Pension funds are the nation’s largest investors. They employ diverse investment strategies, and are governed by diverse laws—private plans by ERISA and public plans by state and local regulations.

Pension Funds and Financial Markets

The growth in pension plan assets over the past 50 years has led to increased interest in how this money—which now amounts to more than $2.3 trillion—is being invested. Pension assets, however, do not consist of one “lump of money.” They are sponsored by private and public employers, overseen by many investment managers, and governed by different laws: private plans by the Employee Retirement Income Security Act of 1974 (ERISA) and public plans by laws of the respective jurisdictions. Consequently, the issues influencing pension plan investment are different for each type of plan and even for each individual plan.

At the end of 1988, assets of trustee private defined benefit plans were $707 billion; trustee private defined contribution plans, $436 billion; and private insured defined benefit and defined contribution plans, $548 billion. State and local pension plan assets amounted to $609 billion at the end of that year.

Pension investment in leveraged buyouts (LBOs) and high-yield bonds has recently caused some concern. However, pension involvement in these investments is very limited. ERISA’s prudent man rule, which leads to private pension plans diversifying their holdings, makes it unlikely that they will be adversely affected by such investments. Some states have adopted the prudent man rule, while others have explicitly limited the amount that can be in invested in LBO funds.

The investment of pension plan assets will continue to be a public policy concern as Congress, as well as state and local governments, examine and evaluate the appropriateness of the various investment strategies and instruments that plans are currently using.
Pension plan assets have been a growing component of the U.S. economy during the past 50 years, and their asset level now exceeds $2.3 trillion. The investment of this money varies among plan types such as private defined benefit, defined contribution, and multiemployer plans; state and local government employee plans; and federal government plans. Many different parties have an interest in pension plans’ financial status and investment activities. Participants and beneficiaries are concerned about benefit security. Sponsoring employers seek to meet legal requirements, make contributions, and provide benefit security. Governments have responsibility for their own plans as sponsors and concern for other plans as regulators. And those who invest the assets of plans are concerned about maintaining independence and achieving high rates of return at acceptable levels of risk.

Current financial market trends—including leveraged buyouts (LBOs), mergers and acquisitions, the use of “junk” bonds, and the use of employee stock ownership plans (ESOPs)—have focused renewed attention on pension plans as investors. Pension plan involvement in these trends has been addressed in several recent congressional hearings; it has been the subject of public comment by the Bush administration; and it continues to be debated by corporate management, plan fiduciaries, and investment managers.

In the discussion of pension plans as investors, it is often overlooked that plan assets do not represent one “lump of money” and that the control of pension funds is widely dispersed. Nearly all of the nation’s 875,000 pension plans have many investment managers. For example, the assets of General Motors’ plans for hourly workers are managed by more than 60 investment management companies. Alternatively, Wells Fargo has nearly 200 clients whose pension plans assets they help manage.

Pension plans also differ in regulation: private plans are regulated by the federal government through the Employee Retirement Income Security Act of 1974 (ERISA), whereas state and local government plans are regulated by their respective jurisdictions. Therefore, it is incorrect to assume that all pension plans move simultaneously, react in similar ways, or share collective responsibility for any market condition.

This Issue Brief reviews the different types of pension plans, including the federal retirement system. It analyzes government regulation of pension investment and discusses the growth of pension assets, the size and allocation of pension fund holdings, contributions to funds, and investment performance. It explores policy issues involved in pension management and investment, including factors affecting investment decisions and proxy voting. Finally, the report reviews pension fund investment strategies such as participation in LBOs, ESOPs as a takeover defense, soft dollars, international investments, and financial futures.

Types of Pension Plans

Pension plans and their assets\(^1\) can be categorized into two broad groups: (1) private-sector employer-sponsored plans; and (2) plans sponsored by state and local governments and the federal government.

Private Plans

Private-sector pension plans are of two primary types: defined benefit and defined contribution. In a defined benefit plan the employer promises employees specific benefits at retirement through a specified formula that is generally based on a fixed percentage of salary per year of plan participation. The sponsor must ensure that its contributions are sufficient, when combined with earnings on pension assets, to meet the future liability for this promise. In this type of plan, the employer bears the investment risk and benefits from

\(^1\) Virtually all pension plans hold assets, including equities, bonds, etc., in a fund to finance their obligations.
any gains. As of September 30, 1987, there were 233,000 defined benefit plans, with 39.6 million participants, in the United States.  

In a defined contribution plan, the employer promises to allocate a specific contribution to each employee's account, commonly based on the employee's pay. Investment earnings on these contributions accrue entirely to the employee, as do any losses. At the end of September 1987, defined contribution plans totaled 641,000, with 37.0 million participants.

Private-sector pension plan assets are either “trusteed” or “insured,” depending on who holds the assets. Private trusteed assets are administered on an individual plan basis by a “named trustee” who is designated either in the plan instrument or by a named fiduciary and is legally responsible for the prudent investment of the fund, among other responsibilities.

Insured pension fund assets are managed by life insurance companies, which include them in their general accounts or in one or more separate accounts. General accounts are large pools of money used to finance an insurance company’s obligations, such as life insurance, homeowners insurance, and pension obligations. Separate insured accounts typically adhere to specific types of investment and are earmarked to finance the investors’ specific obligations. (Pension assets in general accounts and in separate accounts are considered private insured funds in this discussion.)

Insurance companies sell contracts for both general and separate accounts, including group and individual annuities and guaranteed investment contracts (GICs).* A plan may also divide its assets between a trustee and an insurance company—a practice called “split funding.”

The investment of assets held by insurance companies, including general accounts for pension assets, is governed by the states. For example, New York law restricts general account holdings of common stock to 10 percent of admitted assets or to policyholders' surplus, whichever is lower (Mehr, 1987).

State and Local Pension Plans

Pension plans for employees of state and local governments are regulated by the individual state or municipality. They are not regulated by ERISA, which applies only to nongovernment employer-sponsored plans. Written investment policies are being adopted and are currently required in California for all public funds (Miller, 1987). In fiscal year 1985-86, there were 10.5 million active participants and 3.5 million beneficiaries in 2,580 state and local plans. The largest 171 of these systems covered 95 percent of all members. State and local retirement systems are a growing force in the financing of LBOs and in social investing (discussed later) (U.S. Department of Commerce, 1987).

The Federal Retirement System

The Federal Employees’ Retirement System (FERS) replaced the Civil Service Retirement System (CSRS) in 1986, although employees hired before 1984 are still largely covered by CSRS. FERS includes three components: Social Security, a basic annuity, and a thrift savings 401(k) plan. Social Security provisions are the same as those for private-sector employees, while the Basic Annuity Plan provides an additional specific monthly payment after retirement, based on the

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*Editor's note: A GIC is a guaranteed investment contract between an insurance company and a corporate profit-sharing or pension plan that guarantees a specific rate of return on the invested capital over the life of the contract.

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1Participants here include active nonvested and vested workers, retired workers, and those who have separated from service (Employee Benefit Research Institute, 1989).

2This assumes that the employee is fully vested. Before full vesting, the employee accrues only any vested percentage of any gains or losses in his/her account.

3The discussions of fiduciaries and trustees are included in sections 3(21) and 403(a) of ERISA, respectively.

4Policyholders' surplus is the amount by which the difference between the assets and the liabilities can decline before liabilities will equal or exceed the assets (Williams, 1989).

5CSRS includes Medicare and a defined benefit retirement plan.
employee’s length of service and three years of highest earnings.

The federal government automatically contributes 1 percent of an employee's salary to the thrift 401(k) plan account. In addition, the employee may contribute up to 10 percent of his or her salary with pretax dollars, which are matched by the government dollar-for-dollar up to the first 3 percent of salary and 50 cents on the dollar for the next 2 percent of salary. 7

To help ensure payment of promised pension benefits, ERISA establishes minimum funding standards for private employer-sponsored defined benefit plans.

Three investment choices are available to FERS employees: the G fund (Government Securities Investment Fund), 8 the F fund (Fixed Income Investment Fund), and a C fund (Common Stock Index Investment Fund). The Federal Retirement Thrift Investment Board manages the G fund, and Wells Fargo Bank manages the C and F funds. Employees covered by FERS can elect to transfer a portion of their accounts gradually from the G fund into the C and/or F funds, beginning in 1988. The full amount can be placed in those funds beginning in 1997. As of late April 1989, the G fund held $3.3 billion, the C fund held $18.6 million, and the F fund, $7.9 million (Causey, 1989).

Pension Investment Regulation

The investment of pension plan assets is governed by different laws, depending on whether a plan is private or public.

Private Plans: ERISA—ERISA regulates private pension plan investments and must be followed for a plan to qualify for favorable tax treatment. ERISA’s fiduciary provisions establish the legal framework within which investment and proxy voting decisions must be made. However, ERISA does not dictate any specific decisions.

To help ensure payment of promised pension benefits, ERISA establishes minimum funding standards for private employer-sponsored defined benefit plans. In general, plan sponsors must contribute enough money to cover the benefit liabilities accrued each year and make payments toward any unfunded liabilities. The law also specifies maximum annual deductible contributions. Both the maximum and minimum funding limits were tightened by the Pension Protection Act of 1987. 9

State and Local Plans: State Regulation—Some state and local pension plans follow laws or rules similar to those in ERISA, while others are bound by a legal list that enumerates several investment options and often includes the maximum percentage of assets that can be invested in each option. The laws or rules similar to the prudent man rule in ERISA, however, are enforced by the state itself, not by a third party such as the Department of Labor (DOL), Department of the Treasury, or the Internal Revenue Service (IRS). This distinguishes them from the laws that govern private plans.

According to a 1987 survey of public pension plans, 32 percent of state and local plans are subject to laws that restrict investment in foreign securities (Greenwich Associates, 1988b). Thirty-nine percent limit by law

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7CSRS allows employees to contribute up to 5 percent of their pretax salaries to the thrift plan, but there are no matching contributions.

8CSRS employee contributions and earnings are invested in the G fund. Federal government contributions to CSRS are held in a separate fund.

9This act was included in the Omnibus Budget Reconciliation Act of 1987.
the maximum amount that can be invested in common stock, and 32 percent limit the amount that can be invested in equity real estate. In 1988, the median maximum equity position allowed was 50 percent of the market value of plan assets (Dutton, 1987; A. Foster Higgins, 1988).

Restrictions on equity exposure and on the amount of in-state investment are common. A 1987 survey by *Pensions & Investment Age* of 29 of the nation’s largest state and municipal funds revealed that 20 of these funds had equity exposures limited by their respective state or local governments.

Another study, conducted in March and April 1988, found that 25 of 60 large public pension funds target a portion of their in-state investments as part of a formal investment program. Some of these formal statements are in the form of a nominal commitment, while others are much more explicit. According to this study, the Pennsylvania State Employees' Retirement System is one of the more far-reaching, requiring that 50 percent of all residential/commercial mortgages, 50 percent of all commercial real estate, and 50 percent of all venture capital investments be in-state. The study points out, however, that none of the pension plans in the survey permits "any investment which is not evaluated as prudent on its own merits, irrespective of its impact on the local economy" (Buck Consultants, 1988).

**Investment of Pension Plan Assets**

Interest in the role of pension funds in the economy has increased as their assets have grown.

**Growth of Pension Assets**

Private and public pension assets have grown dramatically since 1950, and at the end of 1988 totaled more than $2.3 trillion.

In 1950, private trusteed pension funds held $7 billion; plan assets grew to $159 billion in 1974, the year that ERISA was enacted. By 1980, these assets increased to nearly $470 billion. From 1982 to year-end 1988, assets of private trusteed pension plans grew 95 percent, from $655 billion to $1,274 billion, showing an average annual growth of nearly 12 percent.

Private defined benefit plans grew from $399 billion at the end of 1982 to $707 billion six years later, or 77 percent. Defined contribution plans grew more than 100 percent, from $196 billion to $436 billion, during the same period. The proportion of total private trusteed pension assets held by defined benefit plans decreased from 61 percent to 56 percent in those six years, while the proportion held by defined contribution plans grew from 30 percent to 34 percent. The remainder of private trusteed assets were held by multiemployer plans.

Private insured and public pension assets also have enjoyed rapid growth. Since 1950, private insured assets have experienced an average annual growth rate of 13 percent. At the end of 1987, the funds held $460 billion in assets. Public assets (of state and local
The amount of total equity and bonds in the economy held by pension funds has increased substantially since 1950. Private trusted pension assets alone held 16 percent of equity in the economy at the end of 1988. Defined benefit plans held 9 percent, defined contribution plans held 6 percent, and multiemployer plans held 1 percent. One percent of total equity was held by private insured plans and public plans held 7 percent. (Again, these public holdings are not under federal regulation, only that of the state or municipality sponsoring them.) At the end of 1988, pensions together held 25 percent of total equity in the economy ($768 billion) and 15 percent of taxable bonds ($703 billion) (chart 1). In contrast, in 1950 pensions held only 0.8 percent of total equity and 3.2 percent of taxable bonds.

These large holdings by pension funds illustrate why Congress and other governments are concerned about how this money is managed, how the stock shares are

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**Pension Ownership of Selected Assets in the Economy**

Pension plans are of growing importance to the economy. In 1980, the Securities and Exchange Commission (SEC) reported that institutional investors held more than 35 percent of all stock traded on the New York Stock Exchange, nearly double the level 20 years before (Schrager, 1986).

15Data are from the Federal Reserve Board Flow of Funds and are reported in Employee Benefit Research Institute, Quarterly Pension Investment Report, fourth quarter 1988.

16Institutional investors include pension funds, endowments, foundations, educational institutions, insurance companies, and mutual funds, among others.
voted, and how these funds influence and are influenced by mergers, acquisitions, takeovers, and other corporate activities.

**Trends in the Investment Mix of Pension Assets**

In aggregate, from 1982 to 1988, private trusteed pensions have maintained close to 40 percent of their assets in equity;\(^1^7\) however, the investment of pension assets differs across plan types. Single-employer defined benefit funds have consistently held between 35 percent and 38 percent of their assets in equity (measured as of year-end 1988);\(^1^8\) with bonds accounting for between 16 percent and 22 percent of assets. Single-employer defined contribution funds held more of their pension portfolios in equity (between 37 percent and 41 percent) and less in bonds (between 7 percent and 11 percent) than defined benefit plans.\(^1^9\) Finally, multiemployer funds held a much lower proportion in equity—between 24 percent and 27 percent—while bond holdings varied between 37 percent and 44 percent (chart 2).

Participants in defined contribution plans can generally choose from among various investment options. This raises regulatory issues that differ from those associated with employer-controlled management of defined benefit plans, and further underlines the diverse nature of pensions.

\(^1^7\)This number includes both indirect holdings (through bank pooled funds) and direct holdings.

\(^1^8\)Here, assets refer only to direct holdings; assets held indirectly through bank pooled funds are excluded due to data limitations.

\(^1^9\)Due to potential reporting inconsistencies on IRS Form 5500, some pension holdings of GICs may not be included in private trusteed estimates.

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**Chart 2**

**Percentage of Pension Funds in Equity, by Plan Type, 1982–1988**

Private insured pensions are largely (81 percent) backed by general accounts. It is not meaningful to distinguish which general account monies are specifically allocated to back the pension obligations. The remaining 19 percent of insured pension fund assets are in separate accounts. Nearly one-half of these separate account assets are in equity, and 36 percent are in bonds.

State and local pension plans, which are growing faster than their corporate counterparts, have increased the proportion of their assets held in equity since 1950, while decreasing the proportion held in bonds. In 1950, 95 percent of these funds were invested in bonds. By the end of 1988, bond holdings accounted for 57 percent of total assets and equity accounted for 36 percent.

For 1988, net inflows to all pension funds resulted from a positive $145 billion in earnings and $1 billion in net withdrawals.

Pension Contributions and Earnings

Total net flows to private trusteed pension funds from earnings and net contributions have increased pension assets annually for the past five years—including 1987, when the stock market declined. For 1988, net inflows to all pension funds resulted from a positive $145 billion in earnings and $1 billion in net withdrawals.

Private trusteed pension assets have reported favorable investment returns on aggregate during the past five years. For the five years ending December 31, 1988, aggregate pension assets achieved an estimated average annual five-year return of 13.1 percent. Directly held equity experienced a five-year annualized return of 16.5 percent, compared with 15.3 percent for the Standard & Poor’s 500. Large defined contribution plans (those with more than $25 billion in assets) as a group experienced the largest five-year return on equity (17.4 percent, annualized).

Strong growth in pension assets continued during the fourth quarter of 1988. Total assets grew from $1,245 billion to $1,274 billion, or 2.3 percent for the quarter, capping 12.7 percent growth for the year. Total assets experienced a return of 1.8 percent for the quarter.

Receipts to public pension funds also come from contributions and investment earnings. In the year ending September 30, 1988, employer and employee contributions amounted to 45 percent of the total $82 billion in receipts. During the past several years, earnings have grown as a percentage of receipts, and in the year ending September 30, 1988, made up 55 percent of receipts, compared with 43 percent in the year ending September 30, 1982.20 (U.S. Department of Commerce, various quarters).

Pension Fund Management and Investment Policies

Pension funds are managed in different ways, according to the objectives they seek to realize.

20These earnings exclude unrealized gains and losses on investments.
Determinants of Investment Decisions

Responsibility for investment decisions and the manner in which these decisions are reached can vary from plan to plan and often vary particularly between defined benefit and defined contribution plans.

**Private Defined Benefit Plans**—In a defined benefit pension plan (as in all ERISA plans), responsibility for investment decisions ultimately rests with the “named fiduciary.” One or more “named fiduciaries” are designated in the plan document or are identified as such, as described in ERISA section 402(a)(2). Fiduciary responsibility, however, extends to anyone who has discretionary authority or control over the management and administration of the plan or who renders investment advice.

ERISA requires plan fiduciaries to act in a manner consistent with what a “prudent” person would do (the prudent man rule), and holds those violating this standard personally liable for resulting losses. However, two fiduciaries of different plans could legitimately make opposite decisions based on their plans’ nature and circumstances.

During the 1970s, some companies replaced external management of their pension fund with internal management. This action was probably taken as a result of the strong growth of pension assets during this period and ERISA’s increased regulatory requirements—for example, vesting standards, reporting and disclosure requirements, and fiduciary requirements—which outside managers may have had difficulty understanding (Katzenbach, 1987).

To carry out his or her responsibility, the fiduciary of a defined benefit plan looks to people both within and outside the firm. Inside the firm, the board of directors can help set, or does set, the long-term pension investment objectives (Katzenbach, 1987). Money managers, legal counsel, and advisors can be brought in from outside the firm to facilitate implementation of the board’s objectives and set the pension fund investments on a steady course.

One study found evidence suggesting that, in setting investment objectives, sample firms take their overall financial position into account, as opposed to looking at the pension fund as an entirely separate fund. However, larger firms were more likely to view the pension fund separately (Bodie, 1987).

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In September 1987, DOL published proposed regulations granting defined contribution plans that meet the criteria of ERISA section 404(c) some relief from fiduciary responsibility.

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**Private Defined Contribution Plans**—Some defined contribution plans, as stated above, allow participants to choose among various investment options. Proponents of this practice maintain that it allows individuals to determine their own level of investment risk, while opponents feel participants do not have the advantage of investment advisors, education, information, or perhaps time to make the wisest investment decisions. If participants are permitted to make investment decisions, the plan fiduciary must administer the plan and see that proper investment alternatives are offered, as specified in ERISA.

In September 1987, DOL published proposed regulations granting defined contribution plans that meet the criteria of ERISA section 404(c) some relief from fiduciary responsibility. These regulations state that if participants have investment choices, they should be offered a broad choice of investment alternatives. For an investment choice to qualify as meeting one of these objectives, the participants must have sufficient infor-

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21 This would include the overall borrowing of the company as well as the asset allocation of all the firm’s resources.
A survey of 761 defined contribution plans conducted at the beginning of 1986 found that 76 percent of these plans gave participants some discretion over the investment of their accounts. Of these, 51 percent offered a choice of four or more investment options (A.S. Hansen, Inc., 1987). The most common option was an equity fund, which was offered by 52 percent of the plans for employee contributions and 35 percent for employer contributions. In both cases, the next most popular options were GIC funds and fixed income funds.

FASB 87 suggests to pension sponsors a long-term market interest rate to determine the value of pension liabilities for disclosure on companies’ financial statements.

Defined contribution plan participants apparently have increasing control over the investment of their accounts. According to surveys of defined contribution plans, 96 percent allowed employees some choice in the investment of funds in 1986, compared with 86 percent in 1977 (Bankers Trust Company, 1987). An increase was also found in the number of funds offered. In 1986, 41 percent of plans gave employees a choice of four or more plans, compared with 15 percent in 1977.

The most common investment choice was an employer stock fund, with 85 percent of plans offering this investment option in 1977 and 82 percent offering it in 1986. However, between 1977 and 1986, plans offering GIC funds increased from 23 percent to 63 percent.

Financial Accounting Standard 87—Financial Accounting Standards Board Statement No. 87 (FASB 87), adopted in December 1985, fundamentally changed the public accounting standards for sponsors of private defined benefit pension plans. FASB 87 requires the inclusion of unfunded pension liabilities on the body of corporate balance sheets beginning in 1989, rather than in a footnote as under prior standards. Thus, for disclosure purposes, an underfunded plan will become a corporate liability. In addition, FASB 87 uses the projected benefit obligation instead of the actuarial benefit obligation, as most firms previously used. As a result, future salary increases will be taken into consideration when figuring the benefit obligation.

Pension fund executives may seek ways to avoid having pension liabilities that would appear on the balance sheet or to control expense volatility. If they choose to prevent (or minimize) a pension liability on the bal-

24For a further explanation of FASB 87 and its effects, see Employee Benefit Research Institute, “Employers' Accounting for Pensions and Other Post-Employment Benefits,” EBRI Issue Brief no. 82 (October 1988).

25Because properly adhering to these standards leads to nonqualified financial statements, many firms follow these standards even though they are not required to do so.
ance sheet, they may seek to construct pension portfolios in which the market value of the assets will respond to changes at approximately the same time and in approximately the same amount as the present (or discounted) value of plan liabilities. This could be done through dedicated or immunized bond portfolios.26

Alternatively, plan sponsors may try to limit FASB 87’s impact on their income statements. Plan sponsors with well-funded plans are more likely to do this since these plans would not generally have an underfunded liability to report on the balance sheet. This strategy would require that changes in the market value of plan assets move with changes in projected benefit obligations.27

Within the component to be included on the income statement there is a dampening element designed to minimize the pension cost volatility otherwise resulting from FASB 87. It consists of gains and losses resulting from (1) experience differing from that assumed, (2) realized and unrealized gains and losses, or (3) changes in assumptions. These gains and losses are included only if they exceed a corridor amount.28

As a result of these two provisions, pension funding levels could affect corporate stock prices. In an environment in which market swings can change the value of pension assets, and interest rate changes can affect the present value of pension liabilities, future funded ratios (and, therefore, stock price changes) may become more difficult to predict. Some speculate that plan sponsors will respond to the new rules by seeking ways to stabilize funded ratios.

Passive management attempts to achieve average performance, after adjusting for risk.

Public Plans—There are distinctions among public pension plans concerning the type of management used: internal and/or external management. Internal management is through a plan trustee, an internal manager, or plan participants, whereas external management is through investment managers or a master trustee. According to a 1987 survey, 49 percent of public plans use internal management and 82 percent use external management (Greenwich Associates, 1988b).29 Larger public funds were more likely to use internal management: 72 percent of those with more than $1 billion in assets, compared with 33 percent of those with less than $50 million in assets. The survey also found that state funds are more likely to use internal management than municipal funds.

Passive Versus Active Management

After determining the investment objectives, it must be decided how a portfolio will be managed to achieve them. Although there is a continuum of management strategies, each with its advantages and disadvantages, the two poles are passive and active management. The primary differences between passive and active management are the frequency and time frame of transactions.30

It is possible for plans to use both types of management; therefore, these numbers add to more than 100 percent. “Management” here refers to those who determine how the pension plan fund will be invested.

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26A dedicated portfolio uses a fixed income portfolio whose cash flows match liability requirements. An immunized portfolio matches the durations of the bonds with the duration of liabilities.

27Projected benefit obligation is the actuarial present value of all benefits attributed by the plan’s benefit formula to employee service prior to that date, assuming future salary levels.

28The corridor is defined as 10 percent of the greater of the projected benefit obligation or the market-related value of plan assets. The annual amortization will be equal to the amount of unrecognized gain or loss in excess of the corridor divided by the average remaining service period of active employees expected to receive benefits under the plan.

29It is possible for plans to use both types of management; therefore, these numbers add to more than 100 percent. “Management” here refers to those who determine how the pension plan fund will be invested.
Passive management attempts to achieve average performance, after adjusting for risk. Its proponents assume that markets are basically efficient and the expected gains from active trading are more than offset by increased expenses. In other words, since financial analysts use basically the same methods for choosing stocks and rely on the same information, it is not possible for any manager to outperform the market for long.

Active management attempts to achieve higher-than-market risk-adjusted returns, and in doing so may also risk lower-than-market returns. Some active managers specialize in securities of a specific area or in a specific industry to achieve the higher returns; others use market timing to benefit from price volatility either in a stock, an industry, or in the overall market.

This strategy is more work intensive and sometimes involves performance fees to reward managers for above average investment performance. These fees were used by 7 percent of large corporate funds and 15 percent of public funds in 1988 (Greenwich Associates, 1989).³¹

Although active and passive management can be separately defined, a portfolio investment strategy can combine these investment strategies. For example, one-half of the portfolio could use core investment and the other half could be actively managed through market timing.

Program Trading

Program trading is based on the connection between the stock and futures markets. It is carried out using mathematical models that respond to certain relative price movements. This type of trading is also called “informationless” since the decisions are based solely on price rather than on information about the firm whose stock is being considered. Of the various forms of program trading, the most well-known is portfolio insurance. Using this strategy, a fund manager attempts to sell futures in a stock when the stock price is falling and to buy when the price is rising, thereby, “protecting” the portfolio from unacceptable losses.

Between 1987 and 1988, the percentage of large corporate pensions using portfolio insurance decreased from 7 percent to 4 percent, according to the 1989 Greenwich survey. This survey showed that in 1987...

³¹Thirty-two percent of the respondents to the Greenwich survey of large corporations were either uncertain or did not provide an answer as to whether they favored performance fees. ERISA has sometimes been interpreted as prohibiting such fees, but opinion letters from DOL in 1986 permitted the use of certain types of performance fees after careful examination to avoid conflict of interest.
Proxy Voting

The increased holdings of the equity market by institutional investors has enlarged the role of these investors in proxy voting. A pension fund experiencing poor returns or disagreements with management concerning a particular stock may be unable to sell the stock because of the large amount owned. Therefore, these investors may try to increase the value of stock holdings through proxies and can actually wield much power in proxy issues.

According to DOL’s interpretation of ERISA, the responsibility of voting proxies rests with the investment manager as specified in the plan document or through the named fiduciary, unless it is delegated to others or reserved to the trustee. On accepting this responsibility, the investment manager must follow fiduciary standards. The plan fiduciary must monitor the investment manager’s proxy. ERISA does not allow the investment manager to delegate this responsibility. DOL has emphasized that plan fiduciaries, when voting proxies, must operate in a fashion consistent with the sole purpose of the pension plan: to benefit the participants and beneficiaries. DOL also suggests that written guidelines on voting should be provided to avoid conflicts of interest and potential abuse (Walker, 1988). It is not in keeping with ERISA to decline to vote proxies, even on controversial issues.

Surveys have found that internally and externally managed plans differ in their voting practices.

In February 1988, DOL issued an opinion letter to Avon Products—widely referred to as the “Avon letter”—clarifying issues on proxy voting by plan fiduciaries. The letter states that, in DOL’s opinion, to comply with ERISA, documentation should be kept on the investment manager’s activities, including proxy votes, and on the fiduciary’s monitoring activities (U.S. Department of Labor, 1989a). This position was reinforced in an advisory letter to the Polaroid Corporation on February 23, 1988, which emphasized that it is the responsibility of fiduciaries to exercise independent judgment when voting shares.

A recent DOL study found that 61 percent of investment managers surveyed were responsible for voting proxies and voted the proxies. However, nearly one-half of these managers did not have that authority specifically through written plans or trust agreements.

DOL states that this is not a representative survey, but it provides some insights into the procedures of some plans. However, the study notes, “several relied on the terms in their investment management agreements that gave them investment responsibility that was ‘full discretion’ and ‘full discretionary responsibility’ to assume voting responsibility where their prototype investment management agreements were silent.”
Only 31 percent had formal written procedures for voting. DOL warns in the report that private pension funds and money managers should make their voting practices more explicit in terms of following ERISA guidance (U.S. Department of Labor, 1989b).

Surveys have found that internally and externally managed plans differ in their voting policies. In a survey conducted by the Investor Responsibility Research Center (IRRC) in 1986 to determine how institutional investors, including 19 corporate pension funds, voted their proxies, 15 of the 19 pension plan sponsors said that at least part of their funds were externally voted, and only one reviewed the managers’ voting policies. All four of the internally managed funds reported having established voting policies. Similarly, a 1987 Employee Benefit Research Institute (EBRI) survey of voting policies among 334 corporate plan sponsors showed that more than 43 percent of internally managed funds had a written policy for voting, while only 21 percent of externally managed funds had such a policy (Employee Benefit Research Institute, 1987).

**Several proxy issues, such as shareholder rights plans, greenmail, and investments in South Africa, have received attention recently.**

A small percentage of public funds have policies on voting proxies. In the 1988 Greenwich survey, 19 percent reported having a written policy on proxy voting, and 16 percent said that they discussed proxy votes during review meetings. Large public funds (those with more than $1 billion in assets) were the most likely to have these policies, with 28 percent having written policies although only 16 percent said that they discussed the votes. Among the funds with assets between $250 million and $1 billion, 25 percent had written policies and 25 percent discussed proxy votes. Large public funds were more likely to have a written policy on pressure by senior management (that is, pressure that managers can exert on the person voting the proxy), with 16 percent having such policies, compared with 9 percent for public funds overall (Greenwich Associates, unpublished).

**Specific Proxy Issues** — Several proxy issues, such as shareholder rights plans, greenmail, and investments in South Africa, have received attention recently. There does not appear to be a consistent stance by all pension funds on shareholder rights plans or “poison pills.” Poison pills enable shareholders to purchase shares from, or sell shares back to, the target company at a price that does not conform to their fair market value, i.e., to purchase shares at less than market value or sell them at higher than market value (Institutional Shareholder Services, Inc., 1988). Although stockholders do not vote directly to authorize poison pills, preferred stock authorizations are usually a first step toward implementing them. Corporate pension funds were split on preferred stock authorizations, with two out of four opposing all such proposals, according to the IRRC survey.

The EBRI survey showed that 42 percent of internally managed ERISA funds and 15 percent of externally managed funds had a written policy on recapitalization strategies, including preferred stock authorizations and antigreenmail stock buy-backs. (The latter prohibit certain stock repurchases without shareholder approval to discourage greenmail—whereby the target company managers pay the hostile bidder above-market prices if the bidder agrees not to attempt to gain control for a specified time.)

In the IRRC survey, internally managed corporate pension funds opposed greenmail by supporting anti-
greenmail proposals, except occasionally when these proposals were combined with other provisions. Antigreenmail provisions state that if one shareholder is offered the above-market price, all shareholders must be offered that same price. The IRRC survey found that public pension funds also generally supported antigreenmail proposals.

Finally, the IRRC survey revealed corporate pension plans’ positions on several other controversial issues. Internally managed corporate pension funds were opposed to unequal voting rights plans, the most common of which is a dual class recapitalization plan leading to two classes of stock—one with super voting rights. This can put more power in management’s hands, making a hostile takeover more difficult.

An IRRC survey of institutional investors covering the 1988 proxy voting season focused on several specific social responsibility proposals. Most prominent were proposals to force the withdrawal of business operations from, and/or cut nonequity ties with, South Africa. Overall, pensions varied their voting on these issues, although some funds figured prominently in the list of proponents of these resolutions, including the Teachers Insurance and Annuity Association/College Retirement Equities Fund and the New York State Common Retirement Fund (Williams, 1988).

Pension Involvement in Investment Instruments

Pension fund investments are diverse, and include international stocks and financial futures. The investment by plans in corporate takeovers has become an issue of concern to public policymakers.

Participation in Leveraged Buyouts

An area of growing controversy is pension involvement in the financing of leveraged buyouts (LBOs), although such activity is extremely limited. LBOs are financed through (1) bridge loans (or short-term loans) obtained from an investment bank, (2) money from investors, and (3) bank financing based on the assets of the target company. The bridge loan is later replaced with high-yield or “junk” bonds bought by individuals or institutional investors, including pension funds (Brady, 1989). Total LBO transactions are estimated at $157.1 billion from 1984 to the end of 1988. This figure does not include the $24.5 billion RJR Nabisco, Inc., transaction, which was not completed in 1988 (Bureau of National Affairs, 1989; Kilborn, 1989).

Seven percent of the large corporate pension funds used these bonds in their portfolio in 1988, down from 32 percent in 1984. Among public funds, 9 percent used junk bonds in 1988, up from 7 percent in 1987. According to the Council of Institutional Investors (CII), less than 1 percent of total pension assets are invested in junk bonds, and pension funds account for approximately 15 percent of all junk bond purchases (Teslik, 1989). CII estimates that pension funds currently contribute approximately $3.5 billion to LBO pools, or less than 1 percent of total assets, and that only a small number of funds invest in them—23 of the 200 largest funds (Bureau of National Affairs, 1989).

DOL estimates that pension funds invest less than 2 percent of their total assets in junk bonds and LBOs (Walker, 1989). The Financial Executives Institute Committee on Investment of Employee Benefit Assets (CIEBA) reports that 1 percent of their members’ total assets are invested in LBO equity and debt, with about 30 percent of the members involved in such investments. Investments in publicly traded junk bonds account for 1.3 percent of their total assets (Shultz, 1989; Crain Communications Inc., 1989a).

Six percent of the large corporate pension funds in the Greenwich survey38 invested some money in an LBO

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36This would include all ties that do not include money, such as business relations.

37CIEBA has 40 regular members and approximately 150 advisory members with collective assets of $450 billion.

38This is a survey of 1,000 large pension plans, which may be more likely to make more risky investments than smaller plans.
Public pension funds seem to be growing more cautious about investing in LBOs.

Are pension fiduciaries required, under ERISA, to invest in LBOs to achieve the higher stock prices that normally occur in such takeovers? DOL and the Department of the Treasury have stated that investment decisions are not automatic, and that each decision must be based on an evaluation of relevant facts and circumstances. In other words, there is no requirement for pension fund managers to look exclusively at the short-term high returns; they can take the longer term into account.

Public Funds—According to a report by the Public Policy Institute of New York State, Inc., “With increasing frequency over the past five years, public pension systems have been aiding and abetting corporate takeovers.” The report adds that these actions by public funds, including the movement among some public pension funds to reject any and all takeover defenses, are motivated not by economic factors but by political and legal considerations such as “one share, one vote” or a shareholders’ bill of rights. The Public Policy Institute recommends that these pension funds and corporations should be able to work together to achieve long-term economic goals.

Public pension funds seem to be growing more cautious about investing in LBOs. The Alaska Retirement System was prevented by law until last year from making such investments, and is still studying the potential of this type of investment. The California Public Employees’ Retirement System, the nation’s largest public fund, is considering investing in carefully selected LBOs this year. The Wisconsin Investment Board has also stayed out of LBOs since 1988, although it did commit $700 million to LBOs in earlier years. The Michigan State Employees’ Retirement Systems has been pleased with the results of its $400 million investment in LBOs, but is seeking a provision in future contracts prohibiting the use of its assets in hostile takeovers. The state treasurer wants a policy in which the fund would buy stock of Michigan-based companies to fend off such takeovers (Vosti, 1989). The New York State and Local Retirement Systems has invested $423 million, or about 1.1 percent of the system’s funds, in LBO pools (Crain Communications Inc., 1989b). However, Governor Mario Cuomo has asked the New York state pension fund to halt its investments in takeovers temporarily until a new task force can examine the impact of such holdings on the state’s economy. The task force has not yet returned its findings.

The much-publicized RJR Nabisco Inc. offer was partially funded by public and private pension funds. Kohlberg, Kravis, Roberts & Company (KKR) uses a limited partnership to raise money from company pension funds, university endowments, and state retirement funds. This fund is then used to finance takeovers, including that of RJR Nabisco. Almost one-quarter of the capital for this fund was planned to be provided by 11 state retirement funds, including those of New York, Iowa, Oregon, and Michigan, according to an unidentified partner. Private pensions in the fund included Coca-Cola, Georgia-Pacific, Avon Products, and Chevron (Wallace, 1988).

Increase in LBO Activity—Federal Reserve Board Chairman Alan Greenspan attributes the increase in LBO activity to the rapidly changing economy, including “swings in the exchange value of the dollar . . . rapid technological progress . . . and large movements in real interest rates and relative prices.” These
changes, along with slow productivity during the 1970s, have led to a backlog of inefficient corporate practices and a less-than-optimal mix of assets in many corporations, leaving opportunities for corporate raiders to take over and improve the companies’ financial situation. However, SEC Chairman David Ruder said he feels that corporate cash flows (money coming in compared with money paid out) are more pertinent to making a company a buyout target (Cox, 1989).

Greenspan has indicated that participation in LBOs by pension funds, mutual funds, and insurance companies is not excessively risky, because their portfolios are generally well diversified. This was echoed by a DOL spokesman who said that further restriction of pension investment in LBOs or any other investments could adversely affect the health of pension plans in the long term by limiting their ability to diversify. DOL will continue to monitor the situation, especially if the economy declines, as many of these instruments (including LBOs, junk bonds, etc.) have not been tested in a declining market.

Greenspan has said that the correct way of curtailing LBO activity is to stabilize interest rates, exchange rates, and product prices: good macroeconomic policies. These policies would also include federal budget deficit reduction.

Changing the Tax Code—Changing the tax treatment of various sources of financing available to corporations is often considered as a way to curb LBOs. Debt enjoys favorable tax treatment through the deductibility of interest, while the dividends paid to stockholders come from after-tax earnings and are subject to income taxes.

In testimony before the Senate Finance Committee on January 24, 1989, Treasury Secretary Nicholas Brady stated that raising taxes on debt would only serve to increase the total cost of raising capital for U.S. companies, putting them at a competitive disadvantage with other nations. Instead, he would like to lower the taxation on corporate equity, allowing corporations to deduct a portion of the dividends they distribute, as in ESOPs. Brady also said he realizes this type of change may not be feasible, given the present state of the federal budget deficit. He mentioned that, in combination with lower taxes on equity, a limit could be imposed on the amount of interest that companies are allowed to deduct from their taxes, thus making it a revenue neutral plan (Kilborn, 1989). SEC Chairman Ruder also said that he supported, at least philosophically, granting corporations tax deductions for dividends paid.

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The House Committee on Ways and Means Committee on February 2, 1989, Greenspan stated that the structure of corporate taxes, including the favorable treatment of debt, is not a new development. Therefore, it is unlikely that this situation has led to the increased LBO activity and other kinds of corporate restructuring. He stated, “Restrictions on the deductibility of interest unavoidably involve an important element of arbitrariness, one that will affect not only those types of lending intended [for LBOs] but other types as well.” He added that if it were not for current federal budget deficit problems, the double taxation of dividends could be eliminated, helping to correct the distortion.

SEC Chairman Ruder also said that he supported, at least philosophically, granting corporations tax deductions for dividends paid.
tions or denying the deduction for debt incurred for certain purposes; relieving a portion of corporate-level tax on earnings distributed as dividends; placing an excise tax on services rendered for, or profits from, such activities; placing an excise tax on the acquisition or sale of assets in transactions such as hostile takeovers; and limiting the tax advantages of loans to ESOPs.

ESOPs and Takeovers

Pension plans, including ESOPs, must be managed for the sole benefit of employees; therefore, an ESOP should not be established to avoid a takeover if employees would be made worse off. The courts may disallow an ESOP if it is determined that it was pushed through solely in response to a possible takeover.

Through ESOPs employers may attempt to concentrate voting power in “friendly” hands, that is, with employees.

ESOPs are defined contribution plans qualified either as a stock bonus plan or as a combination stock bonus and money purchase plan. In February 1989, there were an estimated 9,500 ESOPs, covering 10 million employees, with an estimated $30 billion in trusts (National Center for Employee Ownership, 1989). ESOPs must be primarily invested in the employer’s qualified securities. According to a survey conducted in 1985 by the U.S. General Accounting Office (GAO), 5 percent of companies sponsoring an ESOP did so to avoid a hostile takeover (GAO, 1986). The National Center for Employee Ownership (NCEO) estimates that less than 1 percent of all ESOPs, and 15 percent of public company ESOPs, are part of a defense against hostile takeovers.

Through ESOPs employers may attempt to concentrate voting power in “friendly” hands, that is, with employees. Employees may be sympathetic to current management in order to ensure more security. However, ESOP participants may be allowed to direct the voting of securities allocated to their accounts (pass-through voting). Participants need not be allowed to direct the voting of unallocated securities. Participants’ votes can, however, be exercised by corporate management under an arrangement that covers all shareholders.

A “leveraged ESOP” is the type claimed to fend off takeovers because it can borrow money to acquire stock in a short period of time, although according to the GAO study only 6 percent of leveraged ESOPs were started to avoid a hostile takeover. Leveraged ESOPs enjoy several tax advantages not afforded to other ESOPs or defined contribution plans. Contributions

40 For more technical information on ESOPs, see Employee Benefit Research Institute, “Employee Stock Ownership Plans: Impact on Retirement Income and Corporate Performance” EBRI Issue Brief no. 74 (January 1988).

41 This would include readily tradeable common stock, stock with voting power and dividend rights, preferred stock that is convertible into qualified common stock, and stock of affiliated corporations. Debt instruments are not included. For stock acquired after 1986, ESOPs must provide means for qualified participants nearing retirement to diversify up to 50 percent of their account among at least three nonemployer investments.

42 The most popular reason for establishing an ESOP is as an employee benefit plan; in this survey, 94 percent of companies sponsoring ESOPs cited this reason. Tax advantages and increasing productivity were also popular reasons, cited by 74 percent and 70 percent of the companies, respectively. Multiple responses were allowed.

43 This is true if the employer has securities required to be registered under section 12 of the Securities and Exchange Act of 1934. Employers without that type of registration requirement must only allow pass-through voting with respect to major corporate issues if their stock is not publicly traded and if the plan has invested more than 10 percent of its assets in registration-type securities. Major corporate issues are those matters that must be decided by a super-majority of shareholders.

44 Unallocated securities are those acquired by the ESOP through a loan. As the loan is paid off, securities are allocated to the participants’ accounts.

45 Special provisions exist for closely held newspapers. See ERISA sections 401(a)(22) and 409(l)(4) for more detail.
that are used to repay an ESOP loan are tax deductible, thus making payment of principal, as well as interest, tax deductible within limits. Also, the lender does not have to pay federal income tax on one-half of the interest income, an advantage that may be passed on to the sponsor through a lower interest rate on the loan. According to NCEO, ESOPs borrowed $6.5 billion in 1988, a $1 billion increase from 1987, and a record $5.5 billion was borrowed during the first quarter of 1989.

The apparent use of ESOPs as a takeover defense has attracted attention lately. During 1988, Polaroid was almost taken over by Roy E. Disney’s company, Shamrock Holdings, Inc. Polaroid put 14 percent of the outstanding stock into its employees’ ESOP. Shamrock took Polaroid to court, saying that the ESOP was solely a takeover defense. The court decided the ESOP was legal as a redesign of the benefits package financed through pay cuts. The court decision is under appeal (Donovan, 1989).

Lockheed Crop. recently created an ESOP, continuing a company restructuring begun in August 1988. The plan was established, Chief Executive Daniel Tellep stated, to increase incentives for workers, and it replaced part of the company’s 401(k) plan. However, the ESOP was established shortly after Harold Simmons’ announcement that he owned 5.3 percent of the company. The company put $500 million into the ESOP, acquiring about 17 percent of its stock (Harris, 1989).

Some proponents of ESOPs point out that their original purpose—to diffuse ownership—may be lost if ESOPs are used as a takeover defense and as a means of keeping current management in control. Others say that if the bidders were well financed, the price offered for the shares may be high enough that the plan fiduciary would be forced to tender, or sell, the stocks in the plan rather than hold out for current management (Hilder, 1989). An April 4, 1989, ruling of the SEC may dampen the use of ESOPs. This ruling states that if a sponsoring corporation guarantees subordinated debt as part of an ESOP transaction, then the total gain on the transaction is reduced by the amount of the guarantees. However, the IRS would expect taxes to be paid on the full amount of gains.

Investments of tax-exempt funds, including pension funds, in the international community have grown dramatically during the 1980s.

Several companies with recently established ESOPs include Boise-Cascade, J.C. Penney, General Mills, Ralston Purina, ITT Corp., and Procter & Gamble.

Soft Dollars

“Soft dollars” are credits that brokers give big investors such as pension plans in return for stock trading business. The use of this type of credit has recently been questioned by DOL, which is reported to be close to bringing a case against a money management firm involving “the use of soft dollars to correct trading errors made by a money manager, providing no benefits to the pension fund’s beneficiaries” (Ricks, 1989).

According to the Greenwich survey of large corporate pension plans, the use of soft dollars to pay for investment research declined from 13 percent in 1986 to 5 percent in 1987.
International Investments

Investments of tax-exempt funds, including pension funds, in the international community have grown dramatically during the 1980s. In 1979, these funds held $3.8 billion in international investments; by 1986, these investments had grown to $55.4 billion (Rogge, 1987). Tax-exempt funds are estimated to have held $58.6 billion in international investments in 1987 (Frank Russell Asset Strategy Consultants, 1987).

According to Greenwich Associates, the number of large corporate pension funds investing in international stocks is also increasing. Thirty-five percent of the companies in the survey were using international stocks in 1988, an increase from 19 percent in 1983. The survey found that the largest firms were most likely to invest in international securities. The percentage of public pension funds using international stocks increased from 11 percent 1986 to 25 percent in 1988.

Financial Futures

Financial futures are similar to commodity futures except that the “commodity” is a financial instrument, such as a Treasury bill or a certificate of deposit. Financial futures can be used as a hedge on the direction of the price of the financial instrument. Since these prices move with interest rates, financial futures are often used (1) to speculate on the direction of interest rates, or (2) to hedge against adverse fluctuations in interest rates. According to the Greenwich survey of large corporate pension plans, the percentage using financial futures grew from 7 percent in 1984 to 16 percent in 1987. The use of these futures by public funds increased to 9 percent in 1987, up from 6 percent a year earlier.

◆ Conclusion

The growth of pension assets in the economy has been substantial over the past 50 years, and shows no signs of abating. This increased financial status brings pensions to the forefront of many financial issues, including LBOs, corporate takeovers, and proxy voting. Private pension plan fiduciaries must operate within the bounds set by ERISA by ensuring that each investment decision is in the best interest of plan participants and beneficiaries. Public pensions are not subject to ERISA. They are regulated by the respective state or municipality. It is important to remember these constraints and differences in order to understand the unique role of pension plans within the economy and the financial community as well as the differences in private and public pension investment decisions.

Pension plans and corporate management are both owners in the U.S. economy, and both hope that the value of stocks will increase. Each claims to be looking to the long-term but feels constrained by the other. Pension plan managers are often judged by management on a quarter-by-quarter basis vis-a-vis market returns. A pension plan may hold a small percentage of many companies in order to be diversified, but cannot act as an active owner in all these businesses. Management sees pension plan holdings of their own firm’s stock as a short-term situation. Management also can see many pensions investing in their firm, with no one person or plan representing all these interests.

As ERISA is interpreted, private pension investors are required to diversify their assets in accordance with the prudent man rule. As a result, pension plans can be expected to be involved in all types of investments, including those considered high risk. The proportion of assets allocated to such investments is generally small, but a small percentage of $2.3 trillion can make a big difference to venture capitalists, start-up companies, and others who present high-risk opportunities and the potential for high returns.

Pension assets are important to the U.S. economy as well as to the benefit security of millions of workers and retirees. These facts guarantee continued public policy interest in how they are invested.
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