

# **Indiana Pension Funds: Expanding the Impact of Equity**



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**Indiana Pension Funds:**  
**Expanding the Impact of Equity**

**May 2000**

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The Indiana Fiscal Policy Institute (IFPI), formed in 1987, is a private non-profit governmental research organization. It is the only independent statewide source of continuing research into the impact of state taxing and spending policies in Indiana. The IFPI is privately supported by a variety of organizations, corporations, associations, and individuals in Indiana and surrounding states. Contributions to the IFPI are fully deductible under section 501 (c)(3) of the Internal Revenue Code.

## **Foreword**

In November 1996 Indiana citizens voted to change the State's Constitution to allow its public pension funds to invest in equities (stocks). Three and one-half years have past and Indiana's two largest pension funds have moved billions of dollars out of bonds and into public equities. With such a substantial amount of taxpayer funds involved in this change and with hundreds of thousands of public employees' pensions at stake, a much needed evaluation of the State's public equity investment performance is given in this report.

Though Indiana pension funds have caught up with the rest of the country in their ability to invest in public equities, another type of investment that most states use still lies ahead for Indiana funds to embrace – private equity. Over the past twenty years most states have begun investing in private equity after learning of its historically high investment returns and risk reducing characteristics when added to a diversified portfolio. In a similar approach to our 1996 study on public equity, this report addresses the benefits and risks of private equity investing and reports on other states' approach to the asset class.

In addition to being an attractive addition to a diversified pension portfolio, private equity also supports local economic development goals. Indiana is in a race to become the information technology hub of the Midwest. Private equity is the primary source of funding for new technology businesses, and existing technology hot-spots such as Silicon Valley and Boston are not surprisingly home to the majority of private equity partnerships. In a public pension context and consistent with fiduciary duty, we report on what other states are doing to increase private equity investing in their states with the goal of growing a technology-based segment of their economy.

To analyze the performance of Indiana's two largest funds, the Public Employees' Retirement Fund [PERF] and the Teachers' Retirement Fund [TRF], we relied heavily upon data and guidance provided by Diana Hamilton, Director of Public Finance, Bill Butler at PERF, Bill Christopher and Bob Newland at TRF, Pete Keliuotis at William M. Mercer, and Dick Boggs at Burnley Associates. We also want to extend a special thank you to Garth Dickey, former director at PERF and Mary Beth Braitman at Ice Miller Donadio and Ryan for their assistance. Of course, the calculations and conclusions presented in this report are the work of the Indiana Fiscal Policy Institute, as are any errors contained herein.

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## Indiana Pension Funds: Expanding the Impact of Equity Executive Summary

In early 1996 Indiana was one of only three states that prohibited its public pension funds from investing in public equities (stocks). That same year the Indiana Fiscal Policy Institute (IFPI) published a report which demonstrated that if public equities were added to Indiana’s public pension funds, investment earnings would increase, overall portfolio risk would be reduced, and taxpayers would save over \$43 billion over the next 30 years. This report recommended that Indiana public pension funds begin investing in public equities, and later that year voters agreed.

PERF began investing in public equities in May of 1997. From this time through December 31, 1999, PERF’s equity investments achieved annualized returns of 24.2%, narrowly following the S&P 500’s 25.5% annualized gain over that same time period. TRF entered the public equity markets a year later, in August of 1998, and achieved excellent returns through the end of 1999. TRF’s public equity investments earned an annualized 28.9% return over this year and a half time period, while the S&P 500 gained 21.3%.

As stocks soared to historic highs in the 1990’s, bond returns fell back to near long-term averages, achieving annual returns of less than 7%. Although the markets have at times seemed like a roller coaster, the last three years have been very profitable for stock investors. Because of the large spread between stock and bonds returns during this period, Indiana’s pension funds are larger and healthier because of the opportunity to invest in equities. The larger of the two funds, PERF, has an additional \$1,226 million in assets because of equity investing. TRF has earned an additional \$648 million it would not have had – had bonds been the only possible investment. Indiana’s two major public pension funds have proven that they are able to invest in stocks, avoid political traps, and achieve comparable returns to the market as a whole – thus saving the taxpayers’ money and providing safer pensions for public employees.

<b>Comparison of Rates of Return 1969 - 1998</b>	
<b>Investment Class</b>	<b>Annualized Returns</b>
Private Equity	17.2%
Large Company Stocks	12.7%
Small Company Stocks	12.1%
Long-Term Corporate Bonds	9.1%

Source: Venture Economics 1999, Ibbotson Associates 1999

The success from Indiana’s investing in public equities poses the question “Are there other types of investments that will increase investment returns, reduce the risk of Indiana’s public pension funds and save taxpayers more money?” There is an asset class that many other public pension funds utilize but Indiana funds do not, and that is private equity.

Private equity investing involves the purchase of a private company’s stock, which unlike public equity does not trade on a stock exchange. According to Dun & Bradstreet, 54% of U.S. companies with revenues over \$250 million are

privately owned. These companies have chosen not to issue public stock, and therefore the only way to invest in them is with a private equity investment. Private equity returns have historically exceeded the returns of bonds and public equities as shown in the adjacent chart.

Private equity is also an effective diversification tool that lowers the overall risk of a diversified investment portfolio. A Salomon Smith Barney study shows that adding private equity to a stock and bond portfolio reduces the portfolio’s standard deviation, the standard portfolio risk measurement, while increasing portfolio returns.

Investing is a risk versus return subject area, and private equity has some unique risks that must be carefully managed. However, after weighing the risks and returns of private equity investing, most state pension plans have chosen to invest in the asset class. Public pension plans in 37 states currently invest in private equity, allocating between 1% and 15% of their funds to private equity. Both the number of participating states and the amount allocated to private equity has been growing over the past ten years.

The Impact of Private Equity 1986 - 1998				
Portfolio Composition			Portfolio Results	
Stocks	Bonds	Private Equity	Annual Return	Standard Deviation
50.0%	50.0%	0.0%	13.3%	7.6%
47.5%	47.5%	5.0%	13.8%	7.3%
45.0%	45.0%	10.0%	14.3%	6.9%

Source: Salomon Smith Barney, 1999

**Findings and Recommendations:**

*The citizens and taxpayers of Indiana have greatly benefited from the change in the Constitution allowing the state to invest in equities.* In the 3 years since public equities were added to Indiana’s public pension funds, investment earnings have increased, portfolio risk has been reduced, and the public has saved \$1.8 billion. The additional discretion given to the Boards of Trustees of TRF and PERF has been responsibly used for the benefit of the pension funds’ beneficiaries and ultimately the people of the State.

*Indiana’s public pension funds should begin investing in private equity.* The addition of private equity to the funds’ portfolios will produce benefits similar to those obtained by investing in public equities. Increasing returns and reducing risk is an attractive combination that should be pursued by every prudent investor. Moving quickly to start a private equity program now and taking small, deliberate steps as was done when the State began investing in public equity is an effective and prudent approach.

*The State should seek advice from outside experts in private equity investing.* Private equity investing is more complicated than public equity investing. As a result, more than half of U.S. public pension funds that invest in private equity use an outside advisor. Indiana is inexperienced in the private equity asset class and should follow the same approach it uses to invest in other asset classes – hiring outside consultants to assist in selecting professional investors to develop the private equity program.

*Indiana’s pension funds should put fiduciary duty first in developing private equity programs.* Fiduciary duty mandates that the pension funds be managed for the sole purpose and exclusive benefit of the plan beneficiaries. This requires a private equity investment program that has no constraints but that is well diversified over time, geography, industry and investment type. Private equity investing in Indiana should not be mandated but could be prudent if it is part of a well diversified private equity strategy.