



*Fiscal Policy*

# *NEWS RELEASE*

Capital Center, 251 N. Illinois St., Suite 980, Indianapolis, IN 46204 ■ (317) 237-2890 ■ FAX (317) 237-2893

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**Contact: Bill Sheldrake or Ryan Kitchell, Indiana Fiscal Policy Institute 317-237-2890**

Today, the Indiana Fiscal Policy Institute released a report entitled, *Indiana Pension Funds: Expanding the Impact of Equity*. The report demonstrates that Hoosier taxpayers have saved \$1.8 billion over the past 3 years as a result of the 1996 Constitutional change to permit equity investing by the State pension funds. In June of 1996 the Indiana Fiscal Policy Institute projected that the State would save \$43 billion over the next 30 years by investing in public equities (stocks), and the State is well on pace to do just that.

This report analyzes the public equity investments made by Indiana's two largest public pension funds, the \$9.7 billion Public Employees' Retirement Fund [PERF] and the \$5.4 billion Teachers' Retirement Fund [TRF] which collectively oversee the pensions of more than 300,000 Indiana teachers and public employees. This study also includes a survey and analysis of pension management strategies used by other states, and finds that private equity is the most popular type of investment used by other states that is not yet used by Indiana funds.

*The report's major findings as described in the study are:*

► *Hoosiers 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 in 1996 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.*

- ▶ *Of the 7,400 companies in the U.S. with revenues in excess of \$250 million, only 46% are public while 54% are private companies. An equity investor that is restricted from investing in private companies therefore misses the opportunity to invest in over half of the companies in the U.S.*
  
- ▶ *At least 37 of the 50 states currently invest public pension money in private equity, however Indiana public funds have not yet made any investments in private equity.*
  
- ▶ *Private equity achieved an annualized return of 17.2% from 1969 to 1998, substantially higher than returns of large and small company stocks and bonds of 12.7%, 12.1% and 9.1%, respectively, over the same time period.*

Since 1988, the Indiana Fiscal Policy Institute has undertaken, through its research, to point out the problems in Indiana's pension systems and indicate possible solutions. The Institute, under the direction of Earl Ryan, was a pioneer in recognizing the benefits inherent in allowing the State to direct portions of its pension funds into stocks. The citizens of Indiana agreed in 1996 and changed the State Constitution to allow for equity investing by State pension funds. Although some were concerned, the Institute maintained that the Boards of Trustees for PERF and TRF would handle the additional discretion responsibly and through investing in equities would save taxpayers money. These last 3 years have been a good time to be a stock investor, with equities out-earning bonds by a 3 to 1 margin. However, this issue is a long term one. The Institute's research shows that even small percentage differences over long periods make stocks a necessary part of any pension fund's portfolio. The report shows that PERF and TRF have moved in a strategically sound but careful manner to allocate portions of their portfolios to stocks. The winners have been the funds' beneficiaries and the taxpayers of the State.

“The Indiana Fiscal Policy Institute has long been a proponent of public equity investing by the State’s pension funds and was a major factor in our getting the Constitution changed in 1996. The Institute was right in recommending the State’s pension funds invest in public equities, and with the change the pension funds are now much more diversified, stronger and safer. Though it has only been 3 years since the Constitution’s change, the pension funds are well ahead of the \$43 billion projected savings amount,” said Garth Dickey, Managing Director of MWV Capital Partners and former Director of PERF.

Bill Butler, current Director of PERF, adds “The decision of the electorate in 1996 is vindicated in the performance statistics found in this report.”

The report clearly illustrates that PERF and TRF have been good investors in public equities, achieving returns comparable to or exceeding major stock market indices. To continue maturing as sophisticated investors, the report shows that the next logical step is to begin investing in private equity.

“We’ve taken the first big step, and it has proven very beneficial both to retired public employees – who depend on their pension as their primary source of income – and for Indiana’s taxpayers, who also support the pension funds,” Governor Frank O’Bannon said. “I am asking the PERF and TRF boards to look closely at this report as they continue to carefully consider taking the next step.”

“This report is a timely addition to the discussion of pension investment policies in Indiana,” said Bill Butler, Director of PERF. “The Board of Trustees of PERF is looking at a number of the issues surrounding private equity investing. While PERF’s board has not yet moved funds into private equity, they have begun discussions to do so. This report will be a good road map of the necessary steps for them to take, including the due diligence outlined in the report.”

In our surveying and analysis of other state pension funds' investment strategies and practices, we interviewed 33 public pension managers and 23 pension fund consultants and investors throughout the U.S. This research found that most states have been successful in their private equity investing, however the record is mixed. The Kansas and Connecticut public pension funds both lost money on their private investments programs in the late 1980's and early 1990's. Both states found that their failure resulted from a lack of internal supervision and external advice. Kansas and Connecticut have since changed their strategies to utilize private equity consultants that assist the pension funds in selecting and monitoring private equity partnership investments.

The overwhelming majority of states have been very successful in their private equity investing including three neighboring states - Illinois, Ohio, and Michigan. Our research found 7 public funds that had published private equity return calculations for the past 10 years, and their average annualized return was 17.4%. There were 10 more states that had 5 year published private equity returns and their average annualized earnings were 24.8%. These 17 state pension funds currently allocate on average 5.0% of their total portfolios to private equity.

Private equity investors are typically large pension funds and endowments, however the recipients of private equity dollars are various types of private companies. Venture capital, a sub-class of 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 venture capital partnerships. Indiana has historically attracted very little venture capital. In the final six months of 1999, Illinois, Kentucky, Michigan and Ohio respectively attracted 103, 17, 14, and 13 times as much venture capital as did Indiana. Our research found eight state pension funds with programs in place that seek to increase venture capital availability in-state while maintaining their fiduciary duty to their public pension members and beneficiaries.

“Three years ago Indiana voters allowed the state to diversify its funds and invest in stocks. It is now time Indiana public pension funds adopt all techniques to obtain the highest return for the least risk. I agree with the balanced new report from the Indiana Fiscal Policy Institute that recommends state pension funds broaden their portfolios and invest in private equity. Private equity not only boosts pension fund performance, but it can also attract sorely-needed venture capital to Indiana,” said Teresa Ghilarducci, University of Notre Dame professor of Economics and PERF Trustee.

*The report’s recommendations are that:*

► *Indiana’s public pension funds should begin investing in private equity. The addition of private equity to the funds’ portfolios will produce return enhancing and risk reducing benefits similar to those obtained by investing in public equities. 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, the majority 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.*

“This is an excellent piece of research by the Indiana Fiscal Policy Institute and provides another compelling example how the State can help make its business climate more conducive to an entrepreneurial economy,” said Brian Williams, Executive Director of Technology Network Indiana.

Harold Apple, President and CEO of Vector Technologies and past President of the Indiana Information Technology Association, added, “I am pleased to see evidence demonstrating the increased value to Indiana current and future retirees resulting from the policy permitting our state funds to invest in equities. It seems to me there is a logical next step that would permit the prudent allocation of investments in private equities. The end result would be twofold. First, it can provide an additional growth opportunity for Indiana pensioners. Second, it can provide an expansion of the pool of capital available to stimulate more investment in the companies that will drive the economic development of our state.”

This report by the Indiana Fiscal Policy Institute follows a report done in 1996 prior to the change in Indiana’s Constitution which allowed the State to begin investing in stocks. That report, entitled *Does Equity Investing Pose an Unacceptable Risk for Indiana Pension Funds? (1996)*, as well as other Institute publications can be found on the IFPI website at <http://www.indianafiscal.org>.

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The Indiana Fiscal Policy Institute is a statewide non-partisan, non-governmental public policy research organization focusing on state and local public policy issues in Indiana. Through its research on state pensions, education, tax policy and the economy the Indiana Fiscal Policy Institute has contributed to the progress on problems of both immediate and long-term policy interest to Indiana citizens.