a competitive basis, so that the consumer, who is ultimately the payer, is going to get some advantage. As a large financial institution, I think you sometimes don't realize it, but when you have $8 billion as you have, you are one of the market makers. In other words, when they talk about investor reluctance to this and to that, you've got the ability as a large investor to really make the market. For example, long-term bonds. For years institutions have bought long-term corporate bonds where the corporations have the right to call their bonds if interest rates should drop and take them away from you, but as an institution you don't have the right to put them -- I think that's a totally unfair situation in terms of the investor role as opposed to the debtor role. There comes a time, I think, when institutions need to start to assert themselves in the marketplace, in terms of what they can request and what they can require. The opportunities for private placements today are immense, and with the new shelf law registrations, you've got the ability now really to negotiate like you've never had before terms and conditions for financial deals that you're involved in. And I don't think there's anything wrong with doing that. In fact, I think it's advisable, because otherwise you're only going to get whatever -- well, I've talked to underwriters and they'll say as long as there are suckers out there who will buy these bonds, we'll keep printing them. I think at some point we are suckers if we don't take advantage of the market potential that we have.

Time is running short. There are a number of areas that I could cover in addition to the ones I have talked about. I might just want to emphasize, maybe more of a summary outlook on our investment philosophy in terms of what we are attempting to do and what I think most private and public pension funds should be concerned about -- is we look at the investment climate and our objective, of course, is to secure the highest rate of return possible. We must look at the investment climate on an international point of view, actually beyond New Jersey or Minnesota, or even beyond the United States, and we must look at capital as a resource in the same way as we talk about natural resources and the same way as we talk about people resources. That capital may well be the most important resource of the 80s, because we're talking about increasing the productivity of our nation and competing in a world marketplace.

It is no longer an issue of whether New Jersey competes with Florida. It's really a question of whether the United States is going to compete with the merging industrializing countries of the world, and the only way we are going to do that is through improvements in our productivity base, and that's going to come in areas of new technology and other types of considerations. With the shortage of capital, if you look at the debt structure of the Third World, it's mounting and we've got a situation now where frankly there isn't enough capital to go around to meet everyone's needs. With that kind of environment, it is our outlook at least that there is going to be competition for capital and, therefore, probably a higher rate of return on invested capital relative to, say the past ten years. With those opportunities, and that's the way we look at them, there are going to have to be new ways and means to capitalize on them. I think the question of who controls the dollar in the role of the investor is going to be more important in the next ten years than it was in the last ten years. For example, the role of the developer -- in the last ten years there were ample dollars available and the developer really called the shots, and the banks, the insurance companies, and the rest of them, you might say, transferred the money and they were happy to borrow the money at fixed interest rates, and the developer really made the clean-up on the deal.

Well the new game now is, it's your capital. You're the one who's putting up the money, and maybe you ought to be getting something more than just a rate of return on your investment that assumes some kind of rate of inflation. But you could be wrong. We're getting into the issues that Allan talked about with participatory mortgages and other kinds of things. Pension funds have a very unique opportunity because they are the only institutions with any financial stability left. The savings and loans don't have it, and the banks, I would submit, are on the verge if we let the free market system work. I think we might be faced with a -- it may sound overstated, but really the international banking system right now is probably at the weakest point it has been since the depression. Virtually, without the interaction of central banks across the world, I don't think the banking system would hold up because of the various numbers of corporate and country national debts that just frankly can't even be serviced right now. If we're going to be looking for large pools of capital to meet these needs, we're going to have -- particularly when we're talking about commitments that are going to be beyond the short-term commitment, we're going to have to be looking to the pension funds. At the same time, I think there are risks if the pension funds just continue to borrow money on a long-term basis, that is a fixed rate. They're going to have to have some kind of better hedge on inflation.

Therefore, it's like the real estate market. It's become a market of creative finance. I think the whole financial market is on the verge of becoming a market of creative finance. But the traditional way of doing business, where you go on the shelf and you take out Form A and Form B, is over. You are going to have to be prepared and willing to write and make your own deals, and in the long run I think you are going to get better performance by it. Some people think that these ideas are risky and some people think that these ideas will produce a lower rate of return. I would submit that it is a greater risk to buy into guaranteed mediocrity, which in many ways the present system has provided if you look at the total rate of return earned, than it is to look for new ideas. I also would submit that there is no conflict, if properly managed, between economic objectives and social objectives. In the case of our own fund, our total rate of return on internally managed money for the past twelve months ending June 30 is about 18%, which puts us in the top 1% of the A. G. Becker Index. In terms of our total fund performance, we're about 10.7%; this is total rate of return, which puts us in the top 13%, because our outside managers did not do as well. The point is that you can earn substantial rates of return on investments, meet your social objectives and do this under the guise of prudence. These interests are compatible.

The only question really lies in whether you have the willingness to go and to make the effort to accomplish the objective. There are no limits other than the limits you impose on yourself. In your own case, where you have a statute that only gives you the prudent person standard, that's all you have to do is be prudent. You have no artificial guidelines. You have really more opportunity than even those of us in Minnesota have. Even though our statute is long in terms of things that we can do, it is still structured, and the only way to be able to deal in the 80s, I think successfully, is to be able to be flexible -- to be able to move into markets and out of markets, and to be able to change your stripes, so to speak, because the economic conditions in which we operate are changing all the time and are bigger than any of us at any particular level of state government are -- they are international in scope. I guess that's it.

SPEAKER KARCHER: Thank you very much, Mr. Chenoweth. Let me advise you that we're just a little bit ahead of schedule -- let me suggest this. We have provided -- first, before I make that announcement, let me once again thank everyone. They have had the same reaction on you I trust as they had on me. I'm sure that there are literally dozens of questions to be asked on things that you would like to know more about on given specifics.

In order to accomplish that, and also to save you some of your afternoon, we have provided lunch which is going to be served next door. You can have it there, and let's be back here, if we could, rather than 1:30, if we could be back here at say 1:00. We can start the afternoon session at 1:00. I think forty minutes for lunch would be more than ample, especially since it is a box lunch, well catered. We in the Assembly have a tradition of good catered lunches. In the afternoon session we will go as long as may be necessary to answer all the questions that anyone has. With that let me recess this session. Right next door lunches will be served. Please be back at one o'clock with your questions.

(LUNCH RECESS)

AFTERNOON SESSION

SPEAKER KARCHER: From the comments I heard at lunch, everyone seemed to very much enjoy this morning's presentation and found it very informative. Also, from the brief conversations I had, it seems that I was correct in that there are any number of questions on people's minds, and certainly you see -- I'm sure you're satisfied for yourself, that the panel we have assembled is well equipped to answer them.

What I would ask is, that in order to have an entire transcript, if it is not too inconvenient, those of you who do have questions, would you come forward so that we can get it on this microphone so that it will be part of the permanent transcription -- if that's not too inconvenient for you. With that, let me first ask, while some of you in the audience formulate your -- put the finishing touches on any question you may have, maybe some people on the panel would like to give some comment as to the presentation that someone else made. Is there anyone who feels that they would like to do that -- some comments as to the remarks given by someone else?

MR. SILLIPHANT: I have a question for John Chenoweth from Minneapolis. Really, what I'm doing is relaying a question from one of the members of the Assembly during the lunch break. He had to leave, so I'll really ask it on his behalf. You mentioned a return of 18% on at least a portion of your portfolio, and his inquiry was, what was the composition of the investments that produced that kind of return? I'm curious too and maybe some of the other people are as well. If there is a magic formula, we certainly would like to know and perhaps think about it in New Jersey.

MR. CHENOWETH: Well, there's really nothing magic about it. It's just, I suppose, active management. How did we achieve it? At the time of the transfer of assets from the state to us last year, I made the decision to sell stocks, so we sold stocks, so internally we didn't hold any stocks -- we sold all the stocks in June 1981. We moved a large percentage of the assets to cash, about 50% of the assets to cash. The balance was in bonds that were transferred that we couldn't sell because we would have had to have taken a loss in terms of the market versus the book, plus the outlook was longer term for the year. I expected rates would decline and so we just decided to hold those. Then in September, we moved the cash to intermediate bonds in the one to five-year area, and then we moved some of that money back into cash in the Spring, and in mid-Summer we moved it back to the intermediate term bond market in the five to ten-year area.

So, it was nothing fancy in terms of the type of investments. It was just active asset allocation, and that I think is more important -- it's more important where you put your assets in terms of the category, than it is really, you know, the issue. For example, any one who has been in stocks had difficulty showing a positive rate of return. I don't care how smart you were. When the S&P was down at 11% for that period, there was hardly any way that anyone could show a positive return on stocks. I just feel -- personally my theory is that I'm not smart enough to out-guess the market. If the market isn't moving in the right direction, I'm not going to try to fight it. I'm going to get away from it. So that's the in-house philosophy we use.

Now, we were able to use that investment approach because our outside managers on the other hand were bullish on the economy and they thought -- they were buying Reagan economics, you know, and the rest of it. This gave our board an opportunity who were kind of uncomfortable to sort of say, "Well, let the outside managers pursue there, and we'll hedge ourselves." So normally we consider it very risky -- risky in a different sense, risky in the sense of missing the opportunity to be out of the stock market. Most professional investment managers would probably not go to a non-invested stock position. That is a little unorthodox. But in terms of our total overall investment strategy, we have a guideline within our board policies of saying, "We will be no more than 75% invested in common stocks, nor less than 20%." That's our range, and because the outside managers were bullish, that kept us at about a 25% equity exposure. So in essence by not having any stocks internally, I still maintained our overall investment objectives within the range of 20 to 75.

I'm still not in the stock market. I still think there is a better opportunity for a real rate of return in bonds. I think we're going to have a slow recovery -- that's my personal opinion. On the other hand, the nice thing about my job is that I can apply my personal opinion, obviously with some basis, to my day-to-day investment opportunity.

MARK NEMISER: I'm from State, County and Municipal Employees. Mr Speaker, I'm wondering if possibly the panel members couldn't address themselves, and I told them during lunch I was concerned about the apples and oranges, plums and nectarines comparison -- I had plums and nectarines for lunch, but I'm very concerned when we hear the success, or at least the amounts in California and the conditions in California that we not think in some way that that's applicable to New Jersey. I'm wondering perhaps if some of the panelists could address themselves to where they think New Jersey's pension program is today? Are there any serious deficiencies that they know about? I understand that our pension people look at their pension plan -- they probably look at ours -- I'm wondering if they could talk about where they think New Jersey's pension plan is? Do they think there are any drastic mistakes or any areas there should be an emphasis on?

SPEAKER KARCHER: Where would we like to start? Shall we start over on the right? Allan, do you want to --

MR. EMKIN: California is never on the right, Mr. Speaker.

SPEAKER KARCHER: It all depends on who you speak to.

MR. EMKIN: I don't think it is really appropriate for me at least to make some judgment on the activity of your fund. I think the analysis that was done by the first speaker was excellent, and really your fund is in pretty good shape -- it's 85% funded, which is a much higher percentage being funded than a lot of other states. I think Ken would go along with that even further. In relation to apples and oranges, I'd be happy to talk about any specific investments you're not doing that you could do, but I don't think it would be appropriate for me -- I don't feel technically qualified, nor have I done the research to criticize or comment upon your state fund.

SPEAKER KARCHER: Let me go over to the other side and ask John -- with regard to the rating system, where would our rate of return which is 8.7, where would that fit in on the general barometers of effectiveness? Where would New Jersey fall with that kind of rate of return?

MR. CHENOWETH: Well, really, you don't have the data available in your report to make a comparison between New Jersey, California, Minnesota, or any other state, because what I don't see on here is a composite rate of return, time-waited, stated.

MR. NEMISER: You may not see it there, Sir, but are you telling me that you never looked at New Jersey's pension plan, its investments, or how it was going when you made whatever judgments you were making in Minnesota?

MR. CHENOWETH: Well, I didn't come here to speak to New Jersey's pension plan per se, nor am I prepared by way of information or anything else to comment on it in terms of --

MR. NEMISER: Wouldn't you say that your experience, that is that recent experience of getting away from Minnesota and going off on your own for the most part in terms of investment, is much different from what you may generally know about New Jersey's pension plan, which is that it's been --

SPEAKER KARCHER: Mark, I don't mean to interrupt you, but this will not be part of the record unless you come up, because it won't pick you up, so you'll have an answer with no question.

MR. NEMISER: I was talking pretty loud.

SPEAKER KARCHER: Well, they tell me that as loud as you are, they will probably have a blind in the transcript as to what the question was. So, if it is not inconvenient for you -- John, do you --

MR. NEMISER: I think he heard the question.

MR. CHENOWETH: Responding to the question about the condition of the New Jersey pension plan, I think that the speaker on my right has detailed the actuarial condition of your fund. From the point of view of the actuarial condition of your fund being 85% fully funded on a 6% actuarial assumption, it is in relatively good shape on an actuarial comparative basis with other funds across the country. And from that standpoint there is nothing to criticize, and I don't want my comments to be viewed as criticism.

In terms of the investment performance of your fund, I am not criticizing the investment performance, because there is not sufficient data available to be able to make an intelligent analysis of it on a relative basis. The only way you can validly compare investment performance between states is to have the comparison that states the total rate of return time-waited. That data is not available except by category, and by category comparison in terms of rate of return earned in your fund relative to the S&P, it appears to be a satisfactory, certainly not an unsatisfactory, rate of return. This by what I can see. The problem is when you're measuring performances, to be completely fair, you've got to measure comparisons on the basis of what the investment restrictions are and there are a number of factors to go in there. Really, you're talking about an analysis, in order to be fair, that requires some sophistication.

My comments with regard to Minnesota were only to point out that two funds which operate under the same legal restrictions, where the difference then can only be management, can produce substantially different rates of return, and that if you want to do an analysis, or if you want to know where you stand, unless you have information available to you on a time-waited basis done by an independent outside evaluation firm, nobody can make a fair analysis of your fund. My point is that that data isn't here. I think that you should have that data, as well as the yield information which you currently have.

SPEAKER KARCHER: Based upon the yield, which is the 8.7 figure, what would your general impression be of where that would put us in context with regard to other public employment pension systems? Are we average, are we above average, or below average on our yield?

MR. CHENOWETH: Well, I really don't know that I'm qualified to say how you compare with the average of the country. I'm familiar with numbers, for example, in Minnesota. Our own yield for the current year ending June, 1982 -- because you have differences of time periods, and the problem is that when you're -- we've just changed our fiscal year from June to June. We used to be on a December year. That's another thing about apples and apples, you always want to make sure you're comparing the same time frames.

But the numbers that you have -- I would not say that they are, in my opinion, low on a relative basis with other funds. They appear to be within the ballpark of what one might term the median, just from what I'm familiar with. But most of the numbers that I look at are calendar year ending, and these are June periods, so it makes a little difference. If I were to take your '82, say June to June, our particular yield number with our fund will be about 15% for the current year on a yield basis, and 10.7 on a total rate of return basis. Now you don't have your '82 numbers here. Now that's our fund. You have to remember that we were fortunate this year to have been in the right position, so you're talking about comparing one of the better performing funds.

MARK NEMISER: But isn't --

SPEAKER KARCHER: Ken, before we do that -- You have a broad view of the whole country. What overall is considered average?

DR. KIRKLAND: It's always tricky making comparisons like that, but circumscribed by a whole bunch of hedges which I won't bother to go into, the yield figures for New Jersey are probably within, as we say in the business, one standard deviation for like kinds of systems. One of the problems of using yield is that it's almost as subject to variation as is the actuarial variation, and it's really influenced by the time period that you measure over it. The yield, which is the increase over the book value of the original value of the securities, by taking into account your marketing as of the time that you close it off, can vary terrifically. If you measure the worth of a New Jersey stock portfolio on June 30, it's probably a hell of a lot less than it was a week or so ago when the stock market as a whole was up. If one fund has its yield measured June 30 and another fund has its yield measured September 30, they are going to show a terrific amount of difference, not because of any management policy on the part of either of the funds -- it just happens to be a question of timing. That seems to, using something like the Becker -- A. G. Becker's Evaluation Service, not to make a plug for Becker -- they do quite well on their own without any assistance from me. But, unless there is some kind of standardized evaluation that uses the same assumptions, the same basis, and the same time period for measuring performance from one state to another, one fund to another, public funds, private funds, you could actually spend all of your time in this discussion throwing numbers back and forth at each other without getting anywhere.

If you have some experience with pension policies, you know how difficult it is just to get straight answers out of actuaries. "Is this funded?" "Well, what do you mean funded?" "Do we need to put in more money?" "Well, that depends. We have huge unfunded actuarial liabilities, but if you raise your investment assumption 6% you're overfunded and you can take some money out of the fund." What I'm saying is unless you use that kind of outsight, unless I am drastically mistaken, the Becker universe is not included in the New Jersey Division of Investment and so lacking some kind of standardized things, it would be difficult for us to sit down and look at things nationally. How do you react? In some states, the Becker thing is a source of pride, as it obviously is with John -- his fund. I know across the river in Pennsylvania, one of the things that led to this flurry of investment legislation this year was the discovery that the New Jersey Public Employees' Fund and the Teachers' Retirement Fund were in the bottom quartile of all the public funds that Becker --

MR. NEMISER: Pennsylvania?

DR. KIRKLAND: Pennsylvania, yes. So, when you sit down and discover that they are in the bottom quartile, then you're going to say, "Probably there's something there that needs attending to." I'm saying that due to the absence of that kind of systematic comparative information which we know works from state to state, it would be difficult to say anything about it, except that New Jersey has a reputation for being a well administered and well funded system.

SPEAKER KARCHER: Mark, did you have one last question -- do you have another question? I just wanted to try to get a broad spectrum of replies for you.

MR. NEMISER: What I was concerned about was not only oranges, but also didn't you perhaps -- I think all of us were impressed with the figures that you gave, that you did 300% better this year than your Minnesota counterpart, and so on. Then you threw out the figures in terms of the return that you had achieved. They were impressive, but weren't you also in an apples and oranges situation. I mean, they had been in business doing investments and got hooked into mortgages, perhaps at 5% or 6% yield back in the 50s or 60s, and you know where now many of the savings and loans have been in trouble, they are not receiving very much of a return on that, whereas you were able to jump into a pretty good market, given this was your first time out of the box by yourself.

MR. CHENOWETH: That's not true. We got a mix of the portfolio, and if you really want all the details -- we own 16% of the assets in the fund. They held 90 different company stocks. We got 16% of the stock in every issue. They have 15% in cash, we have 15% in cash, and the rest came in bonds. In other words, we got an exact replica of the same portfolio. It would be like, you know I own 16% of the total, so give me 16% of every issue. That's basically how it was distributed, so it was a meaning portfolio. So the only differences that occurred in the year were the management decisions that were made on moving that money. So, if there is any point to be learned, it is that management is a very important ingredient in investment performance, as well as the investment restrictions.

Now, we were fortunate, we made the right moves. There's no guarantee that next year we will make all the right moves again in relation. But the main point I am attempting to make is that it is important for us to be able to know where we stand relative to another institution, which means that unless you have independent, outside evaluation information, there is no way that New Jersey can really ever know how well it is doing. We had the same problem in Minnesota. They told us everything was great in Minnesota. As it turned out, the State Investment Board was in the bottom quartile.

The question of how well you're doing is relative to what, and all I'm saying is the issue is important enough to everyone that you should have, not only yield information, but that you should also have total rate of return time-waited information and participate. For example, you can buy that information from A. G. Becker, or Merrill Lynch with soft dollars just by the direct commissions off your stock transactions without it costing you a nickel. Now what's wrong with getting that information so that you have an objective basis to know how well you're doing relative to another state. Now, if there is a difference between how well you're doing, either better or worse, then the question is why? Is it because of your investment restrictions? Is it because of your asset allocation, or what? In other words, you can use it as a tool to help you concentrate on where you need to devote your efforts. It's not as though it should be misused to blame someone, or to criticize, but as a tool to effectively assist you in an oversight, or monitoring, so that you know where your weaknesses and your your strengths are. Without it I don't think you can have good, ongoing management.

DR. KIRKLAND: Let me add I think that trustees are probably under a positive duty to do just that. Although it does not apply to public funds, the ERISA standard for prudent man conduct says that you are to be measured by that sort of conduct which others, acting in a life capacity conducting an enterprise of similar character with like aims, would follow. If you're going to measure yourself against that which others in a like capacity -- that is managers of other pension funds who have enterprises of a similar character and similar aims -- then you need some kind of investment performance. That's just good management. It's no different from doing performance evaluations on any aspect of state government activity, so that you've got an information base to work from. If you say we're doing well, fine. How can we improve and follow up our strengths? If we have weaknesses, what can we do to modify them?

It seems to me that's a basic. It may be that when you get into it you will find out that you are doing terrifically -- good. But if you don't have a common basis, you're going to be lost, and that's the important first step.

DOLORES CORONA (from audience): Thank you, Mr. Speaker. I have two questions, if I may ask them both.

SPEAKER KARCHER: Would you identify yourself for us?

MS. CORONA: I'm Dolores Corona, representing the New Jersey Education Association. My first question is primarily directed to Dr. Kirkland, but certainly anyone can answer it. My second question is directed to Mr. Chenoweth.

The first question -- we have noted here today that for the most part you're talking about the successes that have occurred in the pension funds and their alternative investments. I would like to know from you, Dr. Kirkland, if there are states which have broadened their investments of pension funds into mortgages particularly, and have retreated from those programs for special reasons and what are those reasons? I'm familiar with, for example, Pennsylvania which went into investing $10 million of each of their funds in mortgages at market value, did not take into consideration the risks, and in a matter of nine months defaulted 18%. That's one of the failures. I would like to know around this nation if there are other failures that you can outline for us, as I've said, who have retreated from the program?

DR. KIRKLAND: I might mention about Pennsylvania that one of the things that we have been talking about today is investing in insured mortgages, one of the normal hedges I think any investment manager takes into consideration. Much of this is too early to tell. I suspect that one of the other Pennsylvania investments such as the teachers fund -- is heavily into Washington, DC real estate, commercial real estate. They have two or three office buildings along Pennsylvania Avenue. It is generally perceived that the commercial real estate market is sought, to say the least, and I suspect that that is a somewhat imprudent investment. A lot of these though are longer term investments and it is going to take time to tell. For the most part, I am not familiar with any failures in residential mortgage programs, primarily because no one goes into them without having insurance pools against defaults and early prepayments. It depends on who is making the individual investment what degree of risk they find acceptable. Otherwise, much of this activity has been more on a legislative level than it has been at the investment level. It takes a long time between the time the Legislature authorizes legislation and the time the pension fund actually implements it, so it may be a little early.

But there is a counterpart in Minneapolis, which is the Minneapolis Teachers' Retirement Fund, which has been in commercial real estate investments for 15 years now and has one of the better track records found in many pension funds around the country, public or private. They specialize -- I'm not sure why they had to get into this, but they specialize in buying sites for fast-food restaurants, mainly McDonalds. They buy the sites, they lease them to McDonalds Corporation, or Wendy's, or whoever it may be, and they take a long-term lease with a low coupon, plus a share of the depreciation on the property. That has provided them with a comfortable, to say the least, rate of return and seems to be working real well.

There is no guarantee that adding flexibility to an investment program will make it better, but on the other hand there is no guarantee that restrictions will keep a fund safe either. -- (Inaudible) investments in an imperfect world, like so much of the rest of the world. But it is true, I think, that over the last four or five years particularly, that ordinary conventional investment practices, whether done by public funds or private funds, or done by individuals, or done by large institutional investors, have not done very well. If you have all your money in the stock market, and simply buy to the present, you'll have very little to show for it. If you have all your money in bonds, you'll have very little to show for it. What is true is that the funds that consistently show the best investment performance, year in and year out, have active management that moves their money around and takes advantage of opportunities and looks for or makes a new market but half the investment strategies, which a number of pension funds, and not just public ones, have adopted have been ruinous. It seems to me that a pension fund that demonstrates a two, three, or four percent rate of return, or even somebody that returns eight percent in the face of ten percent inflation, has by actually devaluing the assets violated their fiduciary duty to their beneficiaries by not taking advantage of investment opportunities.

If I gave my money to a broker, you know my personal assets, and said, "Here, invest this and bring me a good rate of return on my investment," if I got 9% since last year's inflation was 12%, it is actually worth 25% less than when I gave him the money -- I'm tired of that. I think system beneficiaries have a right here. Now obviously some system beneficiaries are protected -- they have a contract, a contractual relationship and their pensions are not dependent on investment performance. But to the extent that poor investment performance means higher taxes and greater employee contributions to make up for places where the investment managers fall down, everybody has an interest in promoting better investment performance on the part of the funds.

MS. CORONA: Thank you. May I ask my second question of Mr. Chenoweth? This may very well be related to the first question which I asked. In your comments you started to list the risks that are involved and you said, and I was amused at the fact, that there is a bias about the competency of public employee trustees, since we are public employees.

You made a comment about exorbitant servicing fees -- that was one of the risks, but you stopped at that point and did not elucidate on any other risks. I thought you had just digressed from your plan. Are there other risks, and will you outline them for us please?

MR. CHENOWETH: Yes, I did digress, I do that sometimes. The risks are -- you just gave one, assuming that that information is true in Pennsylvania. The risks are, for example, one of the underwriting standards that you're using in terms of making mortgages. That's why I suggest you should use industry standards that are used by MGIC or Fannie Mae in terms of percentage of money down, appraisals, and insurance. Those are important considerations, because those are risks if you don't build them in. Those are very important because there can be examples where properties may be given mortgages on amounts greater than what their true fair market value may be, you know the basic underwriting risks that would be true of any kind of mortgage situation.

The general risk is the issue of the risk of rate in the sense of the private institution, whether it be -- well, I've see this, for example, some states have done what I term below market rate financing packages. That to me is a risk, allowing yourself to be put in the position of being pushed into or leveraged by some pressure group to provide financing at below competitive rates. I don't think it's appropriate for public funds to subsidize mortgage rates for any individual or for any institution. The risk is that you want to make sure you have an arm's length transaction and that it is competitive. If you were to draw and make a law that says you could only make your mortgages in New Jersey, that would be a serious mistake because then you have almost built in a limitation to the competition, whereas if you don't put that law on the books you may have a bias toward, or a preference for, which is appropriate. So long as the local institutions know they have to compete in a real market situation you kind of force honesty -- you force competition. I'm a firm believer in competition, which is why we use internal management and external management. I believe in that competition, and I believe in the competition of the marketplace. Now that doesn't mean that you have to do these things on a bid situation. Sometimes bidding doesn't guarantee the best return in the end. The methods we use are negotiation, but we use negotiation with a knowledge of what the rates are because of the nature of the kinds of things that we're doing. So whether they are negotiated or bid, the main thing is that they are competitive and that you are given the assurance that you are getting a fair rate of return.

Those are where the risks are, that is I think the potential risks. I have seen a few states -- Connecticut is an example, or North Carolina, where they have done below market rates. I couldn't justify that. In fact, if I were a plan member I would consider bringing legal action against any board that would enter into those kinds of deals.

MS. CORONA: May I just follow up with one question? In what you've said then, would you feel that there is enough competition if mortgages were allowed within a pension fund just for members of that pension fund and not going beyond that? How do you rate that? Is that risky?

MR. CHENOWETH: It's not risky, so what difference does it make as long as you establish standards, you know clearly established standards. The risk isn't going to be any greater once the standards are established in terms of underwriting as to whether the people who take the mortgages out are members of the fund or not members of the fund. In fact, one might argue the risk is less because public employees are less apt to face layoffs as opposed to making mortgages in Detroit, where the auto companies are involved. Now you notice I didn't say they are immune, but you know -- I'm talking nationally of course, but you know it's true, they're less apt, there's never a perfect situation. So it depends and, of course, not teachers. There are certain employee groups that are being harder hit. But it's like anything -- you know what you're comparing with. If you were to put together a fund of mortgages, I'd rather buy a pool of mortgages held by public employees than I would by steel workers or auto company workers.

MR. EMKIN: Well, John, I think there are ways to avoid that. One of the things an investor can do is shift risks and that's what investment bankers do professionally. They find someone else to assume the risk for a pension fund, whether it is an insurance company, the federal government or a state agency, and by doing that they take a little bit of a reduction in yield, but totally get rid of the risks, so the money still goes into mortgages, but the pension fund, the guarantee of someone's retirement benefits, is never put in jeopardy. So even if all of the money went to steel workers who subsequently became employed, your pension fund would not be reduced one dime in principal and, depending on who insured it, not one dime in interest payments. There are currently programs to guarantee principal and interest on a timely basis and we have been developing projects in California designed against prepayment, so that in the event of a default the investor doesn't suffer any negative consequences of prepayment, which are loss of yield and reinvestment risks. And precedence is shifting that burden from the investor to a party that is capable of absorbing it and who does that for a profit which is an insurance company, or an entity of the federal government such as the Small Business Administration, the Government National Mortgager Association or the Federal Home Owner Corporation, and that's the way to keep the money in mortgages and make it safe with no risk at all.

SPEAKER KARCHER: All of this -- we're talking about market rate on mortgages. We're not talking about any discount?

MR. EMKIN: That is correct.

SPEAKER KARCHER: Thank you. Robert?

R O B E R T L E V Y (from audience): Thank you. Mr. Speaker, I'm Robert Levy on behalf of the Mortgage Bankers Association of New Jersey. We are the people who make the mortgage loans. It seems to me that what we're really talking about here directs itself more at the initiative in terms of deriving or devising a program, rather than the basic concept of what the position of the pension funds is, because I think that's uniform in the sense that everyone is concerned about risk, everyone is concerned about market rate and security, and I think no matter how far you expand that program or diminish the program, you're going to do it within the confines of an overall context, that is it has to be safe, it has to be sound, it has to give me a certain return. The evaluation of what is safe, sound and giving you the return is really up to you. What I'm really concerned about isn't the real initiative in terms of coming up with programs that can be given to a pension whether it's in your state or another state -- to say, "Listen, here is a program. Now evaluate it from a risk standpoint from the standpoint of employees." Isn't the initiative really, and shouldn't it properly be, on industry? Shouldn't it properly be to bring to you the right program so that you can evaluate it from the prospect of safety, soundness and so on? Let us try to devise the technical aspects so that it is safe and so that it works. What I'm offering to you, Mr. Speaker, on behalf of the Mortgage Bankers Association of New Jersey, and we have not gotten to the point of devising a sophisticated program, are the services of that association, the expertise of that association and I offer these to you to show you that we will offer that initiative and incentive if you or anyone else so desires.

We obviously would be more than delighted to sit down and discuss among industry representatives some program that might work for the State of New Jersey, offer it to the pension system, which then can evaluate it in light of their own criteria. And I think that way everyone's happy. You're looking at your criteria and we're looking at ours

MR. CHENOWETH: Could I just respond to that? There's nothing wrong with the mortgage bankers getting together and trying to work out a program to offer to the State Investment Board here. We had a similar attempt in our state. I chose the other course.

Here's the problem that I see. You get all the mortgage bankers together and they work out the deal that's best for them and they all kind of mutually agree and it's like one deal. I like the competition of talking to you today and going to talk to your competitor across the street tomorrow and knowing what kind of a deal I can make independently. I like the competition of the marketplace between dealing. There's nothing wrong though, in fact I would commend your effort. Maybe I misunderstood you, but the effort of the mortgage bankers focusing on an approach to deal with the Investment Board is great. But if everything is channeled through one source, I think that leads to some -- from the point of view of the Investment Board I would rather deal independently. So I'd say this, "What kind of mortgages does the board want to make?" Maybe hire an independent consultant to advise the board. What are the alternatives in mortgages? You can make three-year, five-year renegotiated rate mortgages, you can make participating mortgages, you can make graduated payment mortgages. Let them know what the options are -- what the advantages and disadvantages are, and which one is most appropriate to their needs, and then they select which kind they want. Then, once they determine that, then it's a question of what you and your particular firm, this firm is willing to bid on that.

Now, there's more than one way to skin a cat, but I'm talking about from the institutional point of view I would prefer that, because if we have to be careful I think sometimes, even if it isn't a valid criticism but a perceived notion of what you're doing in the public marketplace of self dealing, any time you can have arm's length and that's why I like outside evaluators of performance -- anytime you can have that arm's length, or at least you always try to create distance between you and the other guy, then I think you're better off from the point of view of the mortgage bankers' credibility and the point of view of the state, and --

MR. LEVY: I am talking about arm's length completely. What I am suggesting to you is the problem we have experienced in the past -- and what I think is very good, Mr. Speaker, about this kind of program is that it offers us this ability to have an interchange, is that we are the people, when I say we I mean the mortgage bankers, those other mortgage lenders in the State I want to preclude -- the savings and loans, the commercial banks, to the extent they're in it -- the savings banks -- my colleagues are here today I know. What the problems have been from time to time, the programs must work in the marketplace and by going to consultants and by taking upon yourselves the process of trying to derive a program, what happens in many instances is we don't get the people who are in the market who are closely next to that market who know all the considerations. For example, our industry is involved heavily in bringing money into the State of New Jersey from out of state, as you are probably aware. The mortgage banker sells his loans into the secondary market. It's a critically important function for the people of New Jersey.

Now, as the prime reporter of funds, we have a very complex system that we have to deal with in terms of the secondary market, the Fannie Mae auctions -- there are a variety of investment vehicles that are outside, we do business with permanent investors in California, for example, and so on. Now all of these factors have to come into play because if that method that you derive does not meet the needs of that industry, they will not deliver those loans. So I think it is critically important not to have a "less than arm's length" situation. What I'm offering is to -- let's have some inducement to have industry sit down, as an industry and say, "Gentlemen, what do you need in order to have a program work where you can still offer safety, soundness and rate of return?" That's all.

MR. EMKIN: If I may comment -- one suggestion, one thing that did happen in California approximately a year ago was that the two biggest state funds asked every mortgage lender doing a certain amount of volume or more to come to a meeting and at that meeting there was a very, very frank discussion about what the needs were. Out of that meeting came a set of criteria which they would accept for California mortgage paper. It may not be applicable, but it had loan value ratios, locations in counties, loan sizes, etc. I would be happy to give that to you as an example. And there, anyone who meets that criteria, the only thing you are going to negotiate is yield, which is the way in my opinion the transaction should take place. It makes it much more professional, and much easier, if you're not saying, "We want it through a 60% condos as opposed to 50% condos." That's number one. Number two is, I work with 50 different funds, from $50 million to $20 billion, and every one of those funds has different criteria, different investment needs, and you cannot get one set of investment needs. If you can get one of the funds saying, "We want seven-year paper," then it is up to your industry, which is very creative, to figure out a way to deliver seven-year paper. And I know you can do it. The consumers, unfortunately, might not like seven-year calls, but that's life in the fast lane, because the investors if they want seven-year paper, they're going to get seven-year paper because if you don't produce it, Solly will.

SPEAKER KARCHER: That's an old Lakewood expression.

MR. EMKIN: No, Solly was an old friend of mine from the drug store.

SPEAKER KARCHER: Thank you, and thank you, Robert, by the way. Assemblywoman Kalik has her hand up. I'll get to her.

A S S E M B L Y W O M A N   B A R B A R A   F.   K A L I K: Thank you, I appreciate it. Not only is he familiar with New Jersey, but he has an accent from New Jersey as well.

I would just like to direct my question, Mr. Speaker -- and thank you. I have found it extremely informative this morning, and I have attended many, many seminars on pension funding, along with the National Council of State Legislatures Convention, but there is information out of this one this morning that has not come forward before, and that's what I would like to direct my question to Mr. Silliphant about, if I may. Do we in fact have the rate of return, you know waited, is that the terminology -- time-waited, do we have that for the State of New Jersey? Before you answer, because I've got to run out, I'm not even going to wait for my answer -- I assume you're going to give me the figure. I would like not only yours, but I would like the trustees of the fund, their figure as well, because I assume they are different. I would also like Becker and whomever, their figure, because I assume it's different. Findings in the Legislature have led me to believe that people come up with different figures -- and I would like both proponent and --

SPEAKER KARCHER: It's apples, oranges, bananas, prunes --

ASSEMBLYWOMAN KALIK: Exactly -- the proponents and opponents of this particular philosophy to come up with those figures. I think somewhere between all of that we will get an idea of whether this is an idea worth pursuing or not. Thank you.

SPEAKER KARCHER: For those of you who do not know Barbara, Barbara Kalik, Assemblywoman Kalik is the Chairman of the State Government Committee of the Assembly and has oversight over the pension system, and is also a member of the Appropriations Committee, so she knows whereof she speaks, and whereof she asks.

MR. SILLIPHANT: Would anyone else like to hear the answer? We'll get it to the Assemblywoman as well.

Now of course the answer to the question is yes, the information is available. The question that I had relayed to Mr. Chenoweth about his 18% return was looking at one aspect -- it's to be detailed later on, of the investment strategy that his board has established. Our Investment Council has its own set of investment strategies. The figure that we have been using, the eight plus percent as a return, is an overall return of pension funds. Material made available to you in your packets through 1981 from the Division of Investment will show that on new investments that the return is much higher. In fact, on short-term securities, the waited average effective rate of return for new investments in 1981 is 14.47%, on long-term securities 12.87%. Why we have a figure at the eight plus range is because we have some securities of many years standing which yield no more than three or four percent, and yet still remain within the portfolio. They still have to be considered since they are still income producers, and as long as they are an active part of the portfolio they're going to tend to bring down this rate of return, even though it is clear from the guidelines within which the Division of Investment is operating that it has diversified itself much more so than in the past in terms of going into new investments. The figure 14.47% I gave you for the 1981 waited average effective rate of return on short-term securities, that compares with a rate of return of only 4.89% five years before that in 1977. I think that when we're making comparisons like this -- my particular interest there is because taking a system which had 50% of its assets liquidated and converted into cash, and then put back into shorter term bond holdings, is unique in comparison certainly with our investment strategy here, but yet that may be a useful component of future investment strategy to be developed for New Jersey.

So, I think we need to look at all these things, first of all in the framework of what the investment strategy is as promulgated by the investment councils as required by law, where the case may be, and certainly in our case here with the "prudent man" rule as interpreted through a hundred plus pages of regulations. It's not a simple answer, it's a composite answer, and Assemblywoman Kalik may have some of the answers already in hand, but we certainly will provide for her everything she needs -- a full answer.

SPEAKER KARCHER: Thank you. Mr. Peterson?

RAY PETERSON (from audience): Thank you, Mr. Speaker. I'm Ray Peterson, President of the New Jersey State Federation of Teachers (AFT). I want to thank the

Speaker for this opportunity to gather all this information. As you know, since last Spring people who represent public employees have been very interested in learning as much as they could about the options with pensions. The yield, of course, is very important, but of more importance to the members of the fund is the safety principal with risk. Last Spring a proposal was made that we invest in mortgages. Now as I understand it, the State of Hawaii is the state with the most experience in pension funds going to private mortgages. I'm wondering if there is someone who can tell us more information about the experience of the State of Hawaii.

As I understand it, the bulk of our funds now are in corporate bonds, and this would represent a substantial shift in pension fund investment policy. Dr. Kirkland would probably be the person with the most information on that, I believe.

DR. KIRKLAND: Let me preface what I say about Hawaii by pointing out that Hawaii has a lot of unique components which don't always make it comparable to the experience of other states.

Because there are some things that are politically feasible in Hawaii, their pension fund is not comparable in other ways. First of all, Hawaii has a state government -- the entire State of Hawaii consists of four local governments. There are no townships, no villages, there are only four counties, no municipalities. There is a single statewide unified school district. Every public employee within the state borders of Hawaii is a member of the Hawaii Public Employees' Retirement System. There is no special treatment -- no special identification.

There is something to be said I suppose for becoming a state late in the game. You don't have to have a lot of things encrusted in tradition, so that the Hawaii Public Employees' Retirement System covers everybody in the state. That being said, what Hawaii does do is, they have made mortgage loans to their members directly. Unlike some other states, the pension system itself actually makes the loans directly to the members. Rather than going to a savings and loan or a bank, the public employee in Hawaii who wants a mortgage applies directly to the pension system. The cost of that, you know the cost associated with having someone around to take the applications and do the servicing of the mortgage, collecting payments, and so forth, those costs are not paid out of the pension system. They are paid by separate state appropriation so that the system doesn't have to bear the costs of the mortgage fees.

About 35% of the system's assets are in mortgage loans made to either retired or currently active public employees in Hawaii. Those have, on average, produced a market or better rate of return for the system. Overall, the rate of return is probably not very good because they have been making mortgage loans ever since statehood, so some of those mortgage loans that the system is holding are fairly low yielding by now.

There is a conscious decision on the part of the system trustees to have them available because of the unique circumstances of Hawaii, because it is out there in the ocean so far. I don't think many people realize it, but Honolulu is closer to Tokyo than it is to most of the large cities of the United States. Because it is so far away it is difficult for them to be participants in the national financial market, and the Hawaii Public Employees' Retirement Fund is one of the very few large sources of capital within the state.

All that being said, their perception in Hawaii is that this program works very well. It meets their immediate needs and produces rate of return comparable to other parts of their asset allocation and some years, because mortgage rates fluctuate up and down, they are pretty much in the same rate as they are nationally, but they have in some cases a better market rate of return on the loans that they made.

So far as I know, California is the only other state which has passed enabling legislation which would allow the systems to make loans directly to members --

MR. EMKIN: And California has not funded one loan in that program.

DR. KIRKLAND: Now, there are some programs whereby state employees got first priority on mortgage loans, and that's what you were asking about indirectly, Ms. Corona, but what those have done was to go through an intermediary like MGIC or somebody else, where they said, "Here is the investment criteria that we want for mortgages. It's got to be," whatever the list may be, single-family, owner-occupied, 80% loan devalue ratio, etc., etc., and on down the line. To the extent that public employees meet this criteria, they will get first preference over non-public employees who also meet the same criteria. In the case of a Kansas program that went out like that, they said for the first 60 days public employees get preference over private employees under this particular certificate, and then its open to everybody. Those have been the kinds of things that other states have done.

MR. PETERSON: Dr. Kirkland, did you say that in the Hawaii plan the fund is open only to members, that loans were available only to members of the pension fund?

DR. KIRKLAND: Yes.

MR. PETERSON: And what about the safety of those loans?

DR. KIRKLAND: Well, they insure them to the extent that they can. They insure them through private mortgage insurance corporations against default.

MR. PETERSON: Thank you.

SPEAKER KARCHER: That is central to all successful mortgages, that they are insured?

DR. KIRKLAND: Absolutely.

SPEAKER KARCHER: Would it be true to say that where there has been, in the last answer, a large -- that where there has been a record of lack of success, that is where they took the risk without the insurance?

DR. KIRKLAND: I think that's the key.

SPEAKER KARCHER: Al, do you have a question?

A L G R I F F I T H (from the audience): Mr. Speaker and members of the panel, I am Al Griffith from the New Jersey Bankers' Association. We'd like to thank the Speaker for the initiative of today's session, and the panelists for the very excellent information that has been presented to us.

A comment that I might have, in those states that tend to target and tend to try in their investment policy to keep pension funds and other state funds as much as within the state border as is possible, and possibly therefore keeping that money in the state perhaps at what might be a lower than market rate, are you aware in any of those states that might do that what the spin-off effect might be of the investment within the state? I'm thinking as an example on the small business loan side that was mentioned in California. To what degree that loan, which may have been perhaps a lower than market rate loan, might have generated employment within that state, and in turn would have generated additional tax revenues, sales tax revenues, and so forth. There is a multiplier effect to money, and when you spend -- or the state loses a million dollars or a billion dollars to other states, that has to adversely impact on the economy of the state. So I'm just wondering, have you been able to see that perhaps the market rate was either equaled or even exceeded where in a given state the investment policy was to give a little more of an advantage to those within the state?

SPEAKER KARCHER: I know that California, in part of the report that was issued, indicated what the multiplier effect was in regard to local taxes, etc., etc., so I know --

MR. EMKIN: The multiplier effect for SBA has been fairly well documented. For every $15,000 in loan value there is the creation of one new job, for the retention of one job that would have left for lack of capital. That is SBA's number, I didn't create the number. But we in the Pension Investment Unit, and not one of the funds that we are working with, will make a below market rate investment, and they end up on the bid side, not the aft side, which means that if they buy a pool of SBA paper it is marked to market the day of the transaction. So they are getting discounted paper. Their underwriting criteria specifically say they will not pay a premium without call protection and, therefore, they were getting market instruments on the day of the transaction which were fully insured by the good faith and credit of the U.S. Mint, and they are a liquid investment.

The difference in California, as opposed to other states, and this is also true in Kansas to the best of my knowledge, is the willingness of the funds to go along and to go fixed rate. Those are two specific needs that small businesses have that the fund is uniquely qualified to do. People who might not go into a bank today for a SBA loan because all you are writing is variables, might start coming if they knew they could get two plus prime fixed, or three plus prime, depending upon the deal. So if you match the needs of the fund which are long-range with the needs of small businesses which are long-range, with the insurance provided by the federal government it can be a very attractive program to all the parties. Does that answer your question, sir?

MR. GRIFFITH: Thank you very much.

SPEAKER KARCHER: If I can exercise the prerogative of the chair for a moment, it's one of those aspects that is truly given short shrifts in all the public discussions we've seen in New Jersey so far, and it's the area that I think personally is the most attractive and I think personally, and I address this to the people here representing public employees, probably the most fascinating aspect of the multiplier effect is this, and as I say it has gotten very short shrift in the newspapers or in any coverage it has gotten so far.

Take hypothetically the $100,000 number. If that $100,000 is invested in New Jersey in real estate construction, new construction in the State of New Jersey, that $100,000 worth of improvements doesn't just give you the rate of return -- say the mortgage is at 15% or 14% or whatever the market is, but on top of that our average real estate tax on improvements in New Jersey across the board is approximately 3%, so that $100,000 immediately yields $3,000 worth of real estate taxes, and that will be in perpetuity and, of course, growing. So you have that benefit from increased real estate taxation, which of course goes back to pay the teachers and to pay the policemen, and to pay the firemen, etc. So you have that extra 3% boost on a permanent taxation and from the real estate tax.

In the year of construction the average ratio, if you just break it down very simplistically and say 50% of every house constructed goes into materials and 50% into labor -- those people who are getting that 50%, that $50,000 worth of wages, will pay state income tax on them. The other 50% component of materials will have sales tax paid on it. There is also some portion of sales tax in the manufacturing process, but beyond that those people who manufacture will be paying corporate taxes, corporate income taxes, etc. So that for the $100,000 invested you not only get your market rate of return going back to the pension fund, but you have a component of perhaps five to six percent additional tax revenues that come into the state and local coffers that go to pay public employees. That is the most neglected aspect of investment or the use of pension funds within a state's economy, but it is probably the most exciting and dynamic aspect and the thing that perhaps public employees should be most enthusiastic about.

Having said that, I see all these hands go up --

DR. KIRKLAND: Mr. Speaker, let me add something to that. I do detect the suggestion in Mr. Griffith's question that, given the various benefits, he might be inclined to look more favorably upon investments in-state. No matter how many benefits there are, if any of those things involve cutting the rate of return back to the public employees, then it's not worth discussing. It seems to me that the only way we have to do any of these kinds of programs is you have to exclude from discussion before you ever start anything that involves any concession on the rate of return back to the retirement system. You can't give more favorable rates in-state than out-state. Even if you can promote construction in New Jersey but if you really found out that you could actually make -- I'm not talking about ten or fifteen basis points, but if you found out that with the same amount of money you could invest it, you know God knows where, maybe in Swedish corporate bonds or something, and make 3% more here --

SPEAKER KARCHER: You can't --

DR. KIRKLAND: -- a lot of people do, Volvo is a terrific investment, then you have a positive obligation to send that money to Sweden, no matter what it might do to the economic benefit.

Indeed, in some cases -- I know there is a bunch of target investment legislation in Michigan. I would think on the whole, you know if I were in the State of Michigan's pension fund, I'm not sure I would want my pension harnessed to the economic future of Michigan because that seems to be here. Maybe you're all backing the wrong horse. In that particular one, maybe you would be better off taking the State of Michigan's Public Employees' Pension Fund and putting it in Datsun stock or something of that nature. They'd have a better chance of surviving over the next 20 years. You know any of these things -- when you look at investment opportunities, you look at one's sort of niches and cracks. You don't commit yourself all to in-state; you don't commit yourself all to out-state.

MR. CHENOWETH: I wonder if I could make a suggestion to the bankers here as to how you can offer the consumer in New Jersey a lower rate on their mortgage without lowering the rate to the public employee. If the average banker is charging a half a point for servicing, you could lower the servicing fee a quarter of a point, because the cost of servicing is not a quarter of a point. That could be passed on to the consumer. Therefore, the rate on the package is a quarter of a percent less and the employee doesn't take any reduction. There are some ways where the bankers can cut off their overhead costs, so long as they know they have a place to park the loans that they service, because you've got the overhead of the institutions and the personnel sitting there underutilized right now; to go service another 10,000 loans probably won't add to your overhead.

So if you look at it creatively like that, you're able to give up your normal profit margin so that there is a way for the consumer, the public employee and the banks to prosper without sacrificing yield. Those are some of the kinds of things that we're doing too.

SPEAKER KARCHER: Mr. Rosenthal would you like to comment on this?

STEVE ROSENTHAL (from audience): I'm Steve Rosenthal from the Communication Workers of America. We represent a lot of the State workers who are so safe and sound and don't get laid off.

My question is to underline something that Dee and Ray Peterson touched on. I guess it's to you, Dr. Kirkland. Is is possible to provide mortgages out of pension money only for members of the system below the prevailing market rate with affordable housing, and is it being done anywhere in the country? We talked about Hawaii and we talked about California. Is it being done anywhere where only members of the system -- the mortgages are made available only to those members of the system?

DR. KIRKLAND: To make loans only to public employees at below market rates, just the pension system, is not possible. The employees benefit on one hand, and take it out of their pockets on the other hand. I don't think it is compatible with the trustees' duties. There are ways in which the pension funds can utilize their leverage to do specific kinds of things. We were talking about an example last night at dinner where, if you will bear with me for a minute and follow a financial transaction -- think of, for example multi-family housing, apartment houses for instance. You could have an apartment house construction starting whereby the pension fund would provide the construction loan at the regular market rate, which is running about two points over prime now, have a state or local Housing Finance Agency have a ten-year mortgage at a below market rate, because the mortgage finance is being done through the issuance of a bond, so that in the initial stages of the apartment development, which is when the developer always has more expenses than he has income, there is a below market rate of financing which makes it feasible for him to do this, so that the first ten years what the pension fund does is finance the construction of the project and then makes a forward commitment to take over the mortgage after the bond is taken off in ten years. At that point the pension fund takes over, except at below market rate of return it takes say half the equity in the apartment house as compensation for keeping it at a below market rate of return. What you've done in that case is encourage construction of affordable housing, with the concession being made not by the pension fund, but by the Housing Finance Agency, whose function it is to provide below market rate financing through the use of tax-exempt paper. The problem is that requires the cooperation of a number of individuals -- it requires the Housing Finance Agency, the developer, and a lot of people to work together in, sort of a creative way.

Pension funds have been reluctant to do this in the past, not because it is incompatible with their duties, not because it is not a good investment for them, but because it is a lot easier, instead of going through all that round of negotiations and discussions, to get on the phone and tell your broker to add another hundred thousand shares of whatever it is you might be interested in buying.

MR. EMKIN: I apologize for having left momentarily. On that particular structuring, the investment that the fund was buying ten years in the future was rated "AA" by S&P, and they were not buying an unknown quantity. They were buying a rated investment by S&P, which basically means it meets their underwriting criteria for safety, and a very high level of safety, which is the same standard that most people use in their bonds, except if they go lower they'll go to "B" bonds. That's a very high investment grade quality. They put the money on the street in Minnesota below 12% for the first five years, and that's very impressive.

MR. CHENOWETH: And the idea that Allan is talking about, using apartments, which he brought up last night, is so good that I'm going to invite him to Minnesota, and I vote that we put this into effect even before California does it. It's like shooting fish in a barrel.

SPEAKER KARCHER: Mark, do you have another question? Go on.

MR. NEMISER: Very simply, Mr. Speaker, I was wondering if there isn't some way to quantify that multiplier effect that you talked about, because we keep getting whipped by that. You know we talk about how it creates jobs, creates taxes, and every other thing. It seems to me there ought to be some way, and perhaps this kind of a forum can produce someone who can quantify that, so that we can actually look and see if there isn't a way to produce a better mortgage or a better situation in terms of a return.

MR. EMKIN: Mr. Speaker, excuse me. We hired an outside private consulting firm who are experts in quantifying input/output models in a giant computer, and they threw all of these variables in and out spouted the numbers. It's mystical to me how it happens. But you have Princeton University, which is within an hour of here. They have statisticians there that can plug the numbers in and out will come the net effect, positive or negative, of any particular investment. Our scientists, and they are scientists, came up with for every dollar invested in California housing, the state in year one gets .16 cents back, not in the form of a pension, but in the form of taxes and increased revenues. That's in year one in California with a different tax structure. They could use the same type of model here in New Jersey and give you that same information, and you could have both sides, both proponents and opponents of the project, pick the consulting firm and I think that's the fairest way to do it, or the professors or the university, because it can all be broken down into statistics and its silly not to do that. It's a minor expense. Does that answer your question?

MR. NEMISER: Partially. I was thinking about quantifying it even further in terms of being able to apply it to a rate, as to what that rate return would then be.

MR. EMKIN: We in looking at the input/output model were just looking at the secondary impacts. The primary impact meaning to the pension fund and ratings of market -- we never at any time talked about anything but market rate investments, and so that was never even considered. Only the secondary impacts of in-state investment were looked at that say, not only was the state going to get a market rate of return which is fully insured, but here as a secondary impact for every dollar that is spent .16 cents in year one comes back in revenues.

Now there are costs too, but you have to calculate that also.

SPEAKER KARCHER: Another question?

J O H N K E L L Y (from audience): My name is John Kelly. I'm the staff representative from Local #1033 of the Communication Workers of America.

In terms of international investment, the gentleman from Minnesota spoke of the effect of investing in union versus nonunion labor, etc., and I was looking at it from another vantage point. If so much money is leaving the United States economy in terms of money being spent on Arab oil, possibly pension funds have been considering any states that could be used as seed capital toward bringing foreign investments, in terms of joint ventures -- has anyone done any studies, etc.?

MR. CHENOWETH: I'm not aware of any public funds as of yet that are doing international investing. I think that we're right on the verge of that. We had a bill in our own state that would have allowed us to do that last year; however, I think the danger of getting into foreign investing is -- I'm not opposed to it, but it's like you should get your domestic house in order first. If you have undue restrictions on your investments in common stocks on a domestic corporate basis, my argument is you should get that cleaned up first and do the job there.

In terms of your long-term strategy, you should be prepared to move in that direction. At the present time, I am not aware of any funds that have. In terms of putting money into a seed capital fund, if a foreign entity, for example, wanted to locate a plant in the United States, depending on the investment restrictions that existed in a given state, or whether it was a domestic corporation, there are opportunities for pension funds either to do private placements for, let's say, bonds for plant and equipment construction, or through a private negotiation to do a shelf registration. There are a number of flexible ways for institutions to put deals together. The question is the specific state laws that regulate and the specific willingness of a particular entity to do it. I don't think we can generalize across the board on a subject that is going to vary by jurisdiction.

SPEAKER KARCHER: We have some -- I'm sorry. Mr. Emkin also has information about foreign investment.

MR. EMKIN: We have done a computer analysis to look at where the California funds are invested. Of the top 25 funds all having assets of more than $100 million, every single one of those funds in California has investments out of the geographical United States -- out of the country, the largest being the City of Sacramento, which has 11% of their portfolio in foreign debt. One of the funds, the Los Angeles Department of Water and Power has 7% in foreign debt, and not one dime in housing, whether it be California housing or New Jersey housing.

We did the analysis just so that we could look at one fund versus another fund and where they are putting the money. One fund was shown to be 75% into cash.

MR. CHENOWETH: On foreign debt, that includes Canada. For example, we have foreign debt in the sense that we own Canadian securities, but I was referring more to foreign stocks that are traded outside the United States, to the extent that a stock is traded on the New York Exchange in the ADRs or American denominated receipts, then we own interest in foreign securities, so long as they are traded for a part of the U.S. Exchange. But my preliminary -- you will find funds I am not aware of that actively trade on the Japanese Exchange in Japanese securities or others. The ownership of foreign debt, which would include international agencies, in Canadian securities is quite common, and I would submit that that I think is a positive thing in terms of U.S. and Canadian relations. For example, Minnesota borders Canada. We invest in Manitoba. If the rates across the border in Manitoba are better -- I'll give you a good example. We can buy Ford Motor Corporation of Canada short-term debt and get 100 to 200 basis points more than we can by the domestic Ford Motor Company. Now you explain that to me. Therefore, that shows up as a foreign security. I'm proud to own that kind of foreign security. So that if California institutions are doing that, that's to their credit. You know, getting back to apples and apples, not all that is bad.

MR. KELLY: First of all to you, sir, was this in Canadian dollars or ADRs?

MR. CHENOWETH: We do everything in ADRs, we hedge all of our investments. If we buy -- that's a good question -- that's a very sophisticated question in fact. Because you have to be careful with foreign investments, then you get into the monetary markets and that's a risk element of owning foreign stocks, which is why we limit ourselves to the U.S. markets.

MR. KELLY: Which is why the Southwest is worried about Mexico. But the point I was really trying to make is that the fact that we're looking at secondary and tertiary development of money within the State is that if we can try to bring foreign investment in in terms of -- this State has a large industrial base, if we can try to bring foreign investment in with its pensions looking toward seed capital, whatever kind of restrictions the actuaries have, whether the prudent man theory or whatever, if we can develop this we can bring in jobs and we can help the public sector, the individuals whose money is invested, as well as the private sector, those people who are, you know, down the street out of a job.

MR. CHENOWETH: For the current year, according to the Department of Commerce, foreign investment in the United States is greater than U.S. investment in the rest of the world. In other words, more dollars came into the U.S. for investment from abroad than left the U.S. and went into the rest of the world.

SPEAKER KARCHER: Let me ask a question, sort of by way of perhaps a partial summary. I am going to ask all the panelists this. Hypothetically, if you were retained today by the State of New Jersey, and we're not going to discriminate between the Executive and Legislative Branches or anything else, but if you were retained today as a consultant for the State of New Jersey, what would be the three suggestions you would give for targeted investments and in what priority? What kind of things should we be looking at over and above, or in the category of special, or targeted, or development investments? Allan? You don't have to be very specific.

MR. EMKIN: Housing, small business and ventures, in that order, and they vary in the degree of complexity, the easiest being housing because there are so many opportunities, guaranteed opportunities. There are fewer currently, although they are being developed in small business. And ventures -- I would go in a very small percentage, but have such a high possibility of return.

SPEAKER KARCHER: Okay.

DR. KIRKLAND: If I were to make a list, it would probably be angled down to the degree that housing is easiest to do, that is one reason it is much more widespread than other forms of targeting. Small business offers some interesting opportunities and states clearly have found -- advantage of being insured. Venture capital is risky. The only way to hedge against that kind of investment is to commit a very small percentage of assets, ½%, ¼%, but even ½% of $80 billion is a lot of money to a small start-up firm. And the advantage of venture capital investing is that when the venture capital partnership closes out and a half a dozen firms that it has financed either have gone public or gone bankrupt, which is the usual outcome for small businesses, there's always a chance one of those firms is going to be Appa Computer, or Gentec, or Intel or somebody else. And if you happened to pick up a third of the equity in Appa Computers for a couple hundred thousand dollars five years ago, you get a fairly nice return on your investment, and the rate of appreciation there will offset the fact that you also invested in a couple of bankrupt companies and the risk, which is of course that the entire venture capital partnership will go bluey and you will lose everything you put into it, is hedged by keeping the investment small, so that its overall impact on your total rate of return is pretty tiny.

So I would say that those are probably the three areas that bear the most investigation. The fourth one that has had a lot of play recently from public and private funds, and one more for investment possibilities there than anything great out here, is investment in oil and gas wells. That's an instate investment in Colorado; it's probably not an instate investment in New Jersey. But that's the fourth area which has -- and again can be done in a low risk sort of way because there are companies, not the least of which is one that my fellow alumni neighbor in Denver is president of, which have turned into one of the largest small businesses in the United States by selling interest in producing wells in terms of raising capital to drill new wells. This particular fund I'm pleased with because I happened to go to school with the fellow who runs the company.

Last year, the company had the highest return on assets and highest rate of appreciation of stock than any company in America. The stock went up 50% in one year; it's also gone down 40% since the energy market softened. So it's a risky investment, but yet one we are considering.

SPEAKER KARCHER: I'm going to skip over Gerry. John?

MR. CHENOWETH: Well, I guess I agree with the other members of the panel that, number one, my choice would be, when you say housing I'd say mortgages. The debt, and I would say non-participating mortgages, in the sense of not participating in the equity, but straight debt mortgages and I would say specifically not 30-year fixed rate mortgages. I'd be talking about three-year, five-year or graduated payment or, what I really like is -- there's a new one called the GEM, which is the mortgage where you have a 4% or 3% increase each year in the rate the consumer pays in the mortgage payment, so what you do is you take a 30-year mortgage and it is amortized down to a payoff in about 12 years on a 4% basis. I think that's the best for the consumer because he pays less interest in the long run. It's best for the fund because they have a hedge against inflation. So, it's not just mortgages, but the types of mortgages in terms of limiting the risk to the institution. That would be my number one choice.

Number two choice would probably be venture capital. I would submit that venture capital is not the most risky. Based on the studies that have been done, the total rate of return earned on dollars invested there over the last ten years has been more than double what the S&P has been. I would submit that it is more risky to invest in smokestack America than it is in emerging new technology companies. Yet I would also agree if you only wanted to put a small amount of your money into that. But in terms of getting "banged for the buck," you'll get more "bang for the buck" in terms of job creation and economic stimulation and rate of return on capital there than you will anywhere else.

The third category would probably be -- and I'll classify this, you can throw in the SBA type loans where you've got an intermediary in terms of determination of credit and guaranteed by the federal government so your risk is low, and/or real estate on a participatory basis with taxable partners. I think that direct ownership of real estate by pension funds in most cases is not maximizing return, if they own it directly themselves, because what's happening is the tax advantages of real estate are being lost. So I think with some innovative and creative partnerships, between the public fund and the private sector partners who are taxable, to trade tax advantages to them and the cash flow to the public funds where you could tie in investments in real estate that could be, for example, apartments, where I think there is a shortage, and which I believe from all economic indications are probably going to do better than other types of real estate, you could meet the needs of housing and at the same time provide yourself with attractive yields, as opposed to more office space or more shopping centers which appear to be in abundance.

SPEAKER KARCHER: One last question before we conclude -- and that we will do in reverse order. It's something we haven't touched upon yet, and I think something that would probably be of interest, especially to those representatives of the public employees here today, all of whom in their policies have indicated a great sensitivity to social issues, environmental issues, etc. Do you, in your experience, have any mechanism for screening or monitoring investments so that you do not wind up having your public employees investing in "Love Canal," Arab oil interests, etc., which is a common instance, or in South Africa -- do you maintain a list of the "dirty dozen" or something like that which are prohibited or that you exclude because of their disregard of the environment or disregard of social concerns?

MR. CHENOWETH: That's a very difficult question. To my knowledge, no one has made a successful effort at creating a standard by which to apply to companies a basis of review on their social or environmental practices. It is one that many institutions have attempted, and it is one that I submit cannot be done by any single institution because of the staff time and what is involved. The only way that can be done is by some special entity with a lot of resources to do it, and then you would have to argue a lot over what the standards were going to be.

To the extent that the Sullivan Principles have been adopted or established as a standard that a number of corporations have used as a standard for making their South African investments, we adhere to and subscribe to the use of the Sullivan Principles in terms of racial practices used by American companies in investments in South Africa. Most of the responsible corporations in this country are subscribers to that. A few of them are not. That is one way to deal with the South African question.

In terms of a day-to-day application of principle, we reserve the right to veto any investment transaction by our outside advisers and we have. For example, there were labor practices with Stevens; we would not buy their stock. We have sold our Halliburton stock, that's an offshore well driller, because of their very, very poor labor practices. In other words, when we become familiar with abuses that we think are obvious, without having a standard, you know on a one-by-one basis, we will direct our investment council to dispose of those investments, or otherwise.

To adopt a written standard, I submit is difficult. We have made an attempt and every time we have made an attempt our board has gotten so uncomfortable because after you start crossing -- you know, it's a very difficult thing to do. I just don't know what the answer is. To the extent that we're sensitive to it, to the extent that we selectively utilize it based on individual criteria, yes, we do.

DR. KIRKLAND: I'd have to agree with John. To my knowledge, no fund successfully has a clearly established set of criteria that enables them to pick ahead of time. There are case-by-case kinds of things I could mention like Halliburton or Stevens, where other funds have decided to disinvest in a particular stock or avoid a particular type of investment because something has been called to their attention. Among institutional investors in the country, probably university endowment funds have been the ones that have been the most sensitive to that because of the pressures put on them by students and alumni.

In general, the only practice that seems to work very well has been just kind of looking at things from time to time. I know that Connecticut has just passed legislation which requires the state pension fund to disinvest in any company that does business in South Africa and doesn't adhere to the Sullivan Principles. As John said, that is not a very big group of companies. It's more common that -- what it may take to do anything like that is just to develop some sensitivity in trustees to those kinds of issues and then trust that they will make the right decisions.

I know, for example, that the Industrial Union Department of the AFL-CIO has now for over a year been running educational programs for union officials, particularly those who serve as trustees, especially the ones who are on Taft-Hartley or other jointly administered kinds of pension funds, to be aware of these kinds of things and to look at investments and suggest that those things ought to be taken into account. You can see as individual cases come up -- for example, the Montana Public Employees' Association decided to get rid of their Annaconda stock after Annaconda pulled out and left a hole in the ground and 10,000 unemployed miners up in Montana. Or the Airline Pilots' Association Fund decided to let go of their Graham stock, since Graham's main contribution to the airline industry was creating unemployed pilots. So you can see where individual cases are being fairly obvious it is probably not in the employees' interest to be holding certain kinds of stock and certain kinds of investments. But it is difficult in advance to formulate a rule that will guide you exactly, or will guide the outside person in the case of an outside manager, and give them a clear signal whether they should or shouldn't buy a particular thing. It seems to me more useful for trustees to be sensitive to those kinds of issues, to be aware of them, and to look at things on a case-by-case basis.

SPEAKER KARCHER: Al, before you answer that -- this morning when you gave us the statistics -- California is truly the largest stockholder or second largest stockholder in the number of companies -- since you really have an opportunity to influence policy, do you exercise through the pension board the proxy votes so that you can dictate policy?

MR. EMKIN: The answer is yes. As a matter of fact, the most effective way that was utilized was during the matter of the Marathon Oil battle when where they put their shares was going to determine the outcome of who got Marathon Oil, and they got $10 a share more because they chose to be active as a shareholder and they were holding about half a million shares. So that was a net gain of $5 million to the fund, because they actively participated as a shareholder. That's strictly from a corporate point of view; I'm not talking about from a social point of view.

The answer is yes. Both the State Teachers' Retirement System and the Public Employees' Retirement System have guidelines. The guidelines basically say that they can take into account non-economic factors which they define. I will leave a copy of these guidelines for your consideration and for the fund's consideration. They have been active both in a proxy area in initiating a proxy battle and in voting their shares for other people, and in the last year that they solicited in the, I guess with Seafirst Bank in Washington, they solicited proxies to get someone on the board. Now the two big funds have put together their own Board Selection Committee and they will be actively trying to get board representation for the California funds in the major corporations. The reason for that is they want their interests as stockholders protected and they feel consistent that that is the non-economic factors, but preeminent of course is the benefit of the fund and the safety of the fund, as well as the yield of the fund.

SPEAKER KARCHER: I think we have come to the conclusion of this day. I thank primarily and first off the panelists who have just been absolutely excellent. I could not, no matter what I say, exaggerate how appreciative I am as the Speaker that you have come and contributed today in such large measure to the education of all of us, and the edification of all of us. As Barbara Kalik said, we have probably all attended one or two seminars on the subject, but nothing was quite as comprehensive or informative as today was.

I thank secondly those people who have come to participate. I hope it has been fruitful for you. I hope that some of your questions have been answered. I hope, also, that we have been given a great deal to think about with regard to what we are doing here in New Jersey.

I am harking back to the opening comments today and may be out of character, and I hope you won't consider it out of character, but to agree once again with the Governor and what the Governor said in his inaugural address was that New Jersey has to look to itself. We have to rely upon our own resources. I, for one, concur with that remark 100%. I would just suggest and submit that perhaps the greatest asset, the greatest national resource that we have in this State -- the resource available to us, is that $8 billion worth of pension money. If we can find an intelligent and comprehensive method to utilize that, something that will enjoy the backing of a consensus of opinion from the people who are most closely affected -- most immediately affected, the public employees -- if we can harness that and can direct and channel it to ways in which we can help build our State, I think we will have accomplished a great deal and it will be something to our credit, and at the same time protect, and perhaps enhance, the security and stability of the public employees of this State.

Let me conclude by telling you that the transcript of this is going to be available. If anybody would like a copy, they can contact my office and we'll make sure that you get it. We, of course, will forward copies on to the Investment Council and to the Governor's Office, etc.

With that, let me once again thank you for the participants and for the audience.

(HEARING CONCLUDED)

DIVISION OF INVESTMENT
DEPARTMENT OF THE TREASURY
STATE OF NEW JERSEY

FIVE YEAR SUMMARY

	Fiscal Year Ended June 30					
	1977	1978	1979	1980	1981	
			$ Millions			
FUNDS UNDER THE SUPERVISION OF THE STATE INVESTMENT COUNCIL:						
Book Value at Year End:						
Pension Funds	$ 4,425	$ 4,968	$ 5,575	$ 6,215	$ 6,959	
All Funds	5,448	5,974	6,686	7,882	8,300	
Book Value of All Investments at Year End by Category (1):						
U.S. Government, Agencies and Municipals	$ 495	$ 368	$ 1,261	$ 2,013	$ 1,802	
Commercial Paper and Certificates of Deposit	471	562	902	857	810	
Corporate and Other Bonds	3,266	3,547	3,087	3,110	3,254	
Mortgages and Real Estate	224	321	430	721	1,017	
Common and Preferred Stocks	747	919	1,006	1,181	1,417	
Common Pension Fund C	95	64	—	—	—	
Cash Management Fund	150	193	—	—	—	
	$ 5,448	$ 5,974	$ 6,686	$ 7,882	$ 8,300	
Net Investment Earnings:						
Pension Funds	$ 257	$ 294	$ 354	$ 416	$ 491	
All Funds	290	341	421	539	609	
Weighted Average Effective Rate of Return:						
Pension Funds	6.28%	6.61%	7.09%	7.52%	8.17%	
All Funds	6.08%	6.68%	7.48%	8.06%	9.29%	
Weighted Average Effective Rate of Return for New Investment:						
Short Term Securities	4.89%	6.31%	9.14%	11.97%	14.47%	
Long Term Securities	8.14%	8.15%	9.05%	10.78%	12.87%	
Total Rate of Return (2):						
Common Pension Fund A	(3.5)%	(1.1)%	14.1%	17.3%	21.4%	Equities
Common Pension Fund B	14.2%	0.6%	5.9%	(2.4)%	(13.2)%	Bonds
Supplemental Annuity Collective Trust	(1.2)%	0.0%	15.7%	13.0%	20.1%	
Salomon Brothers' Bond Index	15.1%	(0.8)%	7.2%	(2.4)%	(13.0)%	
S&P's 500	0.4%	0.2%	13.6%	17.3%	20.6%	
S&P's 400	(1.0)%	0.2%	13.7%	19.0%	20.3%	
Dow Jones Industrials	(4.4)%	(5.4)%	9.1%	8.8%	19.3%	
N.Y.S.E. Composite	3.1%	2.1%	14.1%	17.5%	21.7%	
Solomon Brothers' Index of GNMA mortgage pass through certificates	—	—	9.3%	3.3%	(12.0)%	
State of New Jersey Cash Management Fund:						
Book Value of Units of Participation:						
All Participants	$ 149	$ 193	$ 672	$ 1,485	$ 999	
Other than State Participants	—	$ 8	$ 49	$ 475	$ 156	
Average Daily Rate of Return:						
State Participants	—	6.21%	9.07%	11.63%	12.03%	
Other than State Participants	—	—	8.88%	11.44%	11.76%	
Number of Funds Under the Supervision of the State Investment Council	56	65	73	74	76	
Total Number of Transactions	11,953	13,140	12,040	13,186	13,858	
INVESTMENTS FOR NEW JERSEY STATE AUTHORITIES AND AGENCIES:						
Book Value at Year End	$ 385	$ 450	$ 420	$ 403	$ 541	
Number of Funds in the Authorities and Agencies Group at Year End	76	94	125	138	166	
AGGREGATE TOTALS FOR THE INVESTMENT DIVISION (INCLUDING AUTHORITIES AND AGENCIES)						
Book Value of All Investments at Year End	$ 5,833	$ 6,424	$ 7,106	$ 8,285	$ 8,841	
Total Number of Funds	132	159	198	212	242	
Total Value of Transactions	$38,612	$36,553	$32,547	$33,073	$33,142	

1. In fiscal 1979 the Division restated its method of categorizing various classes of investments. In fiscal 1978 and prior years, the aggregate book value of the units of Common Pension Funds A and B were included in "Common and Preferred stocks" and "Corporate and Other Bonds", respectively, and the book value of units in Common Pension Fund C and the Cash Management Fund were shown separately. In fiscal 1979 and subsequent years the holdings of the Common Funds were shown in their respective categories in conformance with the presentation in Note D to the attached financial statements.
2. Includes income and changes in market prices for securities held by the funds.

INVESTMENT POLICY
FOR PUBLIC EMPLOYEE PENSION FUNDS:
AN OVERVIEW OF RECENT CHANGES

Legislative Finance Paper #28
September 1982

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The assets of state and local public employee pension plans are increasing at unprecedented rates. In fiscal 1980, for example, net receipts of state-administered plans (after subtracting benefits and withdrawals) were $18.3 billion, equal to the total assets of all public plans in 1960. Currently, these plan assets are increasing at an annual rate of nearly 16 percent, which would double their size in five to six years. In 1980, total earnings on investments alone were over $10 billion. (State administered systems make up only about 250 out of the more than 10,000 public employee pension plans in the United States. However, these systems constitute more than 90 percent of the total assets of public plans, and cover more than 85 percent of the state and local public employees in the country.)[1]

The sheer size of these assets would command attention to investment decisions even if it were the only consideration. But investment decisions have signifcant impacts on state budgets and are now generally conceded to have an influence on the general course of the economy as well.

A widely used actuarial rule of thumb indicates that a 1 percent increase in long-term investment performance will generate savings equivalent to about 20 percent of employer costs. Since employer contributions for state-administered systems exceed $12 billion a year, the potential impact on state budgets is enormous. Pension contributions typically cost 15 to 25 percent of payroll, so any savings that can be gained by improving investment performance are significant. Investment earnings now make up more than a third of all state retirement system receipts, and in most cases equal or exceed employee withdrawals and benefits paid.

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[1]Census Bureau, Finances of Public Employee Retirement Systems, various years.

In the current economic environment, however, maintaining investment performance has become increasingly difficult. Public and private funds alike are being forced to consider a much broader range of possibilities than the blue-chip stocks and highgrade bonds--which have constituted the bulk of pension portfolios in the past--if they wish to exceed inflation and demonstrate a positive real rate of return on assets.

At the same time, thoughtful observers have recognized that pension funds are becoming the nation's largest single pool of investment capital, and that the investment choices made with these assets will have major consequences for the economic future. Public and private funds acquired 64 percent of all new stocks and bonds issued by U.S. companies in 1978, and a recent study estimates that pension funds will own about 70 percent of all corporate equity within the next fifteen years.[2] The pressure to increase real rates of return and the recognition of the broader consequences of investment policy have placed investment decisions at the center of the pension agenda for many states. Particularly as legislators see the opportunity for influencing their own state's economy through the investment process, a number of states have begun active consideration of an issue which was formerly left to state treasurers, boards of trustees, or other groups far removed from the public eye.

Traditionally, pension funds have been conservative and risk-aversive investors. Fund portfolios have largely consisted of U.S. Government and agency securities, corporate bonds with at least an A rating, and some stocks. Even the equity investments have tended to be closely circumscribed

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[2]Lawrence Litvak, Pension Funds and Economic Renewal, Washington, D.C., Council of State Planning Agencies, 1981.

with rules limiting stocks to those with a five-year history of consecutive dividends, listing on the New York Stock Exchange, and the like. In recent years, however, a number of new investment opportunities have been made available to institutional investors.

These include such things as investment in commercial real estate, natural resource partnerships (such as oil and gas wells), mortgage pass-throughs and participations, foreign securities and equities, venture capital partnerships, private placements, repurchase agreements, and put and call options on stocks.

States have been active in two kinds of investment activity. One has been to broaden the investment authority given to systems in order to increase their options; a second approach, often referred to as targeted investment, aims to develop investment approaches which will also influence the state's economy by promoting capital formation, job creation, or other goals as well as improving investment performance.

The NCSL has conducted two surveys this year to review recent state activity in both areas; this report offers a compilation of the results of those surveys.[3] All states regulate the investment authority of their pension systems by statute. Nine states currently have a "prudent man" rule with no further restrictions; the rest operate under a law that enumerates the permitted investments or categories of investments. Known as the "legal list," it varies in specificity from state to state. The prudent man standard is a common-law rule formulated in an 1830 case (Harvard v. Amory) regarding the legality of investments by a trustee. The court stated: "All that can be required of a trustee to invest is, that he shall conduct himself faithfully

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[3]An earlier version of the first survey was published in State Legislatures, April 1982.

and exercise a sound discretion. He is to observe how men of prudence, discretion, intelligence manage their own affairs, not in regard to speculation, but in regard to the permanent disposition of their funds considering probable income, as well as the probable safety of the capital to be invested." With some clarifications, this has been the basic case law standard against which investment behavior was to be measured. However, when Congress passed the Employee Retirement Income Security Act of 1974 (ERISA), it formulated a somewhat different rule. ERISA underscores the trustee's duty to act solely in the interest of the plan beneficiaries, but sets the standard of conduct as that which others, acting in a like capacity, conducting an enterprise of similar character with like aims would follow. This change, although subtle, allows individual investments to be evaluated not according to the aims of some universal rational investor, but rather according to their role in the total portfolio and according to the characteristics of each plan. While ERISA does not apply to public pension plans, it does set the tone for institutional investment policy; many states that have adopted the prudent man rule use the ERISA version (sometimes referred to as the "prudent expert").

Thirteen states have recently taken action to broaden investment authority for their systems; another seventeen states have taken action to target investments in-state for various goals. Several states are undertaking both tasks simultaneously; in still other states, the systems have taken advantage of existing authority to begin programs of targeted investment.

In 1980, the Alaska Legislature gave the state treasurer increased authority to invest pension funds in gold, foreign-currency denominated securities, and futures contracts. (The state caused something of a stir in investment circles when it proceeded to buy a metric ton of gold, hedged with futures contracts against price declines.) Arkansas uses the prudent man rule within the restrictions of the legal list; in 1981, the list was expanded to include securities lending and the writing of covered call options against stocks in the system portfolio. The legislation also raised the maximum permissible investment in equities from 20 percent of the portfolio to 40 percent.

Colorado increased the maximum equity investment from 30 to 50 percent. The change applies to both the major state-local system which covers the bulk of public employees and to the public safety retirement system.

In Florida, the State Board of Investment, which invests state short-term monies and pooled local funds, as well as the pension funds, had prime commercial paper, bankers' acceptances, and obligations of the Federal National Mortgage Association ("Fannie Mae") added to its list. The board is also now allowed to enter into repurchase agreements for any permitted investment.

In Illinois, a legislative-executive study commission recommended that the state laws for all pension systems be amended to a prudent expert standard; the commission without making that preference part of the law also expressed a preference for in-state investments. The recommendations were enacted into law early this summer. (California and Texas have been carrying out similar studies; see details below.)

The Minnesota State Board of Investment had its authority broadened in 1980 and again in 1981, so that it now comprises one of the most extensive legal lists in the country. The 1980 law gave the Board wide authority to invest in American and Canadian public and private bonds, corporate stock up to 50 percent of the portfolio, and international securities payable in dollars, such as those of the Inter-American Bank for Development. It also allowed the writing of covered call options, securities lending, repurchase and reverse repurchase agreements, commercial paper and bankers' acceptances. Mortgage participation certificates were also permitted. The 1981 legislation raised the equity maximum to 75 percent, allowed mortgage pass-throughs as well as certificates of participation, and added limited partnerships in venture capital investments and natural resource ventures as well as commercial real estate purchases.

Nebraska joined Illinois as the tenth state to substitute a prudent man rule for its earlier restrictions. (Washington added similar authority in 1981. The following states now all operate solely under the prudent man rule: Delaware, Idaho, Illinois, Kentucky, Maine, Nebraska, New Jersey, Oregon, South Dakota, and Washington.) The Nebraska legislation also provided specific authority to the state investment officer to write put and call options.

In New York, legislation signed in July expands total equity maximums from 35 to 40 percent of assets, raises the maximum commitment to equities to six percent of assets in one year, allows the system to hold up to 2 percent of the total stock of any one corporation, and adds a "basket clause" which permits up to 5 percent of assets to be invested in investments not otherwise permitted.

Ohio passed legislation in 1981 that requires all state-administered systems to use the prudent man rule, and gives specific authority for a wide variety of investments, including real estate, mortgage certificates and pass-throughs, convertible debentures, over-the-counter stock, repurchase agreements, and any other investment in a corporation which would not otherwise be permissible, provided that the corporation has at least one-half its assets, employees, or its corporate headquarters in Ohio.

In Pennsylvania, several pieces of legislation broadened investment authority significantly as well as adding legislators to the boards of trustees of the systems. Under the new laws, the maximum equity portion of the system portfolio is raised to 50 percent of book value; there are no more restrictions on the maximum amount acquired in any one year, and restrictions on multinational and over-the-counter stocks are increased to 5 percent of the portfolio. The legislation also adds U.S. Government and agency obligations, pooled real estate funds (up to 15 percent of assets), and a "basket clause" which allows investment of up to 10 percent of assets in any investment not otherwise permitted. The prudent man rule, which previously applied only to stock selection, would be applied to all investment decisions, including selection of investment advisors and managers. Finally, Wyoming, which has previously invested only in bonds, has a passed a constitutional amendment, which, if ratified at the general election in November, would permit investment in common stock for the first time. Stock would be allowed up to 35 percent of the system assets.

A number of states have attempted or are considering forms of targeted investment--programs that would bring a market rate of return but would also offer other economic or social benefits. The most common of these strategies focus on increasing the capital available to the housing industry through the purchase of mortgage pass-throughs or certificates of participation. Other popular forms of targeted investment have emphasized in-state private placements or equity investments in order to stimulate the state economy or staunch a capital outflow. Not all of these programs are the result of new legislation. In some cases the pension system has acted under existing authority to target investment in certain areas, occasionally as the result of legislative stimulation.

In Alabama, the system has strongly emphasized the use of private placement loans to in-state corporations, arguing that the interest earned should stay in the state rather than going to money center banks. A California study commission recommended a number of changes in investment authority; thus far, the legislature has enacted laws allowing one of the state systems to make home mortgage loans to its members, and created a Pension Investment Unit in the governor's office to assist systems in developing in-state opportunities. A constitutional amendment on the November ballot would significantly broaden investment authority for state systems, and implementing legislation will be considered following its passage.

The newly-formed Mortgage Corporation of Colorado has sold its entire first issue of mortgage-backed securities to the Public Employees Retirement Association. Further issues are planned, with sales contemplated to both public and private systems.

Connecticut passed legislation allowing similar purchases by their state system. An intermediary corporation known as "Yankee Mac" has been created to package mortgages for resale; first preference on the initial sale was given state employees who were system members.

Legislation passed in Florida authorizes, but does not mandate, investments in home mortgages. The State Advisory Council on Intergovernmental Relations has completed a study on the feasibility and desirability of targeted investments.

Hawaii has had a program for several years that offers mortgage loans at market rates to system members; about 35 percent of the system assets are in such mortgages. Idaho has begun investing in mortgage pools, and plans to allocate up to ten percent of assets in such investments. Some of the Illinois systems have begun similarly investing, and more will no doubt follow in the wake of their new investment legislation. Indiana also passed legislation allowing investment in mortgages, with the State Housing Finance Authority authorized to package the mortgages for investment.

The Kansas Public Employees Retirement System has a history of targeting investments through various vehicles, but they have been initiated by the system, often with legislative encouragement. To date, the system has set up funds to invest in Kansas corporate equities, certificates of deposit in Kansas financial institutions, and most recently in several packages of residential mortgages, with first preference in the intital package going to system members for home loans. Massachusetts has also passed legislation encouraging purchase of in-state mortgages. An initial package has already been purchased, and more are currently under way.

Michigan retirement systems began investing in home mortgages through an intermediary known as "Maggie Mae" over a year ago; the Michigan legislature also passed legislation to significantly broaden investment options in the state as well. Signed into law recently, the bill raises the limit on stocks to 40 percent of assets, and adds direct investment in commercial and government real estate as well as other investments in-state. Although in form the legislation appears to be primarily intended to broaden investment options, it was passed primarily because of its potential to promote in-state economic development.

Minnesota has considered several versions of targeted investment legislation, but has been unable to reach agreement between the House and Senate. Conference committees considered, but could not agree upon, bills that would both consider prudent man standards and legal prohibitions, but also specify that preference was to be given to investments that would promote the economic interest of system beneficiaries and the state as a whole. While such language was common to both bills, the two houses could not agree on how such interests ought to be defined, although the bills included such goals as promotion of alternative energy uses, increasing the supply of housing, preservation of family farming, and job creation.

Both New Hampshire and New York passed enabling legislation which added pooled mortgages as a permissible investment. North Carolina was the first state in the nation to create an intermediary for mortgage purchase when it created the North Carolina Mortgage Investment Corporation (NCMIC). NCMIC markets to both public and private funds in order to improve the liquidity of state mortgage markets; however, the state systems played a key role in launching NCMIC when they made a forward commitment to purchase a third of their original securities offering.

Oklahoma also passed enabling legislation for mortgage purchases this past session; Texas, Utah, Vermont, and Virginia systems have already begun mortgage purchase programs under existing authority.

In both Texas and Wisconsin, studies of investment policy are under way. A Wisconsin law which merged the three existing state-administered systems requires the Legislative Council to appoint a special study committee to consider investment policy, including targeted investment; the committee must report back to the legislature with its recomendations by January 1, 1983. In Texas, both a gubernatorial commission and a House committee have been examining investment policy for state funds generally, looking into pension funds as well as the permanent funds and short-term monies. The studies are expected to recommend changes to broaden investment policy, but thus far the committees have apparently not been hospitable to the notion of targeted investment.

Whether targeting or simply looking to improve investment performance, legislatures have clearly shown that they consider investment issues to be at the center of the pension agenda this year. This is not meant to imply that improving investment policy is, or ought to be the sole goals of legislative oversight of pensions. Administration, plan design, adequate reporting and disclosure to beneficiaries, legislative and executive branches and the general public, full funding of benefits and removal of unfunded liabilities all remain problem areas for public pension policy and are equally deserving of legislative attention. Investment flexibility is important for the fiscal health of a plan, but legislators need to ensure that investments are still made at the best rate of return available. Any concession on rates of return amounts to a disguised increase in employer contributions or a cut in benefits, and is fiscally irresponsible; more fundamental, however, is that such investment is incompatible with the fiduciary duty of a plan trustee. As a result, there has been considerable discussion of whether or not permissive legislation broadening investment authority amounts to targeted investment. One state fund director (quoted anonymously in Pensions and Investment Age)[4] fears that "may" bills will become "shall" bills because of political pressure put on boards of trustees, treasurers, or other investment fiduciaries. While there is no evidence for this as of yet--and most advocates of targeted investment are careful to stress that it should only be done within the limits of the prudent man rule--the issue is obviously a thorny one which each state will have to resolve in its own way. What is clear is that investment policy is no longer the prerogative of trustees, but rather is out in the open as a significant issue of public policy.

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[4] February 15,1982

APPENDIX:
GLOSSARY OF INVESTMENT TERMS

Bankers' acceptances: A bank advances money to a third party, backed by money due that party at some future date (e.g., sales of goods for future delivery when the seller needs immediate cash); the bank then resells its interest.

Commercial paper: Corporate promissory notes, usually less than ninety days' duration. Though not backed by a covenant such as a bond has, it is frequently guaranteed by a bank letter of credit, as well as the credit reputation of an issuer.

Convertible debentures: Corporate bonds issued where purchaser has the option of converting some or all of his interest into stock in lieu of cash repayment.

Equities: Corporate stock is referred to as equity, as distinguished from bonds, which are debt interests.

Government and agency notes: "Governments" are obligations of the United States Government, backed by the full faith and credit of the Treasury, such as Treasury notes and bills; "agencies" are notes which do not carry the full faith and credit, but rather are evaluated on their own merit such as HUD notes backed by housing committments or Federal National Mortgage Association notes ("Fannie Mae").

Mortgage pass-throughs and certificates: Purchase of mortgages on the secondary market from the original lender (bank, savings and loan association, etc.). Much of the state interest in this area stems from the fact that such purchases allow the original lender to reloan the proceeds rather than holding the mortgage to maturity, thus making mortgage money more readily available to prospective homeowners. Three federally chartered institutions pioneered in this area: Government National Mortgage Association ("Ginnie Mae"), Federal National Mortgage Association ("Fannie Mae"), and the Federal Home Loan Mortgage Corporation ("Freddie Mac"). Much of the state interest in this area stems from their desire to have other intermediaries package mortgages from a single state or region, rather than nationally as the federal corporations have. Such packaging is often done to meet specific goals, such as one-to-four family owner occupied housing, limited to first-time home buyers, or whatever other goals a state may have in mind. One private firm, the Mortgage Guarantee Investment Corporation (MGIC) has been particularly active in this area, although some states have set up private corporations such as NCMIC to handle the packaging, or in some cases used a state Housing Finance Agency to package the mortgages. In any case, the usual practice is to assemble a package of mortgages in a manageable size, insure them against default, and then offer them for resale. Participations are securities offered by the packager with mortgage payments serving as collateral and a revenue stream to repay the bond. Pass-throughs are pools of mortagages where the loan originator collects from the homeowner, deducts a small fee for servicing the loan, and then forwards the payment directly to the holder of the pass-through.

Natural resource partnership: a limited partnership in a natural resource venture, generally an oil or gas well. Well owners frequently sell a share of future royalties for capital to drill new wells.

Private placement: A loan made directly by a pension fund to a corporate borrower, where the fund acts as a bank.

Put and call options: A stock owner sells the right to buy ("call") or sell ("put") a stock at a specified price. If the stock later rises in value, the seller of a call option cannot take advantage of it, but does have the income from the call. If the stock falls, the income from the option helps to offset the loss. Selling options against stock owned is referred to as "covered calls"; selling without owning the stock--in effect, betting that the stock will fall--is referred to as "naked calls". Most states have thus far limited calls to covered calls.

Real estate: Though self-explanatory, it is worth noting that a number of funds have become active real estate investors. Some have invested directly in office buildings, shopping centers, apartments, or other ventures; other funds have invested in pooled real estate funds which make the actual selection of projects for investment. In recent years, this has been a major area of investment activity for public and private pension funds.

Repurchase: An agreement to sell and buy back the same security within a specified time period (often overnight). It is used to help a bank or other purchaser meet margin or reserve requirements. When a security is bought and then sold back, it is a reverse repurchase. Frequently referred to as a "repo."

Securities lending: Loan of a bond to a broker or bank who needs it for margin or other requirements at an agreed-upon fee. Similar to a repurchase.

Venture capital partnerships: A venture capitalist sells partnership interests, and then invests the funds in new companies, often just starting up. In return for his investment, he generally takes a substantial block of stock in the company, and may often sit on its board to guide its growth in the early years. When all investments made by the partnership are liquidated, either through the company going public or--as sometimes happens--collapsing, then the profits are divided among the partners. While risky, such investments have become popular both because of a renewed interest in new business creation as well as the hope that one of the companies chosen will become the next Apple Computers. Though admittedly risky, venture capital partnerships have gained recognition as a serious and often lucrative investment alternative for large investors who have the patience to wait for the partnership to mature.

NOTE: In most cases, the NCSL can supply copies of legislation or studies carried out by states; please address inquiries to the author at the address on the front cover. Copies are available free to legislators and staff; all others are subject to a ten cent per page charge for copying and handling.

FINAL REPORT

October 1981

· FINAL REPORT ·

GOVERNOR'S PUBLIC INVESTMENT TASK FORCE

THE GREAT SEAL OF THE STATE OF CALIFORNIA

EUREKA

October 1981

STATE OF CALIFORNIA

Edmund G. Brown Jr., Governor

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EXECUTIVE SUMMARY

Public and private pension fund assets in the United States total $650 billion, of which almost 10% are assets of California funds. Pension funds have become a major source of capital for U.S. corporations, acquiring 64% of the total new stocks and bonds issued by U.S. firms in 1978. Their influence is growing. A recent study by the Council of State Planning Agencies projects pension funds will own about 70% of all corporate equity within the next 15 years.

Recognizing the importance of pension fund investments in the economy, Governor Edmund G. Brown Jr. appointed the Public Investment Task Force in July 1980 to develop prudent investment proposals that would help public pension funds earn competitive yields on investments while targeting those investments to positively affect California's economy.

The Task Force – comprised of public employee and union labor leaders, investment bankers, pension beneficiaries, government officials, builders, and public interest advocates – concentrated on investment proposals which would be feasible for the state public employee retirement systems. In order to implement these proposals, the Task Force sought to recommend changes in tax and pension laws and regulations, and to develop guidelines to ensure that public investment practices meet socially responsible criteria.

The Task Force was divided into three working committees: Affordable Housing; Business, Economic Development, and Energy; and Responsible Investments. Each committee discussed, developed, and evaluated proposals in its specific area. All committee recommendations included in the Final Report were approved by a majority vote of the Task Force. The commitment to this endeavor along with the tough standards applied to the proposal evaluation process make the Public Investment Task Force Final Report a benchmark study in the development of alternative pension fund investments.

The Affordable Housing Committee developed proposals which would encourage the flow of new capital into the housing market to make home financing more affordable and to enable pension fund assets to assist in increased production of affordable housing in California. The Committee recommended:

- Creating a California-based secondary market for California-originated mortgage loans;

- Encouraging public pension systems to invest in home mortgages for their participants;

- Exploring new mortgage instruments, such as shared appreciation mortgages, graduated payment mortgages, or flexible low-start mortgages, all of which attempt to offer affordable loans to homebuyers while guarding the lender against inflation;

- Encouraging an evaluation of the degree of cost reductions and subsidies necessary to make multi-family housing a feasible and attractive investment for pension funds;

- Exploring the possibility of co-investing by sharing in the homebuyers' equity interest or the principal mortgage lenders' joint first trust deed;

- Encouraging cooperative housing investment as a means of promoting a larger volume of affordable housing for a given level of investment; and,

- Encouraging public and private sector pension funds' cooperation on joint housing finance projects.

The Business, Economic Development, and Energy Committee based its activity on several national and California studies which show higher rates of innovation and job creation and greater price competition among small- and medium-sized firms than large, well-established firms. Focusing on proposals which would help stimulate those sectors of the economy, the Committee recommended:

- Easing legislative restrictions on pension fund investment, as proposed in Senate Constitutional Amendment 21;

- Making forward commitments to purchase Small Business Administration (SBA) and Farmers Home Administration (FmHA) federally-guaranteed loans increasing the availability of loan funds to participating banks;

- Making forward commitments to purchase the guaranteed portion of SBA loans originated by State Assistance Fund for Energy-Business & Industrial Development Corporation (SAFE-BIDCO), as long as the investment return is competitive with federal securities or equivalent maturities;

- Purchasing FmHA industrial development loans in rural areas to expand incentives for private lending;

- Encouraging private sector interests to set up equity funds in which pension funds could purchase equity issues of small- and medium-scale firms;

- Encouraging private sector intermediaries to set up a private intermediary that would bring plant and equipment expansion and modernization to the attention of pension fund investors in California;

- Creating a secondary market to purchase packaged solar and conservation loans made by private lenders; and,

- Establishing a California Venture Capital Fund by committing a small percentage of fund assets to investments in California-based, venture capital limited partnerships.

The Responsible Investments Committee developed general guidelines to ensure that public investment practices meet socially responsible criteria and public interest goals. The Committee, believing that the investment of large sums of money cannot be divorced from its social consequences, recommended that all public retirement funds:

- Adopt the State Teachers' Retirement System (STRS) Guidelines;
- Allow public access to proxy voting records;
- File proxy resolutions at the request of 10,000 or 10% of the system's participants; and,
- Establish an advisory committee to consider proxy issues and in-state investment policies.

In addition, the Committee recommended that:

- The Public Employees' Retirement System (PERS) and STRS pursue a more active proxy strategy including electing members to corporate boards of directors in which they are major stockholders, coordinating institutional investor voting, and actively seeking and providing information on shareholder issues;
- The University of California and California State University encourage investments in affordable housing for faculty, students, employees and surrounding communities;
- The California Pooled Money Investment Board adopt responsible investment guidelines to benefit the state's economy and the financial needs of the fund; and,
- Capital needs of local areas be considered when temporarily idle funds are invested.

Based on the recommendations made by the Public Investment Task Force, the California Legislature allocated $400,000 to create a Pension Investment Unit in the Governor's Office of Planning and Research. The Unit will work to implement the recommendations of the Task Force during the 1981-82 fiscal year. In addition, the California Senate passed SCA 21, aimed at relaxing the restrictions on pension fund investments. It will be introduced in the Assembly in January 1982.

The importance of pension fund investments will continue to grow in the coming years. The Final Report of the Governor's Public Investment Task Force and the formation of the Pension Investment Unit signify a continuing commitment to the creation of prudent investment vehicles which both provide competitive yields and favorably impact California's economy.

FOREWORD

On July 30, 1980, Governor Edmund G. Brown Jr. established an advisory Public Investment Task Force to develop public policy that would assist California's $60 billion of public and private pension funds and temporarily idle government funds to invest in ways responsive to the needs of the state's economy.

The Task Force was charged with the following responsibilities:

- Develop specific proposals for new investment alternatives that are both prudent and responsive to California's need for affordable housing, small business, and the development of new industries, alternative energy resources, and jobs;

- Study how pension funds can earn higher rates of return on the billions invested;

- Recommend any necessary changes in California tax and pension laws and regulations that will facilitate new investment alternatives; and,

- Develop guidelines to assure that public investment practices meet socially responsible criteria and public interest goals.

The Task Force's deliberations have focused primarily on the California public employee funds with the largest assets: the Public Employees' Retirement System (PERS), $14 billion; the State Teachers' Retirement System (STRS), $7.5 billion; the University of California (UC), $2.5 billion; and the Los Angeles County Employees' Retirement Association (LAC), $3 billion. LAC is the largest of 22 counties known as the 1937 Act Counties which manage their own funds. The Task Force also gave consideration to Taft-Hartley jointly-managed union funds during its discussion of construction proposals included in the Affordable Housing section.

In March 1981, an Interim Report which outlined a variety of preliminary proposals resulting from the initial months of the group's work was issued. Hearings were held during April in Los Angeles and Sacramento to obtain the broadest possible input from beneficiary groups and the public on those proposals. Testimony from the hearings and other public comments have been incorporated into the final proposals presented in this report.

The Task Force's experience over the past year has provided a working model for future efforts toward constructing a new governing coalition – a coalition of citizens, labor, government, and business – to strengthen and revitalize the state and national economy. Task Force members, including government officials, public employee and union labor leaders, investment bankers, pension beneficiaries, builders, and public interest advocates, conducted months of spirited and enlightened deliberations, agreeing on most, but not all, items in this report.

The issues tackled by the Task Force were new and uncharted. Since they concerned the retirement savings of millions of California workers, they were controversial and sensitive. Through the concerted outreach efforts of the Task Force, the idea of utilizing pension investments to meet a secondary objective of bolstering the state's economy has become more widely understood and accepted. Perhaps most importantly, a viable plan of action has been proposed and a general policy consensus has been attained.

During the past year, considerable support has grown among those most concerned: the retirement plan participants and beneficiaries. The cautious but supportive perspective of these groups is typified by the comments of Charles Valdes, President of the California State Employees' Association (CSEA), the largest public employee organization in California: "We heartily support this effort, as long as the strictest standards of prudence are followed."[1] Other important employee groups have emphasized the job creation potential of Task Force proposals. Richard Lucero, President of the Peace Officers' Research Association of California (PORAC), editorialized in the Association's newspaper that "by facilitating new ways to increase the flow of pension capital into productive investment in California, more employment opportunities will be created. The issues and plan of action proposed by the Task Force are credible and exciting."[2] Like CSEA, PORAC is especially supportive of the proposed constitutional changes to grant fund managers more flexibility.

Other public employee groups that have formally indicated support include the Service Employees' International Union, the California School Employees' Association, the California Independent Public Employees' Association, the California Firefighters' Association, the California Teachers' Association, the Federated Firefighters of California, the Communications Workers of America (CWA) Psych-Tech Union, the San Joaquin County Employees' Association, and the San Diego County Employees' Association.

Some groups have voiced conditional support for increased investment flexibility and prudent investments that bolster the state's economy. The Retired Public Employees' Association, the Association of Retired Teachers, and the United Professors of California have taken the position that increased returns resulting from the new policies should be translated into increased direct benefits for their constituencies.

The AFL-CIO state and national leadership has indicated strong support of the new approach to pension investing represented by the Task Force proposals. Speaking for the national AFL-CIO, Bert Seidman, Director of the AFL-CIO's Social Security Department, called the Task Force Interim Report "constructive and pioneering."[3] John Henning, President of the California Federation of Labor, AFL-CIO, said in support of Task Force proposals: "We believe it is time for us to begin prudently investing our pension funds in ways that will create more California jobs and build economic security for the future."[4] Glenn Watts, President of the Communications Workers of America, exemplified the position of many large national unions in a letter to Governor Brown: "We fully support the ambitious and farsighted goals of the Interim Report . . . control of the ever-growing multi-billion dollar pension funds will certainly be one of the main issues of organized labor during the remainder of this century."[5]

Other major unions that have communicated their support to the Task Force include the International Association of Machinists and Aerospace Workers, the International

Chemical Workers Union, the International Union of Operating Engineers, the Amalgamated Clothing and Textile Workers Union, and the United Auto Workers. A broad array of California building trade unions, who have taken the lead nationally by investing their pension funds locally for job creation, also gave support to the proposals.

Public pension trustees have also endorsed the Task Force proposals. Alan Lowy, Chairman of the Board of the Los Angeles County Board of Investments, has written: "Due to the size of our fund, I've always felt that we should be in the forefront of innovative investment policy . . . I have always maintained that our fund is local taxpayer and employee money and, therefore, should be invested as best possible in our own community."[6]

Kathie McKenney, Vice Chair of the State Teachers' Retirement System (STRS), has said, "One direction I feel major institutional funds must take is that of greater activism in the financial community . . . Active contribution to strengthening mechanisms of investment is in the best interests of the members and the soundness of the California economy which provides their employment."[7] Michael Thome, STRS Chief Executive Officer, agrees: "Who's paying the taxes? Who's supporting this institution in California – the taxpayers, and that being the case, all other things being equal, yes, we want to invest in California by all means."[8]

Speaking as a member of the governing board of the Public Employees' Retirement System (PERS) fund, Wilson Riles Jr. stated: "The Governor's Task Force proposals are imaginative, yet responsible. They have focused attention on a little-recognized fact: the way these powerful pension funds are invested profoundly affects our economic life."[9]

All three of these large California public pension funds' governing boards – PERS, STRS, and LAC – have endorsed the investment flexibility changes proposed in the Task Force Interim Report. It should also be noted that PERS investment policy, as indicated in its 1980 Annual Financial Report, gives preference to California investments, including high quality real estate mortgages, all other considerations bring equal.

In June 1981, the California Legislature appropriated $400,000 to the Governor's Office of Planning and Research for a Pension Investment Unit to implement Task Force proposals – a significant measure of support in a very tight budget year.

The Task Force's activities have also generated widespread interest outside of the state. The Governor's Office has received over 3000 inquiries from more than 30 states, including requests for information from labor unions, state legislatures, state pension funds, major investment houses, and various agencies of the federal government.

With publication of the Governor's Public Investment Task Force Final Report, and funding of the Pension Investment Unit by the Legislature, the pension investment issue has advanced to a new stage in California. The period of study and investigation has concluded. The time for implementation has arrived.

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