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### **ABSTRACT**

This paper presents a dynamic model of a public pension fund's choice of portfolio risk. Optimal portfolio allocations are derived when pension fund management maximize the utility of wealth of a representative taxpayer or when pension fund management maximize their own utility of compensation. The model's implications are examined using annual data on the portfolio allocations and plan characteristics of 125 state pension funds over the 2000 to 2009 period. Consistent with agency behavior by public pension fund management, we find evidence that funds chose greater overall asset – liability portfolio risk following periods of relatively poor investment performance. In addition, pension plans that select a relatively high rate with which to discount their liabilities tend to choose riskier portfolios. Moreover, consistent with a desire to gamble for higher benefits, pension plans take more risk when they have greater representation by plan participants on their Boards of Trustees.

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## **I. Introduction**

This paper examines the portfolio allocation policies of U.S. state and local government pension funds. It presents a dynamic model of public pension fund investment choice and analyzes how risk-taking behavior may vary with the pension plan's characteristics. Risk is measured by the volatility of a fund's asset portfolio rate of return relative to the rate of return on the market value of its liabilities. The model's implications are examined using annual data on 125 state pension funds over the period from 2000 to 2009.

The asset allocation choice of a public pension fund is critical to understanding the problem of public pension plan under-funding. A public pension fund's annual investment return is typically much larger in magnitude than its annual employer and employee contributions (Munnell and Soto (2007)). Furthermore, the fund's portfolio allocation across broad asset classes is the major determinant of its investment return (Brinson, Hood, and Beebower (1986) and Brinson, Singer, and Beebower (1991)). Thus, a pension fund's portfolio allocation policy has first-order consequences for its funding status.

Public pension fund asset allocation also is of interest because, in aggregate, it has changed drastically over time. Based on Federal Reserve Flow of Funds data, Figure 1 shows that state and local government pension funds invested almost entirely in cash and fixed income instruments during the 1950s, but gradually increased their portfolio allocations in equities and, more recently, in other investments (including real estate,

private equity, and hedge fund investments).<sup>1</sup> This trend slowed over the last decade, a period when public pension portfolio allocations to equities, fixed income, other investments, and cash have averaged 59%, 30%, 9%, and 2%, respectively.

A benchmark policy for assessing a pension fund's investment choice is a portfolio allocation that best hedges or "immunizes" the risk of its liabilities. The value of a pension fund's liabilities equals the value of the retirement annuities that it is obligated to pay its employees and retirees. These retirement annuities typically are linked to a worker's wages and years of service, and most often payments are partially indexed to inflation. Hence, the value of pension liabilities is exposed to risks from real or nominal interest rate changes and also changes in wage rates. Therefore, a satisfactory analysis of portfolio choice with a goal of liability immunization should account for uncertainty in both interest rates and wage growth.

Portfolio allocations that deviate from the benchmark portfolio which best immunizes liabilities introduce what we refer to as "tracking error." This paper considers how different pension fund objectives influence the choice of tracking error volatility and how this volatility might be influenced by the pension plan's funding ratio, past returns, and other plan characteristics. Our study is perhaps the first to examine the overall asset - liability risks of a time series – cross section sample of public pension funds. We use data on state and local government wages and various investment classes to compute a single measure of tracking error volatility for each pension fund during each year. We estimate the risks of wage changes and changes in the returns on long-term real and nominal liability payments as well as the risks of returns on seven different investment

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<sup>1</sup> Munnell and Soto (2007) also document this trend in public pension allocation. Similar behavior has

categories: U.S. equities, foreign equities, U.S. fixed income, foreign fixed income, real estate, private equity, and hedge funds. By using the covariance matrix of these assets' returns and an individual pension fund's portfolio allocation and liability structure, we calculate each fund's overall tracking error volatility and then relate this measure to the fund's characteristics.

The plan of the paper is as follows. Section II briefly discusses related theoretical and empirical work on the portfolio allocations of state and local pension funds. Our model is presented in Section III. Section IV describes our data and variable construction, while Section V presents the empirical results. Concluding comments are in Section VI.

## **II. Related Literature on Public Pension Fund Portfolio Allocation**

The focus of this paper is a public pension fund's portfolio allocation relative to a benchmark portfolio that best hedges (immunizes) the fund's liability risks. To evaluate liability risk, one must first determine a method for valuing pension liabilities since they are not marketable securities. There is disagreement on how this should be done, with the major conflict between the actuarial approach specified by the Government Accounting Standards Board (GASB) and the market value approach based on finance theory.<sup>2</sup> The GASB actuarial approach discounts a pension plan's future retirement payments using the expected rate of return on the pension plan's assets, rather than a discount rate appropriate to the actual risk of the pension plan's retirement payments.

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occurred with corporate defined-benefit pension plans. See, for example, in Ruthen (2005).

<sup>2</sup> GASB is a private organization established in the early 1980s. While not obligated to do so, in practice state and local pension plans report the value of their pension liabilities using GASB standards. GASB also sets standards for contributions that public pension funds should make to prevent significant underfunding. Munnell, Haverstick, Sass, and Aubrey (2008) credit the creation of GASB with improved funding by public pension plans.

As pointed out in many papers, most recently by Brown and Wilcox (2009), Lucas and Zeldes (2009), and Novy-Marx and Rauh (2009), valuation using the GASB actuarial standard is inconsistent with basic financial theory. Moreover, its use creates moral hazard incentives in the form of “accounting arbitrage”: a pension plan has the incentive to invest in assets with high systematic risk in order to justify a higher discount rate that will reduce the actuarial valuation of its liabilities. The GASB standard also can lead to accounting games that reach beyond the public pension fund by reducing the accounting value of a municipality’s overall budget deficit via the issuance of pension obligation bonds.<sup>3</sup>

A financial valuation approach eliminates these arbitrage opportunities and moral hazard incentives. We take it as a settled question that a financial theory-based market valuation approach more accurately reflects the risk of pension liabilities. A more subtle issue is whether the most relevant market value measure should be the pension fund’s Accumulated Benefit Obligation (ABO) or Projected Benefit Obligation (PBO). Typically, the annual annuity payment paid by a public pension plan to a participant is the product of the participant’s final average salary over the last one to five years, years of credited service, and a benefit multiplier often from 1% to 2.5%. The ABO is the present value of these payments based on current years of service and the current average salary, whereas the PBO is the present value based on current years of service and an estimated future average salary just prior to retirement.

Arguments for using ABO include Bulow (1982), Bodie (1990), Gold and Hudson (2003), and Brown and Wilcox (2009). In contrast, Lucas and Zeldes (2006),

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<sup>3</sup> Munnell, Calabrese, Monk, and Aubry (2010) show that issuance of pension obligation bonds became a

Peng (2009), and Munnell, Kopcke, Aubry, and Quinby (2010) support the use of PBO. ABO may better reflect the pension fund's current legal obligation to pay benefits. However, for hedging liability risk when the public pension plan is likely to be a continuing concern, the PBO better incorporates future risks. Therefore, we employ it to value our benchmark immunizing portfolio.<sup>4</sup> The effect of using PBO is to include future wage uncertainty as a component of overall liability risk.

Black (1989) recommends that if a pension fund manager takes a narrow view by hedging the ABO measure of pension liabilities, the pension portfolio should invest almost exclusively in duration-matching bonds. If a broader PBO view is taken, then he recommends some allocation to stocks under the assumptions that stock returns are positively correlated with wage growth. Peskin (2001) supports this view and finds that a 20% to 90% allocation to equities could be optimal depending on the characteristics of a particular public pension fund.

Lucas and Zeldes (2009) come to a similar conclusion from a model where a municipality wishes to minimize tax distortions and pension liabilities are positively correlated with stocks. Their model predicts that pension funds should invest more in stocks if their liabilities are more wage-sensitive, which should be the case if a pension fund has a relatively high ratio of currently-employed pension participants to pension plan retirees. However, they find no empirical evidence for this prediction based on year 2006 Boston College Center for Retirement Research (CRR) data on equity allocations

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losing investment strategy as a result of the recent financial crisis.

<sup>4</sup> Bodie (1990) argues that a corporate pension fund's relevant obligation to be hedged is its ABO because its PBO is not guaranteed by the corporation or by the Pension Benefit Guaranty Corporation (PBGC) should the corporation fail. This reasoning is less relevant for public pension plans. Peng (2009) argues that public plan benefits are relatively more secure because, unlike corporate plans, municipalities typically

for state and local pension funds. They did find that pension plans with higher funding ratios allocated more to stocks.

### **III. A Public Pension Fund Model**

A public pension fund's portfolio choice will derive from its objective function. Therefore, we begin by considering both normative and positive objectives of a public pension fund's investment management.

#### **III.A The Public Pension Fund's Investment Objective**

As will be discussed, academics and practitioners often disagree on the proper objective of a public pension plan. The divergence of views partly may arise due to the difficulty of envisioning an objective for a public pension fund that is separate from the overall objective of its municipal government. As one component of the government, a public pension fund's portfolio choices could be made in conjunction with the municipality's other asset and liability decisions. For example, pension portfolio decisions might account for a desire to hedge liability risks that include municipal bonds and other benefit obligations, in addition to pension liabilities.

Taking an even broader Ricardian (1820) / Modigliani-Miller (1958) perspective would imply that even the municipal government's overall objective is not relevant when it is but one component of individuals' overall portfolio decisions. As discussed in Bader and Gold (2007), arguments along the lines of Barro (1974) imply that any balance sheet (including pension fund) decision made by a municipal government would be offset by the savings and portfolio decisions of rational private agents. If private individuals and firms recognize the future tax consequences of a government's (dis-) savings and

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cannot extinguish their obligations to pay pension benefits, even following bankruptcy. As a consequence,

portfolio decisions, those public decisions could be over-turned by private portfolio decisions.<sup>5</sup>

However, as summarized in Elmendorf and Mankiw (1999), the conditions that enable private individuals to fully neutralize government savings and portfolio decisions are unlikely to hold in practice. Heterogeneity amongst individuals, borrowing constraints, tax distortions, and imperfect information regarding government policies implies that public pension policies very likely effect the net tax burdens by individuals and, therefore, have real welfare consequences.

Due to such frictions, Peskin (2001) argues that the risk that pension fund returns fail to match pension fund liabilities imposes intergenerational transfers because future generations are not compensated for the taxes they pay to cover current pension obligations resulting from pension underfunding. Intergenerational equity is likely to be improved if unfunded pension costs are not borne by later generations of taxpayers. Moreover, relative to the federal government, state and local governments have more limited means with which to cope with underfunding: they cannot inflate-away the value of their liabilities via money creation. Thus, unlike the federal social security program that operates on a pay-as-you-do basis, state and local governments may want to maintain a funded pension plan in order to minimize the possibility of unsustainable fiscal imbalances. Peng (2009) believes this is the reason why almost all state and local pension plans are pre-funded.

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a public-sector worker who continues to be employed is likely to receive her PBO at retirement.

<sup>5</sup> For example, McDonald (1983) argues for a Miller Theorem result where a reduction in equity issuance by private corporations offsets increased municipal bond issuance. Lucas and Zeldes (2009) discuss how a Modigliani-Miller (1958) Theorem can hold where private portfolio decisions undo public ones.

Even if pension fund deficits are covered by an immediate rise in taxes paid by the current generation of taxpayers, risk-aversion and intra-generational equity can be an additional rationale for hedging. Not only might a pension fund's objective be to fund the present value of pension obligations as they accrue, but also to reduce the uncertainty that investment returns fail to match the change in the present value of obligations due to changing market conditions. A fully-funded pension plan whose investments best hedge the change in value of its liabilities fits this ideal of minimizing the uncertainty of taxes needed to fund pension obligations.<sup>6</sup>

We find this argument compelling, with one caveat. It is unlikely that a municipal government's other expenditures for non-pension benefits are fully matched by contemporaneous tax revenues at each point in time. In particular, during economic downturns, tax revenues (excluding pension contributions) typically fail to cover non-pension expenditures. If one wished to hedge the net tax surplus of the municipality's aggregate balance sheet, pension investments might be chosen so that their returns outperform those of pension liabilities during economic recessions and underperform them during economic expansions.<sup>7</sup>

Thus, from a normative view based on minimizing inter- and intra-generational inequities, a strong argument may be made that pension liabilities should be funded as they accrue and investment policy should be that which best hedges liabilities and, possibly, the municipality's other budget deficits.

In practice, state and local governments typically do not incorporate pension fund investment decisions within a single, framework for managing their overall balance

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<sup>6</sup> The Lucas and Zeldes (2009) model with costly tax distortions provides these insights.

sheets. Rather, governments delegate the administration of a public pension plan to a Board of Trustees who may be appointed or may be elected by plan participants. The Board's scope of responsibility tends to focus narrowly on the pension plan, without regard to other municipal assets and liabilities. Most commonly the Board sets policy objectives regarding investment policies and asset allocation that are carried out by a supporting staff headed by an executive director. The Board and staff often further delegate investment decisions to professional pension plan consultants and money managers.

The typical procedure is for the Board to establish broad asset allocations in various investment classes, such as fixed income, equities, and alternative investments. Within these classes, internal staff and/or external money managers are given responsibility for choosing particular securities and investments. Most frequently, a money manager's performance is measured against market benchmarks or peer money managers having similar investment styles.

Evidence suggests that the most important aspect of a pension fund's overall investment performance is its decisions regarding allocations into various asset classes, rather than the choice of money managers for each given asset class. Empirical studies of large corporate pension funds by Brinson, Hood, and Beebower (1986) and Brinson, Singer, and Beebower (1991) find that over 90% of investment returns are explained by a fund's asset allocation policy. Hence, it would appear that the pension Board's asset class allocation decisions are critical.

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<sup>7</sup> One indication of such a situation is when a municipal government finds it difficult to make pension contributions to cover accrued liabilities during poor economic conditions.

Presumably, the objectives set by a public pension fund's Board would determine the chosen asset-class allocations. Peng (2009) notes that typically these objectives state numerical goals for ex-post investment returns, rather than a desire to hedge the risk of liabilities. Moreover, asset-class portfolio weights often are chosen based on mean-variance portfolio efficiency with little regard to the risk characteristics of pension liabilities. As a consequence, a pension fund's chosen investments may leave it exposed to significant risk from changes in the market value of its liabilities.<sup>8</sup>

Why might the investment objectives of many public pension funds have minimal connection to the risk characteristics of their liabilities? A potential explanation for this behavior is that archaic GASB pension fund accounting clouds the true market valuation of pension liabilities. Lacking a market value measure of liabilities to benchmark the market value of pension assets may discourage the hedging of pension liability risk. Moreover, opaque accounting of pension liabilities may affect how the pension fund's performance is measured. Rather than, or in addition to, being judged on how the pension fund's investments hedge the market risk of its liabilities, the pension Board and staff's performance may be gauged against the investment performance of similar public pension funds. Peskin (2001) describes such a peer group benchmark as belonging to the "traditional" approach to public pension investment management. Park (2009) argues that such a peer group benchmark is a result of career concerns by the public pension plan's Board of Trustees and staff and is reinforced by "prudent person" fiduciary standards.

### III.B Public Pension Fund Portfolio Choice

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<sup>8</sup> For example, Ruthen (2005) and Adams and Smith (2009) point out that the typical pension fund's large

Given the previous discussion, we begin with a model that assumes a non-Ricardian environment where a pension fund's objective recognizes that its future funding status has tax consequences for a representative resident of the municipality. Since a pension plan's Board of Trustees tend to have a narrow scope of responsibility, we also assume that the pension fund's objective is separable from the other assets and liabilities composing the municipality's overall balance sheet. Because future funding status depends on the risk of pension liabilities, in addition to pension investments, our analysis first recognizes the role of liability risk and considers a liability immunizing portfolio as the benchmark investment strategy. We will later consider the consequences of an investment objective that is divorced from liability risk and where the pension fund's benchmark becomes the average performance of its peers.

The model is similar to Chen and Pennacchi (2009), and details regarding its derivation can be found in that paper. Let the initial date be 0 and let the end of the pension fund's performance horizon be date  $T$ . The interval from date 0 to  $T$  might be interpreted as the municipality's fiscal year or a longer period over which pension over- or under-funding has tax consequences and thereby affects the wealth of the municipality's residents. Since our focus is on portfolio allocation given an initial level of funding, we assume that contributions by the pension fund's government employer and its employees are made just prior to date 0, as are any cash outflows to pay retirement benefits. Thus from date 0 to date  $T$ , the only changes in the values of pension assets and liabilities are assumed to derive from their market rates of return.

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allocation to equities while its liabilities are fixed income in nature exposes it to increased underfunding when interest rates unexpectedly decline.

During the interval from dates 0 to  $T$ , the pension fund's benchmark, which for now is assumed to be its liabilities,  $L_t$ , follows the process

$$\frac{dL_t}{L_t} = \alpha_L dt + \sigma_L dz_L \quad (1)$$

where  $dz_L$  is a Brownian motion process. The Appendix shows how a rate of return process of this form can be derived from the value of individual employees' projected benefits and retirees' annuities. In particular, the process depends on risks from changes in wages and changes in the value of nominal or, in the case of Cost of Living Adjustments (COLAs), inflation-indexed (real) bonds.

The pension fund can choose investments that are assumed to perfectly match (immunize) the above rate of return on liabilities. It can also choose another portfolio of "alternative" securities. These alternative securities are defined as the portion of the fund's total assets that accounts for the difference between the fund's portfolio and one that is invested solely in the liability immunizing benchmark portfolio. Let  $A_t$  be the date  $t$  value of this alternative securities portfolio. Its rate of return follows the process<sup>9</sup>

$$\frac{dA_t}{A_t} = \alpha_A dt + \sigma_A dz_A \quad (2)$$

where  $dz_A$  is another Brownian motion such that  $\sigma_L dz_L \sigma_A dz_A = \sigma_{AL} dt$ . For simplicity,  $\sigma_A$ ,  $\sigma_L$ , and  $\sigma_{AL}$  are assumed to be constants.  $\alpha_A$  and  $\alpha_L$  may be time varying, as would be the case when market interest rates are stochastic, but it is assumed that their spread,  $\alpha_A - \alpha_L$ , is constant.

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<sup>9</sup> Although we only consider the choice of a single alternative securities portfolio, the appendix of Chen and Pennacchi (2009) shows that permitting multiple alternative security choices can simply to this single alternative portfolio choice problem.

If at date  $t$  the pension fund allocates a portfolio proportion of  $1-\omega_t$  to the immunizing portfolio and a proportion  $\omega_t$  to the alternative investments, then the value of the pension fund's asset portfolio,  $V_t$ , satisfies

$$\begin{aligned}\frac{dV_t}{V_t} &= (1-\omega_t)\frac{dL_t}{L_t} + \omega_t\frac{dA_t}{A_t} \\ &= \left[ (1-\omega_t)\alpha_L + \omega_t\alpha_A \right] dt + (1-\omega_t)\sigma_L dz_L + \omega_t\sigma_A dz_A\end{aligned}\quad (3)$$

Whenever  $\omega_t \neq 0$ , the fund's return in equation (3) deviates from the liability immunizing portfolio's return. Now define  $G_t \equiv V_t/L_t$  to be the pension fund's date  $t$  funding ratio; that is, value of the fund's assets relative to that of its liabilities. At date 0,  $G_0 = V_0/L_0$  and then by Itô's lemma evolves over the interval from date 0 to date  $T$  according to

$$\frac{dG_t}{G_t} = \omega_t (\alpha_A - \alpha_L + \sigma_L^2 - \sigma_{AL}) dt + \omega_t (\sigma_A dz_A - \sigma_L dz_L) \quad (4)$$

Given that a public pension fund must pay its promised retirement benefits, future over- or under-funding at date  $T$  is assumed to be the obligation of the municipality's taxpayers. Thus, an aggregate change of wealth equal to  $V_T - L_T$  accrues to taxpayers at date  $T$ . For analytical convenience, the population of representative taxpaying individuals at date  $T$  is assumed to be proportional to the value of date  $T$  liabilities.<sup>10</sup>

Hence, the representative taxpayer's date  $T$  wealth might be written as

$$\begin{aligned}W_T &= \hat{w} + \lambda \frac{V_T - L_T}{L_T} = \hat{w} - 1 + \lambda G_T \\ &= w + \lambda G_T\end{aligned}\quad (5)$$

where  $w \equiv \hat{w} - 1$  is assumed to be a constant that includes wealth unrelated to pension funding and  $\lambda > 0$  is the ratio of pension liabilities per representative taxpayer. The

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<sup>10</sup> This would be approximately the case if there is a steady-state ratio of pension benefits to population,  $\lambda$ .

larger is  $\lambda$ , the more sensitive is the taxpayer's wealth to the pension plan's funding status. If taxpayers' utilities display constant relative risk aversion with coefficient  $(1 - \gamma) > 0$ , and pension investment policy has the objective of maximizing their utility, then the pension fund's asset allocation problem is

$$\text{Max}_{\omega(t) \forall t \in [0, T]} E_0 \left[ \left( \frac{w + \lambda G_T}{\gamma} \right)^\gamma \right] \quad (6)$$

subject to the pension funding ratio dynamics in equation (4). The solution for the optimal portfolio proportion invested in the alternative securities for any date  $t \in [0, T]$  is<sup>11</sup>

$$\omega_t^* = \frac{\alpha_G}{(1 - \gamma) \sigma_G^2} \left( 1 + \frac{w}{\lambda G_t} \right) \quad (7)$$

where  $\alpha_G \equiv \alpha_A - \alpha_L + \sigma_L^2 - \sigma_{AL}$  and  $\sigma_G^2 \equiv \sigma_A^2 - 2\sigma_{AL} + \sigma_L^2$ . Equation (7) says that when  $\alpha_G$  is positive (*negative*), the pension fund takes a long (*short*) position in the alternative securities.<sup>12</sup> This deviating position is tempered by the relative volatility of the alternative securities,  $\sigma_G$ , and also the representative taxpayer's coefficient of relative risk aversion,  $(1 - \gamma)$ .

Perhaps the most interesting insight from equation (7) is how allocations away from the perfectly immunizing portfolio vary with the current pension funding level,  $G_t$ :

$$\frac{\partial |\omega_t^*|}{\partial G_t} = -w \frac{|\alpha_G|}{(1 - \gamma) \lambda G_t^2 \sigma_G^2} \quad (8)$$

This derivative is negative whenever  $w$  is positive, so that when the representative taxpayer's wealth unrelated to pension funding is sufficiently large, declines in  $G_t$  raise

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<sup>11</sup> See Chen and Pennacchi (2009) for the derivation.

$|\omega_t^*|$ . In other words, a fall in the pension plan's funding ratio leads to a larger deviating allocation and greater "tracking error" risk, which might be interpreted as risk-seeking behavior. The reverse holds when  $w$  is negative, so that when wealth unrelated to pension funding is small, the pension fund decreases its deviating allocation (tracking error) with pension underfunding; that is, it better hedges its liabilities as its funding ratio declines. The intuition for this behavior stems from the desire to avoid negative wealth when  $w < 0$  makes it a possibility.

Based on our earlier discussion, these model results come with several caveats. First, the representative taxpayer faces taxation risk not just from the municipality's pension under-funding but from other deficits/surpluses that may arise from the government's other activities. Recognizing these other sources of tax uncertainty in the individual's wealth in equation (5) could motivate the pension fund to hedge those risks. For example, if budget surpluses were procyclical, the pension fund might wish to choose counter-cyclical alternative securities that produce high (*low*) returns relative to the benchmark during economic recessions (*expansions*).

Second, the model takes the individual's portion of wealth unrelated to pension returns,  $w$ , as non-stochastic, as might be the case if the individual invested entirely in a default-free bond maturing at date  $T$ . If this other wealth were invested in risky assets, then again there would be a hedging motive when the pension fund chose its portfolio weight in the alternative securities. Third, if the representative taxpayer's choice of assets that composed her personal wealth were endogenous, then the pension fund's portfolio choice and the uncertainty of  $G_T$  could be offset by personal portfolio decisions.

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<sup>12</sup> It can be shown that the optimal portfolio behavior ensures that  $[1 + w/(\lambda G_t)]$  is always positive.

Fourth, if personal portfolio decisions were endogenous and the municipality wished to maximize the representative taxpayer's utility of wealth after paying federal income taxes, then Bader and Gold (2007) show that the pension fund should be invested in bonds, rather than equities. Because equities are taxed at a lower federal personal tax rate relative to bonds, but all pension fund investments are federal tax-exempt, individuals would pay lower federal taxes if their exposure to (relatively high-taxed) bonds were held by the pension fund and they held equities in their personal portfolio.

Finally, it may be unrealistic to assume that when the pension fund ends with a surplus ( $G_T > 1$ ) that the representative taxpayer's wealth is incremented by that amount. Political pressure leads to a sharing of the surplus with employees in the form of a reduction in employee contributions or an increase in pension benefits.<sup>13</sup>

These numerous caveats cast doubt on whether a public pension fund's investment strategy should attempt to provide an optimal tradeoff of expected return for risk on behalf of taxpayers as outlined in equation (7). Rather, these qualifications tend to favor an investment policy that passively follows the liability immunizing strategy where  $\omega_t = 0 \forall t$ . Such a strategy would be transparent to taxpayers, allowing them to focus on their individual portfolios. It also avoids generating surpluses that taxpayers would be forced to share with employees. In addition, since this policy entails primarily fixed-income investments, it provides federal tax savings.

Shifting from a normative to a positive theory of public pension fund investment behavior, we note that the practice of delegating pension fund management could lead to agency problems where the Board of Trustees and staff maximize their own utility of

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<sup>13</sup> This point is made by Peskin (2001), Bader and Gold (2007), Peng (2009), among others.

wealth rather than that of a representative taxpayer. In addition, since stated objectives guiding pension plan investments often downplay the risk of pension liabilities, the Board and staff may be judged against a broader set of benchmarks that include the investment performance of peer pension plans. In this light, the wealth in equation (5) can be re-interpreted as that of the pension Board and staff where the process followed by the benchmark  $L_t$  in (1) may not necessarily be the rate of return on the pension fund's liabilities but could be a benchmark such as the average rate of return earned by other public pension funds. Thus, if explicit or implicit (career concern) compensation is performance-related, the pension Board and staff's wealth will be linked to future relative performance,  $G_T = V_T/L_T$ , measured as the pension plan's funding ratio or its investment performance relative to its peers.

The solution for optimal portfolio choice continues to satisfy equations (7) and (8), so that if the Board and staff's wealth unrelated their pension performance is sufficiently large ( $w > 0$ ), they will increase the fund's tracking error risk as their relative performance declines. If their wealth that is unrelated to performance is low ( $w < 0$ ), the pension fund's management will decrease its tracking error risk as its performance declines.

The next sections of the paper examine the empirical evidence related to our model based on a time series and cross section of state pension plans. We investigate how a state pension plan's choice of tracking error volatility, which from equation (4) is given by  $|\omega_i| \sigma_c$ , relates to its characteristics, such as the plan's funding ratio and its performance relative to its peers. We also consider other characteristics related to plan

design, governance, and participant demographics that could determine tracking error risk.

#### **IV. Data and Variable Construction**

Our data on state pension funds comes from two sources. The first source is Wilshire Associates who generously provided us with an annual time series of investment information on 125 state pension funds over the 2000 to 2009 period.<sup>14</sup> This data includes each fund's actuarial values of liabilities and actuarial and market values of assets for each of the ten years. Also for each year, it gives every fund's proportion of assets allocated to eight different categories: U.S. equities, non-U.S. equities, U.S. fixed income, non-U.S. fixed income, real estate, private equity, hedge funds, and other. Also included is each fund's assumed rate for discounting liabilities and the total payroll for active participants in the pension fund.

The second source of pension fund information comes from the Boston College Center for Retirement Research (CRR). This is publicly-available data on 112 state pension funds for the year 2006.<sup>15</sup> It includes individual pension fund characteristics pertaining to governance, the type of plan participants (general employees, teachers, or police and firefighters), the design of plan benefits (e.g., the type of COLA), and numbers of active members and annuitants.

Comparing the state pension funds in the Wilshire data to those in the CRR data led to 97 matches. Based on these 97 state plans, we selected from the CRR the following variables: the ratio of a pension fund's Board members who are plan participants to the total Board members of the pension fund; a dummy variable equaling

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<sup>14</sup> Due to late reporting, information on only 50 state funds is available for the year 2009.

1 if the pension fund had a separate investment council (zero otherwise); and a dummy variable equaling 1 if the contribution rate of the pension fund sponsor was statutorily set (zero otherwise).

As previously mentioned, our measure of a pension fund's overall asset - liability risk-taking is its tracking error volatility. To translate a given pension fund's asset-class allocations for a given year into this risk measure, we collected for the period January 1997 to April 2010 monthly time series of asset returns in order to estimate a covariance matrix of returns for seven different asset classes.<sup>16</sup> The following asset return series were chosen: U.S. equities – Vanguard Total Stock Market Index Institutional Fund; Non-U.S. equities – Vanguard Total International Stock Index Fund; U.S. fixed income – Vanguard Total Bond Market Index Institutional Fund; Non-U.S. fixed income – Barclays Capital Global Majors, Ex. U.S., Fixed-Income Index; Real estate – Wilshire U.S. REIT Index; Hedge funds – Morningstar MSCI Composite Hedge Fund Returns; and Private equity – Cambridge Associates U.S. Private Equity Returns.<sup>17</sup> In addition, while not an asset class specified in the Wilshire data, a part of our analysis of tracking error volatility will use a Treasury Inflation-Protected Securities (TIPS) return series, which we proxied by the Vanguard Inflation-Protected Securities Institutional Fund.

Time series were also collected on wage growth and returns on nominal and real (inflation-indexed) bonds. This data was used to estimate the variances of market returns

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<sup>15</sup> This data is at [http://crr.bc.edu/frequently\\_requested\\_data/state\\_and\\_local\\_pension\\_data\\_4.html](http://crr.bc.edu/frequently_requested_data/state_and_local_pension_data_4.html).

<sup>16</sup> Recall that the Wilshire data reports eight different asset allocation classes, but one of them is "Other." Because the average "Other" allocation was only 1.9%, we ignored it when computing tracking error volatility and proportionally increased the other allocation weights so that they summed to one.

<sup>17</sup> Each of these asset return series is at a monthly frequency except for the Cambridge Associates U.S. Private Equity Returns, which is quarterly. We used the monthly series to estimate the covariance matrix of returns, except for those matrix elements relating to the private equity returns, which were estimated based on a quarter time series of returns.

on pension fund liabilities as well as these returns' covariances with the different asset classes. For wages, we used the Bureau of Labor Statistics quarterly Employment Cost Index for State and Local Government Workers. For bonds, a monthly time series of 15-year maturity, zero-coupon bond returns were constructed for nominal Treasuries and Treasury Inflation-Protected Securities (TIPS) using the data of Gürkaynak, Sack, and Wright (2007, 2008).<sup>18</sup> We choose return series for nominal and real bonds having a maturity of 15 years because several sources indicate that the typical pension fund's liabilities have a duration of that length.<sup>19</sup>

In our model, tracking error volatility was represented by the quantity  $|\omega_t| \sigma_G$ , which is mathematically equivalent to the square root of the variance of the difference in the rates of return on pension assets ( $V_t$ ) and pension liabilities ( $L_t$ ):  $\sigma_V^2 + \sigma_L^2 - 2\rho_{VL}\sigma_V\sigma_L$ .<sup>20</sup> We estimated the variance of a pension fund's assets in a given year as  $\sigma_V^2 = \omega' \Omega \omega$ , where  $\Omega$  is the estimated covariance matrix of returns for the seven asset classes and  $\omega$  is the 7×1 vector of the fund's portfolio weights (allocations) in these seven asset classes.

As shown in the Appendix, pension liabilities under a PBO measure are composed of wage and bond risk, where the bond risk is either nominal or real (in the case of COLA benefits). Thus, the standard deviation of pension liabilities  $\sigma_L$  can be computed from the estimated standard deviations of wage growth ( $\sigma_{Lw}$ ) and nominal or real bond returns  $\sigma_{Lp}$  as well as their correlation  $\rho_{wp}$ :  $\sigma_L^2 = \sigma_{Lw}^2 + \sigma_{Lp}^2 + 2\rho_{wp}\sigma_{Lw}\sigma_{Lp}$ . We

<sup>18</sup> This Treasury and TIPS yield data is at <http://www.federalreserve.gov/econresdata/researchdata.htm>. We converted the monthly real returns on a 15-year TIPS to nominal ones using the Consumer Price Index.

<sup>19</sup> Ryan and Fabozzi (2002) state "an average 15.5 duration should be close to the median or average duration of the pension industry." Also, consulting firm Mercer LLC (2010) uses a 15-year duration for the average pension plan and states that a pension plan with a typical mix of active members and retirees has a duration between 13 and 16 years.

calculated this pension liability standard deviation,  $\sigma_L$ , for four different assumptions: 1) nominal liabilities; 2) real (COLA) liabilities; 3) nominal liabilities adjusted for the ratio of active to total plan participants; 4) real (COLA) liabilities adjusted for the ratio of active to total plan participants. The Appendix details how, in the latter two cases, the standard deviations of wage growth and bond risk (duration) were adjusted using the fund's ratio of active (employed) to total plan participants (including retirees). These adjustments permit a fund's liabilities to have a duration between 6 and 20 years.

As discussed in the previous section, in practice some pension funds may not view their liabilities as a benchmark but may benchmark their performance to that of peer public pension funds. Therefore, we created an additional tracking error volatility measure where, instead of the liability volatilities just discussed, we set

$\sigma_L^2 = \omega'_a \Omega \omega_a$  where  $\omega_a$  is a  $7 \times 1$  vector of portfolio weights (allocations) that are the averages across the 125 state funds for a particular year.

The last step in constructing tracking error volatility calculates the covariance between a fund's chosen assets and the selected liability/peer performance for a particular year:  $\rho_{VL} \sigma_V \sigma_L$ . Then the final measure of tracking error volatility is the square root of

$$\sigma_V^2 + \sigma_L^2 - 2\rho_{VL} \sigma_V \sigma_L.$$

Table 1 gives summary statistics for different asset class rates of return, as well as state and local employee wage growth and returns on 15-year zero-coupon nominal and real bonds. It is the annualized standard deviations and correlations from this table, which were calculated over the 1997 to 2010 period, that we use to construct tracking

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<sup>20</sup> Note  $\sigma_V^2 = (1 - \omega_i)^2 \sigma_L^2 + \omega_i^2 \sigma_A^2 + 2\omega_i (1 - \omega_i) \sigma_A \sigma_L \rho$  and  $\rho_{LV} \sigma_V \sigma_L = (1 - \omega_i) \sigma_L^2 + \omega_i \sigma_A \sigma_L \rho$ .

error volatilities. Of particular interest is the estimated correlation of -0.27 between state and local wage growth and U.S. equity returns. Prior research, including Black (1989), Cardinale (2003), and Lucas and Zeldes (2006, 2009) advocate pension fund investments in equities as a way to hedge wage uncertainty under the presumption that equities and wages are positively correlated.

A potential criticism of our negative wage-equity correlation estimate is that it is calculated over a quarterly holding period. Recommendations for using stocks to hedge wage growth assume that their correlation is positive over a longer holding period. Models by Lucas and Zeldes (2006), Benzoni, Collin-Dufresne, and Goldstein (2007), and Geanakoplos and Zeldes (2010) show that wage growth and stock returns can have zero short-run correlation but, due mean reversion, a correlation that becomes approaches 1 over long horizons.<sup>21</sup>

As a check, we calculated correlations between wages and equity returns over longer holding periods. Because the BLS state and local worker wage index extends back to only 1981, correlations between wage growth and equity returns and wage growth and bond returns were calculated using the BLS national wage index, which extends back to 1952. The return on equities was taken to be the S&P 500 return and the return on bonds was a 10-year and 20-year maturity Treasury bond return obtained from the Center for Research in Security Prices (CRSP).

Table 2 presents estimated wage – asset return correlations for holding periods from one year to nine years. Panel A indicates that there is little evidence of a positive correlation between wages and stock returns, and the correlation point estimates trend

more negative as the holding period increases. This pattern of correlation is consistent with Jermann (1999) who estimates wage – stock correlations over the 1929 – 1996 period, finding correlation point estimates that are negative at horizons from 7 to 17 years before turning positive. Since a typical pension fund’s duration of liabilities is about 15 years, it is not clear whether stocks are the best hedge of wage risk if their correlation becomes positive only at longer horizons.

Another asset class, possibly bonds, might better hedge wage risk.<sup>22</sup> Panels B and C of Table 2 find a correlation between wage growth and bond returns whose point estimates becomes more positive as the holding period increases. Though none of the correlation estimates in Table 2 are statistically significant, the overall evidence does not justify large equity holdings for hedging wage risk at horizons relevant to a typical pension fund.

Given our estimated asset return and wage growth standard deviations and correlations, the final input in constructing tracking error volatilities is each pension fund’s asset allocations for each year. Summary statistics of these allocations and the resulting tracking error volatilities are given in Table 3. Over the 2000-2009 period, there was a moderate decline in the allocation to U.S. equities that was offset by a rise in Non-U.S. equities and private equity. The allocation to U.S. fixed-income peaked at 33% in 2002 following the decline in technology stocks, but then trended downward to its minimum of 25% in 2009.

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<sup>21</sup> In contrast, Lustig and Van Nieuwerburgh (2008) present theory and empirical evidence for a negative correlation between innovations in human capital and financial asset returns that is counter to models such as Benzoni, Collin-Dufresne, and Goldstein (2007).

<sup>22</sup> Most models that demonstrate a long-run correlation between stock returns and wages assume that interest rates are constant. Hence, they do not consider the hedging characteristics of bonds.

The average tracking error volatilities in Table 3 show the average overall risk taken by the pension funds. The volatilities tend to be slightly lower when adjusted for fund-specific demographic differences as measured by the ratio of active (employed) to total participants. It may be unsurprising that when the average of funds' allocations is used as the benchmark, rather than a fund's liabilities, tracking error volatilities typically are the least.

Table 3 also includes the yearly averages for two variables that our model predicts may influence tracking error volatility: the plan's funding ratio and its investment return. The funding ratio is measured as the market value of assets divided by the actuarial value of liabilities. The plan's investment return in a given year is estimated as the product of its asset-class allocation weights times the returns earned by each of the asset classes.<sup>23</sup> As might be expected, the average funding ratio of these 125 state pension plans was highest at 109% during 2000 prior to the technology stock decline and was at a minimum of 58% during 2009. The significant underfunding in 2009 followed an estimated 30% investment loss in 2008.

## **V. Empirical Evidence**

### V.A Immunizing Allocations

As a prelude to examining how state pension funds' tracking error volatilities vary with their plan characteristics, we first ask what would be the asset portfolio allocations that minimize the typical fund's tracking error volatility.<sup>24</sup> This was done

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<sup>23</sup> While we have no data on each fund's actual investment return but only the fund's portfolio allocation for different asset classes and the asset classes' returns, the evidence Brinson, Hood, and Beebower (1986) and Brinson, Singer, and Beebower (1991) suggests that our proxy should be a close approximation.

<sup>24</sup> In principle, we could compute "optimal" portfolio allocations according to the model results in equation (7). However, this computation requires each asset class's expected rate of return, which are inaccurately estimated over our short sample period (Merton, 1980), so that the results would be highly speculative at

using our estimated covariance matrix for the asset classes' returns as well as these returns' covariances with wages and the 15-year duration liabilities of a typical pension plan.<sup>25</sup> We adjusted this typical pension fund's liabilities for demographics that assume a ratio of active participants to total participants of 66.57%, which was the average for our sample of pension plans. The portfolio allocations that best hedge (immunize) this pension fund's liabilities are given in Table 4.

Columns 1, 2, and 3 of Table 4 show results when the pension fund's liabilities are assumed to be purely nominal, having no COLAs. In column 1, the unconstrained allocation that minimizes tracking error volatility calls for a 9% short position in U.S. equities, a 160% allocation to U.S. fixed income, a 24% allocation to private equity, and a 67% short position in hedge funds. The huge allocation to U.S. fixed income is partly explained by our assumption that the pension funds' fixed-income investments are of lower duration (lower interest rate sensitivity) than the 15-year duration of the pension funds' nominal liabilities.<sup>26</sup> Effectively these allocations imply that the pension fund should borrow via short positions in other asset categories in order to increase its U.S.

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best. For example, Table 1 reports that the mean return on U.S. equities is less than that on U.S. fixed-income over the sample period, implying a negative equity premium. While a longer time series for equities and fixed income might be used to estimate expected returns, longer series for other asset categories are not generally available. Also, the aforementioned model caveats tend to move the socially optimal allocation toward full immunization, so arguably tracking-error minimizing allocations are probably close to optimal.

<sup>25</sup> The tracking error minimizing weights are given by  $\omega^* = \Omega^{-1}\Psi - \lambda\Omega^{-1}\mathbf{1}$  where  $\Omega$  is the 7×7 covariance matrix of asset returns and  $\Psi$  is a 7×2 vector of covariances between the asset returns and pension liabilities (wage and nominal or real bond),  $\mathbf{1}$  is a 7×1 vector of ones, and  $\lambda = (\mathbf{1}'\Omega^{-1}\Psi - 1) / (\mathbf{1}'\Omega^{-1}\mathbf{1})$ .

<sup>26</sup> Table 1 shows that the annualized standard deviation of U.S. Fixed Income returns is 0.0885 while that of the 15-year nominal bond is 0.1376, implying that the duration of the pension funds' U.S. fixed-income investments is approximately  $15 \times (0.0885 / 0.1376) = 9.6$  years. Adams and Smith (2009) believe that the typical pension funds' fixed income investments are of a lower duration than that of their liabilities.

fixed income investment, thereby raising its asset interest sensitivity.<sup>27</sup> If, instead, the pension fund's U.S. fixed income portfolio was assumed to take the form of 15-year zero-coupon bonds, then its tracking error minimizing allocation would be approximately 100%, rather than 160%, in U.S. fixed income.<sup>28</sup>

Because a short position in hedge fund investments is infeasible and a large allocation to private equity may be unrealistic, column 2 of Table 4 shows the volatility minimizing allocation if no private equity or hedge fund investments are permitted. There the allocation to fixed income becomes 136%, with a 13% short position in U.S. equities and a 17% short position in non-U.S. fixed income. Column 3 reports tracking error minimizing allocations when short sales are not permitted. Interestingly, the immunizing allocation is to invest 100% in fixed-income.

Columns 4 to 8 of Table 4 assume that the pension fund's liabilities are fully inflation-indexed, real liabilities. Given the widespread presence of COLAs in state and local pension benefits, this case may be more realistic relative to that of purely nominal liabilities. Though the Wilshire data do not specifically identify funds' allocation to inflation-indexed bonds (they would likely be included in U.S. fixed income), we consider allocations with and without including TIPS. When TIPS are included, column 4 shows that the immunizing allocation is 139% in TIPS with a large short position in private equity. If, as in column 5, private equity and hedge fund investments are disallowed, the TIPS allocation becomes 101%. Column 6 reports allocations when TIPS

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<sup>27</sup> Interestingly, some public pension funds are borrowing (short-term) to fund greater long-term bond investments. However, their motivation for this strategy appears more to increase their expected target rate of return rather than better hedge their liabilities. See "Pensions Look to Leverage Up: State of Wisconsin Investment Board Clears Plan to Borrow to Juice Returns," *The Wall Street Journal*, January 27, 2010.

<sup>28</sup> This ignores the desire to hedge the wage risk of liabilities. The allocation might be slightly more than 100% given the positive correlation between bond returns and wage growth.

are excluded. The allocation to U.S. fixed income becomes 60% and the allocation to non-U.S. fixed income is a large 18%. Moreover, the allocation to hedge funds switches signs, to a large 38% allocation financed with a 20% short position in private equity.

In column 7, the allocation that excludes TIPS and short sales calls for U.S. and foreign fixed income allocations of 70% and 21%, respectively, with an 8% allocation to hedge funds. The sizable position in foreign fixed income makes sense since it is likely to be a good hedge against U.S. inflation, assuming that exchange rates adjust with purchasing power parity. Column 8 permits investments in TIPS but no short positions. The result is a simple 86% allocation to TIPS and a 14% allocation to U.S. fixed-income.

Finally, note from the last row of Table 4, the minimum tracking error volatilities for both nominal and real liabilities are much lower than the average tracking error volatilities estimated in Table 3 for our sample of state pension funds. Figure 2 explores this point further by plotting the sample distribution of tracking error volatilities. It graphs, for each fund during each year, the volatility of tracking error relative to the fund's demographically-adjusted real liabilities (horizontal axis) versus the fund's volatility of tracking error relative to its peers (vertical axis). The distribution appears skewed, with only a few pension funds (primarily those with very high allocations to U.S. fixed-income) choosing allocations that immunize real liabilities.<sup>29</sup> The vast majority of pension funds' allocations result in peer tracking error volatilities below 4%, indicating a tendency to herd far away from an immunizing portfolio.

#### V.B Tracking Error Volatility and Plan Characteristics

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<sup>29</sup> A similar pattern of tracking error volatilities occurs if the funds' liabilities are assumed to be nominal.

Let us now investigate the relationship between a fund's characteristics and its choice of tracking error volatility. Our examination is based on the following linear regression model:

$$\begin{aligned} \sigma_{TE,i,t} = & \beta_1 \times (\text{Funding ratio})_{t-1} + \beta_2 \times (\text{Return relative to peers})_{t-1} \\ & + \beta_3 \times (\text{Governance variables}) + \beta_4 \times (\text{Other Control variables}) + \varepsilon_{it} \end{aligned} \quad (9)$$

where  $\sigma_{TE,i,t}$  is the tracking error volatility of fund  $i$  in year  $t$ . Taking the normative view that the pension fund should maximize the utility of a representative taxpayer, our model predicts that tracking error should be negatively related to the plan's funding ratio ( $\beta_1 < 0$ ) if the taxpayer's wealth is sufficiently large ( $w > 0$ ).

Instead, if the pension fund is managed to maximize the utility of wealth of the pension Board and staff, and their benchmark for compensation includes the "traditional" one of return performance relative to the fund's peers, then tracking error volatility should vary with the fund's past investment return. In particular, if the wealth of the pension Board and staff is sufficiently large ( $w > 0$ ), then tracking error risk should be high following a poor relative return. A poor relative return might also proxy for the amount of recent underfunding for which the Board and staff are directly responsible. Consequently, these interpretations of the model predict  $\beta_2 < 0$ .

The regression includes additional explanatory variables listed in Table 5. These include governance-related variables as well as other controls related to the type of participants and other characteristics such as a proxy for fund size (the natural log of the market value of pension assets), the ratio of payroll to pension liabilities, and the rate chosen by the fund to discount its liabilities. We include the fund's chosen discount rate,

not because it is an exogenous variable, but to explore whether tracking error risk is associated with a possible motive to underreport liabilities via a higher discount rate.

Table 6 reports the outcome of regressions in the general form of equation (9). Each regression specification controls for time (year) fixed-effects. In columns 1, 3, 5, 7, and 9, the regressions include time-invariant fund characteristics from the CRR dataset, so our observations drop to 97 pension plans per year. In columns 2, 4, 6, 8, and 10 we exclude the CRR data but control for fund fixed-effects, in which case the observations equal 125 pension plans per year.

The results in Table 6 do not differ much when the dependent variable, tracking error volatility, is based on a nominal or real pension liability benchmark that is or is not adjusted for the demographic characteristics of the individual pension plan. As shown in columns 1 to 8, three explanatory variables are always statistically significant: the prior year's investment return relative to peers; the fund's chosen rate used to discount liabilities; and the proportion of members of the Board of Trustees who are participants. In addition, the prior year's funding ratio is significant when the larger 125 plan sample, estimated with fund fixed effects, is used.<sup>30</sup>

The negative coefficients on the fund's prior-year return and its funding ratio can be interpreted as risk-taking behavior on the part of the Board and its staff. If compensation depends on the fund's investment performance relative to its peers, as well as possibly its funding ratio, then our model predicts that when Board wealth is

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<sup>30</sup> In unreported regressions that exclude the discount rate, the results are nearly identical except that the lagged funding ratio is significantly negative only for the regression with demographically unadjusted real liabilities and fund fixed-effects. As another check of robustness, we also substituted each fund's equity allocation for tracking error volatility as the dependent variable and obtained qualitatively the same results.

sufficiently large ( $w > 0$ ), the pension fund chooses greater tracking error volatility following poor investment performance.

The positive relationship between a fund's chosen rate to discount liabilities and its tracking error volatility also seems consistent with risk-taking behavior, though the direction of causality is unclear.<sup>31</sup> According to GASB standards, funds with higher tracking error volatility may be able to justify a higher discount rate because they are investing in assets with higher systematic (priced) risks. Or, it might be the case that a fund is motivated to select a higher discount rate in order to understate its liabilities and fictitiously increase its net worth in order to justify greater tracking error risk.

The finding that a fund takes more tracking error risk when it has greater participant representation on its Board of Trustees might be explained in a couple of ways. If pension participants are less financially literate than typical Board members, they may have less ability to select asset class allocations that provide a good hedge of the pension plan's liabilities. Alternatively, participants may knowingly wish to take more tracking error risk. If such a gamble results in a significant pension surplus, Peskin (2001), Bader and Gold (2007), and Peng (2009) point out that this surplus is typically shared with participants in the form of increased benefits or lower employee contribution rates. In contrast, if the gamble ends with a greater deficit, benefits for current participants typically cannot be cut and greater contributions by the state's taxpayers may result.

Columns 9 and 10 report regression results where the benchmark is assumed to be the average investment allocation by peer pension plans. The estimated coefficients tend

to be qualitatively different from the previous regressions where a liability benchmark was used. The positive and statistically significant coefficients on the plan's prior-year funding ratio and prior investment return indicate that pension funds deviate more from their peers following better performance. This finding that better-performing pension funds increase their tracking error relative to the average allocation of other funds is not inconsistent with the previous regression results. Figure 2 shows that peer and liability benchmarks are quite different, so when better-performing funds deviate more from their peers they move closer to an immunizing portfolio. In other words, a poorly-performing pension fund reduces the hedging of its liabilities and gambles by choosing a riskier portfolio more typical of its peers.

## **VII. Conclusion**

This paper presented a model of public pension fund asset allocation that might guide how a municipality chooses its pension investments. Our model suggests that hedging risk from changes in the market value of the pension fund's liabilities would be the primary concern in determining asset allocation decisions. The model also was extended to a setting where career concerns dictate the behavior of a pension fund's portfolio managers. Our empirical results seem consistent with such agency behavior. We find that a public pension fund's Board of Trustees and staff tend to allocate assets based on the performance of peer pension funds rather than based on hedging the pension plan's liabilities.

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<sup>31</sup> That funds choosing higher discount rates also choose higher tracking error volatility is consistent with Park (2009) who finds that public plans selecting higher discount rates are more likely to invest in real estate and alternative investments (including private equity and hedge funds).

Consistent with this positive, rather than normative, interpretation of the model, our empirical analysis of 125 state pension plans over the 2000-2009 period finds that a fund tends to take more asset - liability “tracking error” risk following declines in its relative performance. Tracking error volatility also is higher for pension funds that select a high rate with which to discount their liabilities and pension funds that have a greater proportion of participants on their Boards of Trustees.

The portfolio choices of public pension plans that deviate substantially from the liability immunizing strategies advocated by many academics seem hard to justify on public policy grounds. Opaque and misleading accounting standards that are divorced from finance theory may encourage public plans to follow their “traditional” investment strategies of choosing investments with little regard to their true liability risks. The pension fund asset-liability mismatches resulting from these strategies pose a potential burden to taxpayers that will be realized then economic conditions decline and when losses are most difficult to bear.

## Appendix

This appendix derives the value and risk characteristics of a pension fund's projected benefit obligation (PBO) when an employee's retirement benefit equals an annuity proportional to the employee's wages over the last  $N$  years of work. Both wage rates and interest rates are stochastic. One source of uncertainty that we neglect is the worker's probability of separation, though it would be relatively straightforward to incorporate this risk.<sup>32</sup>

Let the date  $t$  wage rate be  $w_t$ , which is assumed to grow at a rate that is a constant  $\delta$  less than the rate of return on a tradeable security that has the same priced risk as wage growth.<sup>33</sup> Then the risk-neutral process followed by the wage rate can be modeled as

$$dw_t / w_t = (r_t - \delta) dt + \sigma_w dz_w \quad (\text{A.1})$$

where  $\sigma_w$  is the standard deviation of wage growth and  $r_t$  is the instantaneous-maturity default-free (riskless) interest rate.

It is assumed that the term structure of default-free interest rates follows the model of Vasicek (1977), so that the risk-neutral process for  $r_t$  is

$$dr_t = \alpha(\bar{r}^\theta - r_t) dt + \sigma_r dz_r \quad (\text{A.2})$$

where  $\alpha$  measures the strength of mean reversion of  $r_t$  to its unconditional mean,  $\bar{r}^\theta$ , and the volatility  $\sigma_r$  is a constant. The risk-neutral unconditional mean equals  $\bar{r}^\theta = \bar{r} + \theta\sigma_r / \alpha$ , where  $\bar{r}$  is the interest rate's physical unconditional mean and  $\theta$  is a market price of interest rate risk. The wage process and interest rate process may be correlated, such that  $dz_w dz_r = \rho dt$ . This model of the instantaneous-maturity interest rates implies that the date  $t$  price of a zero-coupon bond that pays \$1 at date  $t + \tau$  is

$$P(r_t, \tau) = A(\tau) e^{-r_t B(\tau)} \quad (\text{A.3})$$

where  $A(\tau) \equiv \exp\left[\left(B(\tau) - \tau\right)\left(\bar{r}^\theta - \frac{1}{2}\sigma_r^2 / \alpha^2\right)\right]$  and  $B(\tau) \equiv (1 - e^{-\alpha\tau}) / \alpha$ . Applying Itô's lemma to equation (A.3) implies that the risk-neutral bond price process is

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<sup>32</sup> One could introduce a termination date that differs from the date when the annuity begins, since our framework already values individual cashflows that occur following retirement. Demographic data could be used to estimate a worker's probability of termination (or survival) during a maximum working horizon, so that valuation would assign a probability of different horizon annuities for each worker. Valuation would be particularly straightforward if termination probabilities were uncorrelated with interest rates and wages.

<sup>33</sup> Pennacchi (1999) similarly models wages. His footnote 18 discusses how to estimate the parameter  $\delta$ . If wage growth has positive systematic risk, as is probable if it is positively correlated with stock returns, then Geanakoplos and Zeldes (2010) correctly point out that expected future wages should be discounted at a higher than the risk-free rate. Our risk-neutral valuation approach also accounts for this effect.

$$\frac{dP(r_t, \tau)}{P(r_t, \tau)} = r_t dt + \sigma_p(\tau) dz_p \quad (\text{A.4})$$

where  $\sigma_p(\tau) \equiv \sigma_r B(\tau)$  and  $dz_p = -dz_r$ .

An employee is assumed to retire at date  $T$  and receive an annual annuity payment for  $m$  years. Each annual payment is set to  $c \sum_{n=0}^{N-1} w_{T-n}$ ; that is, a proportion of the last  $N$  years of wages.<sup>34</sup> To value this annuity, we divide it into  $N$  annuities, each starting at date  $T$  (with the first payment at date  $T+1$ ) but set to a different year's prior wage. The value of the annuity linked to the wage  $w_{T-n}$  is denoted  $V_E^n$ . Its value at date  $t < T-n$  is

$$\begin{aligned} V_E^n &= E_t^Q \left[ e^{-\int_t^T r_s ds} c w_{T-n} \sum_{i=1}^m P(r_T, i) \right] \\ &= c w_t E_t^Q \left[ e^{-\int_t^T r_s ds + \int_t^{T-n} (r_s - \alpha_w - \frac{1}{2} \sigma_w^2) ds + \sigma_w \int_t^{T-n} dz_w} \sum_{i=1}^m P(r_T, i) \right] \\ &= c w_t e^{-(\alpha_w + \frac{1}{2} \sigma_w^2)(T-n-t)} E_t^Q \left[ e^{-\int_{T-n}^T r_s ds + \sigma_w (z_{wT-n} - z_{wt})} \sum_{i=1}^m E_T^Q \left[ e^{-\int_T^{T+i} r_s ds} \right] \right] \\ &= c w_t e^{-(\alpha_w + \frac{1}{2} \sigma_w^2)(T-n-t)} E_t^Q \left[ e^{\sigma_w (z_{wT-n} - z_{wt})} \sum_{i=1}^m E_{T-n}^Q \left[ e^{-\int_{T-n}^{T+i} r_s ds} \right] \right] \\ &= c w_t e^{-(\alpha_w + \frac{1}{2} \sigma_w^2)(T-n-t)} E_t^Q \left[ e^{\sigma_w (z_{wT-n} - z_{wt})} \sum_{i=1}^m P(r_{T-n}, i+n) \right] \\ &= c w_t e^{-(\alpha_w + \frac{1}{2} \sigma_w^2)(T-n-t)} \sum_{i=1}^m A(i+n) E_t^Q \left[ e^{\sigma_w (z_{wT-n} - z_{wt}) - r_{T-n} B(i+n)} \right] \end{aligned} \quad (\text{A.5})$$

Given that  $r_t$  satisfies equation (A.2), its discrete-time distribution is normal with mean  $E_t^Q[r_T] = r_t e^{-\alpha(T-t)} + \bar{r}^Q (1 - e^{-\alpha(T-t)})$  and variance  $\text{Var}_t[r_T] = \sigma_r^2 (1 - e^{-2\alpha(T-t)}) / (2\alpha)$ .

Therefore the risk-neutral expectation in (A.5) equals

$$\begin{aligned} &E_t^Q \left[ e^{\sigma_w (z_{wT-n} - z_{wt}) - r_{T-n} B(i+n)} \right] \\ &= e^{-\left[ r_t e^{-\alpha(T-n-t)} + \bar{r}^Q (1 - e^{-\alpha(T-n-t)}) \right] B(i+n) + \frac{1}{2} \sigma_w^2 (T-n-t) + \frac{1}{2} B(i+n)^2 \frac{\sigma_r^2}{2\alpha} (1 - e^{-2\alpha(T-n-t)})} \\ &\quad \times e^{\rho \sigma_w \sigma_r B(i+n) \sqrt{(T-n-t)(1 - e^{-2\alpha(T-n-t)})} / (2\alpha)} \\ &= e^{-E_t^Q[r_{T-n}] B(i+n) + \frac{1}{2} \sigma_w^2 (T-n-t) + \psi(i+n, T-n-t)} \end{aligned} \quad (\text{A.6})$$

where

$$\begin{aligned} \Psi(i+n, T-n-t) &\equiv \frac{1}{2} B(i+n)^2 \frac{\sigma_r^2}{2\alpha} (1 - e^{-2\alpha(T-n-t)}) \\ &\quad + \rho \sigma_w \sigma_r B(i+n) \sqrt{(T-n-t)(1 - e^{-2\alpha(T-n-t)})} / (2\alpha) \end{aligned} \quad (\text{A.7})$$

<sup>34</sup> Typically, annuity payments are computed as the product of years of service, average wages over the last  $N$  years of service, and a conversion ratio. To value the plan's accrued liabilities adjusted for likely wage growth, the parameter  $c$  would equal the employee's current years of service times the conversion ratio.

Substituting this result into (A.5):

$$\begin{aligned} V_E^n &= cw_t e^{-\alpha_w(T-n-t)} \sum_{i=1}^m A(i+n) e^{-E_t^Q[r_{T-n}]B(i+n)+\psi(i+n,T-n-t)} \\ &= cw_t e^{-\alpha_w(T-t-n)} \sum_{i=1}^m P(E_t^Q[r_{T-n}], i+n) e^{\psi(i+n,T-n-t)} \end{aligned} \quad (\text{A.8})$$

The value of the entire annuity composed of those linked to each wage equals the sum:

$$\begin{aligned} V_E &= \sum_{n=0}^{N-1} V_E^n \\ &= cw_t e^{-\alpha_w(T-t)} \sum_{n=0}^{N-1} e^{\alpha_w n} \sum_{i=1}^m A(i+n) e^{-E_t^Q[r_{T-n}]B(i+n)+\psi(i+n,T-n-t)} \\ &= cw_t e^{-\alpha_w(T-t)} \sum_{n=0}^{N-1} \sum_{i=1}^m P(E_t^Q[r_{T-n}], i+n) e^{\alpha_w n + \psi(i+n,T-n-t)} \end{aligned} \quad (\text{A.9})$$

Equation (A.9) shows that the present value of the PBO obligation is a function of the current wage rate,  $w_t$ , various times until maturity ( $T-t+i$  where  $i=0, 1, \dots, m$ ), and the current interest rate,  $r_t$ , through the expectation

term  $E_t^Q[r_{T-n}] = r_t e^{-\alpha(T-n-t)} + \bar{r}^Q (1 - e^{-\alpha(T-n-t)})$ . Recognizing that the risk-neutral expected rate of return on the employee's benefit must equal  $r_t$  and its risk-neutral and physical volatilities are the same and given by Itô's lemma, this risk-neutral process satisfies

$$\begin{aligned} \frac{dV_E}{V_E} &= r_t dt + \frac{1}{V_E} \frac{\partial V_E}{\partial w_t} \sigma_w w_t dz_w + \frac{1}{V_E} \frac{\partial V_E}{\partial r_t} \sigma_r dz_r \\ &= r_t dt + \sigma_w dz_w + \frac{1}{V_E} \frac{\partial V_E}{\partial r_t} \sigma_r dz_r \end{aligned} \quad (\text{A.10})$$

The partial derivatives with respect to the interest rate is

$$\begin{aligned} \frac{\partial V_E}{\partial r_t} &= cw_t e^{-\alpha_w(T-t)} \sum_{n=0}^{N-1} \sum_{i=1}^m \frac{\partial P(E_t^Q[r_{T-n}], i+n)}{\partial E_t^Q[r_{T-n}]} e^{-\alpha(T-n-t)} e^{\alpha_w n + \psi(i+n,T-n-t)} \\ &= -cw_t e^{-\alpha_w(T-t)} \sum_{n=0}^{N-1} \sum_{i=1}^m P(E_t^Q[r_{T-n}], i+n) e^{\alpha_w n + \psi(i+n,T-n-t)} B(i+n) e^{-\alpha(T-n-t)} \end{aligned} \quad (\text{A.11})$$

Dividing this derivative by  $V_E$ ,

$$\begin{aligned} \frac{1}{V_E} \frac{\partial V_E}{\partial r_t} &= \frac{-\sum_{n=0}^{N-1} \sum_{i=1}^m P(E_t^Q[r_{T-n}], i+n) e^{\alpha_w n + \psi(i+n,T-n-t)} B(i+n) e^{-\alpha(T-n-t)}}{\sum_{n=0}^{N-1} \sum_{i=1}^m P(E_t^Q[r_{T-n}], i+n) e^{\alpha_w n + \psi(i+n,T-n-t)}} \\ &= -\sum_{n=0}^{N-1} \sum_{i=1}^m \omega_i^n B(i+n) e^{-\alpha(T-n-t)} \end{aligned} \quad (\text{A.12})$$

where

$$\omega_i^n \equiv \frac{P(E_t^Q[r_{T-n}], i+n) e^{\alpha_w n + \psi(i+n, T-n-t)}}{\sum_{n=0}^{N-1} \sum_{i=1}^m P(E_t^Q[r_{T-n}], i+n) e^{\alpha_w n + \psi(i+n, T-n-t)}} \quad (\text{A.13})$$

is a weight for the annuity payment having the horizon of  $i$  years linked to the wage  $w_{T-n}$ . Using (A.12), equation (A.10) can be rewritten as

$$\begin{aligned} \frac{dV_E}{V_E} &= r_t dt + \sigma_w dz_w - \left[ \sum_{n=0}^{N-1} \sum_{i=1}^m \omega_i^n \sigma_r B(i+n) e^{-\alpha(T-n-t)} \right] dz_r \\ &= r_t dt + \sigma_w dz_w + \left[ \sum_{n=0}^{N-1} \sum_{i=1}^m \omega_i^n e^{-\alpha(T-n-t)} \sigma_p(i+n) \right] dz_p \end{aligned} \quad (\text{A.14})$$

Equation (A.14) shows that the stochastic process for the PBO liability of a given worker includes the same stochastic component as wage growth and a weighted average of discounted stochastic components of zero-coupon bonds of various maturities.

Equations (A.9) and (A.14) give the value and rate of return process, respectively, of the PBO liability for a given worker. Next, consider the similar quantities for a retired pension plan participant. The retiree's annuity payment is known (in nominal terms if there is no COLA and in real terms if there is a COLA). Let  $c_r$  be the retiree's annual benefit that is to be paid for  $m_r$  remaining years. Then the value of her annuity is

$$V_A = c_r \sum_{i=1}^{m_r} P(r_t, i) \quad (\text{A.15})$$

and its risk-neutral process satisfies

$$\frac{dV_A}{V_A} = r_t dt + \frac{1}{V_A} \frac{\partial V_A}{\partial r_t} \sigma_r dz_r \quad (\text{A.16})$$

where

$$\frac{1}{V_A} \frac{\partial V_A}{\partial r_t} = - \frac{\sum_{i=1}^{m_r} P(r_t, i) B(i)}{\sum_{i=1}^{m_r} P(r_t, i)} \quad (\text{A.17})$$

so that

$$\frac{dV_A}{V_A} = r_t dt + \sum_{i=1}^{m_r} \omega_i^p \sigma_p(i) dz_p \quad (\text{A.18})$$

where  $\omega_i^p \equiv P(r_t, i) / \sum_{i=1}^{m_r} P(r_t, i)$  is the value of annuity payment  $i$  relative to the value of all remaining annuity payments.

To determine the value and the rate of return process for the pension fund's aggregate liabilities, define  $V_{j,E}(t)$  to be the date  $t$  value of current employee  $j$ 's annuity, which reflects her particular retirement date,  $T$ , and wage level,  $c$ . Then if the pension fund has  $N_E$  eligible employees, the value of liabilities for all current employees is

$$L_t^E = \sum_{j=1}^{N_E} V_{j,E}(t) \quad (\text{A.19})$$

Let  $\gamma_{j,E} \equiv V_{j,E}(t) / L_t^E$  be the value weight of employee  $j$ 's annuity to the value of all employee annuities. Then the rate of return on the pension fund's total employee liabilities is

$$\frac{dL_t^E}{L_t^E} = \sum_{j=1}^{N_E} \gamma_{j,E} \frac{dV_{j,E}}{V_{j,E}} \quad (\text{A.20})$$

where  $dV_{j,E}/V_{j,E}$  follows the process in (A.14). Since  $\sum_{j=1}^{N_E} \gamma_{j,E} = 1$ , this implies that total employee liabilities follow a risk-neutral process of the form

$$\frac{dL_t^E}{L_t^E} = r_t dt + \sigma_w dz_w + \sum_{j=1}^{N_E} \gamma_{j,E} \Omega_{j,E} dz_p \quad (\text{A.21})$$

where  $\Omega_{j,E}$  is the term in square brackets in the last line of equation (A.14) that pertains to employee  $j$ .

Similar logic implies that the pension fund's total liabilities for its  $N_A$  retirees satisfies:

$$\frac{dL_t^A}{L_t^A} = r_t dt + \sum_{j=1}^{N_A} \gamma_{j,A} \Omega_{j,A} dz_p \quad (\text{A.22})$$

where  $L_t^A = \sum_{j=1}^{N_A} V_{j,A}(t)$ ,  $\gamma_{j,A} \equiv V_{j,A}(t) / L_t^A$ , and  $\Omega_{j,A}$  is the term multiplying  $dz_p$  in equation (A.18) that pertains to retiree  $j$ .

Finally, let  $L_t = L_t^E + L_t^A$  be the pension fund's total liabilities. The previous results imply that its risk-neutral process satisfies

$$\frac{dL_t}{L_t} = r_t dt + \frac{L_t^E}{L_t} \sigma_w dz_w + \left( \frac{L_t^E}{L_t} \sum_{j=1}^{N_E} \gamma_{j,E} \Omega_{j,E} + \frac{L_t^A}{L_t} \sum_{j=1}^{N_A} \gamma_{j,A} \Omega_{j,A} \right) dz_p \quad (\text{A.23})$$

Equation (A.23) shows that the pension fund's liabilities have a standard deviation associated with wage risk equal to the volatility of wage growth times the weight of employee liabilities to total liabilities. The standard deviation associated with bond risk is a linear combination of different maturity zero coupon bond standard deviations that correspond to the times when employees' and retirees' benefits are to be paid. If these standard deviations are approximately constant over time, so that the last two terms in (A.23) can be written as  $\sigma_{Lw} dz_w + \sigma_{Lp} dz_p \equiv \sigma_L dz_L$  then the physical process corresponding to the risk-neutral process in (A.23) equals equation (1) in the text where  $\sigma_L^2 = \sigma_{Lw}^2 + \sigma_{Lp}^2 - 2\rho\sigma_{Lw}\sigma_{Lp}$  and  $\alpha_L = r_t + \theta_L \sigma_L$  where  $\theta_L$  is the market price of risk associated with the Brownian motion  $dz_L$ .

Our empirical work approximates  $L_t^E / L_t = 1 - L_t^A / L_t$  by the pension fund's number of active participants to the total number of active participants and annuitants;

that is,  $N^E/(N^E + N^A)$ . Also, we approximate the bond standard deviation term in parentheses in equation (A.23) as  $\varphi\sigma_p(15)$ , where

$$\varphi = 0.4 + 0.558 \frac{N^E}{N^E + N^A} + 0.0425 \left( \frac{N^E}{N^E + N^A} \right)^2 \quad (\text{A.24})$$

and  $\sigma_p(15)$  is the standard deviation of a nominal or real zero-coupon Treasury bond having a maturity of 15 years. Note that when  $N^E/(N^E + N^A) = 0$ ,  $\varphi = 0.4$  and the pension fund's bond standard deviation is approximately equal that of a bond with maturity 6 years, which Mercer (2010) states is the duration of a pension fund with all retirees. When  $N^E/(N^E + N^A) = 1$ ,  $\varphi = 1.33$  and the pension fund's bond standard deviation is approximately equal that of a bond with maturity 20 years, which Mercer (2010) states is the duration of a pension fund with all active participants. Finally, when  $N^E/(N^E + N^A) = 0.6657$ , which is the average for our sample of public pension funds,  $\varphi = 1$  and the pension fund's bond standard deviation is approximately equal that of a bond with maturity 15 years, which Mercer (2010) states is the duration of a "typical" pension fund.

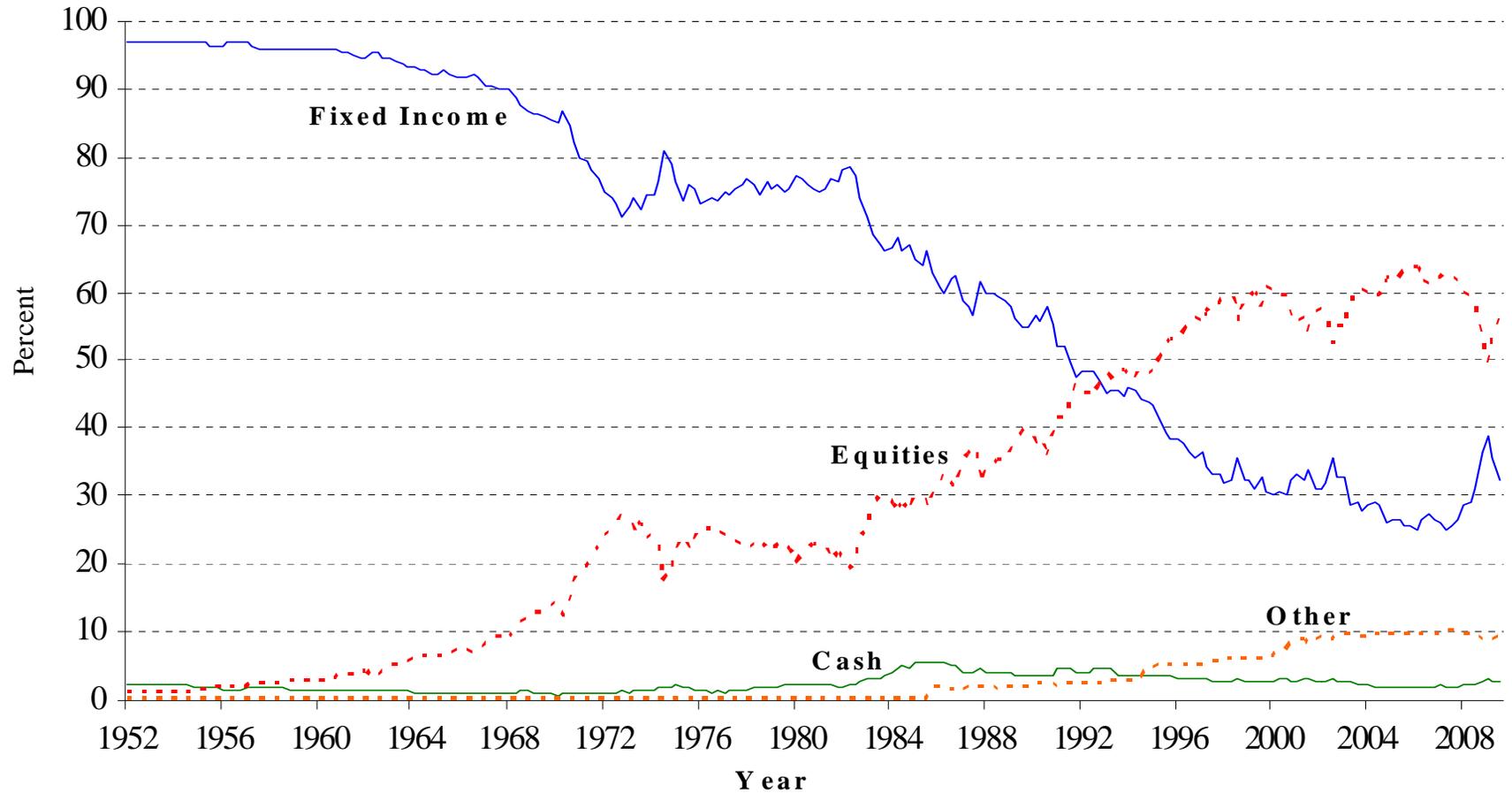
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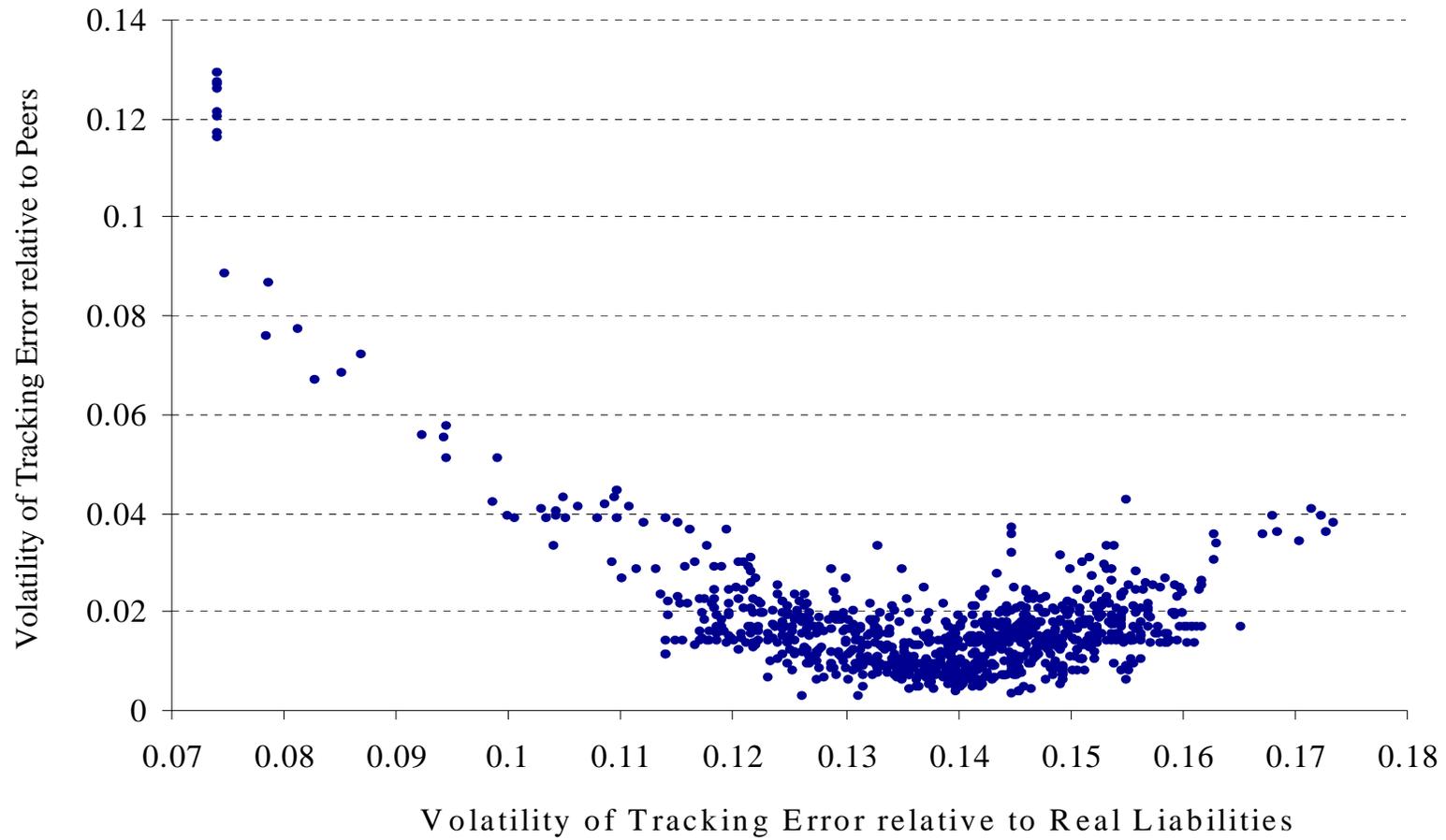
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**Figure 1**  
**Portfolio Allocations of State and Local Government Pension Funds**



Source: Federal Reserve Flow of Funds Accounts Table L.119

**Figure 2**  
**Distribution of Tracking Error Volatilities**



**Table 1****Summary Statistics of Asset Returns and Wage Growth**

	US Equities	Non-US Equities	US Fixed Income	Non-US Fixed Income	US-Real Estate	Private Equity	Hedge Funds	TIPS	S&L Wage Growth	15-Year Nominal Bond	15-Year Real Bond
<b>Rates of Return:</b>											
Mean	0.0533	0.0488	0.0727	0.0529	0.0858	0.1295	0.0815	0.0666	0.0293	0.0795	0.0795
Standard Deviation	0.1714	0.1891	0.0885	0.0838	0.2447	0.1232	0.0512	0.0601	0.0107	0.1376	0.0971
Minimum	-0.1939	-0.2496	-0.0908	-0.0609	-0.3913	-0.1567	-0.0537	-0.0927	0.0010	-0.1466	-0.1285
Maximum	0.1007	0.1341	0.1072	0.0768	0.2841	0.1466	0.0501	0.0588	0.0196	0.1760	0.0976
Correlation Matrix:											
US Equities	1										
Non-US Equities	0.87091	1									
US Fixed Income	0.06412	0.11068	1								
Non-US Fixed Income	0.04328	0.22146	0.49819	1							
US-Real Estate	0.57669	0.57607	0.17921	0.16747	1						
Private Equity	0.79986	0.73599	-0.20965	-0.17387	0.46705	1					
Hedge Funds	0.63777	0.69356	0.12148	0.02080	0.33082	0.74276	1				
TIPS	0.06630	0.14086	0.70857	0.49254	0.25107	-0.07349	0.15824	1			
S&L Wage Growth	-0.27389	-0.29040	0.20711	0.14081	-0.00980	-0.25375	-0.21839	0.15864	1		
15-Year Nominal Bond	-0.07907	-0.04836	0.94010	0.46061	0.02485	-0.29953	-0.01632	0.66265	0.25426	1	
15-Year Real Bond	0.04059	0.11604	0.72275	0.49579	0.16940	-0.18294	0.14551	0.95675	0.18128	0.68908	1
Observations:	159	159	159	159	159	52	159	159	52	159	159

Note: Summary statistics for rates of return on eight different asset categories: U.S. Equities; Non-U.S. Equities; U.S. Fixed Income; Non-U.S. Fixed Income; U.S. Real Estate; Private Equity; Hedge Funds; and Treasury Inflation-Protected Securities (TIPS), as well as State and Local Employee Cost Index wage growth and 15-Year Nominal and Real (TIPS) Bond returns. State and local employee wage growth and private equity returns are calculated based on quarterly data from the second quarter of 1997 to the first quarter of 2010. All other statistics are calculated from monthly return data between February 1997 and April 2010. Means and standard deviations are annualized. Minimums and maximums for wage growth and private equity are one quarter rates while minimums and maximums for the other series are one month rates.

**Table 2****Correlations of Equity and Bond Returns with National Wage Growth, 1952- 2008**

Panel A: Correlation between National Wage Index Growth and S&P500 Return				
Holding Period	Correlation	Observations	t-statistics	p-value
one-year	-0.0389	57	-0.2890	0.7737
three-year	0.0246	19	0.1014	0.9205
five-year	-0.4348	11	-1.4483	0.1815
seven-year	-0.2860	8	-0.7312	0.4922
nine-year	-0.4406	6	-0.9816	0.3819

Panel B: Correlation between National Wage Index Growth and 20-year Treasury bond Return				
Holding Period	Correlation	Observations	t-statistics	p-value
one-year	-0.2163	57	-1.6427	0.1061
three-year	-0.3201	19	-1.3932	0.1815
five-year	-0.2645	11	-0.8228	0.4319
seven-year	0.0859	8	0.2113	0.8397
nine-year	0.2449	6	0.5053	0.6399

Panel C: Correlation between National Wage Index Growth and 10-year Treasury note Return				
Holding Period	Correlation	Observations	t-statistics	p-value
one-year	-0.1095	57	-0.8171	0.4174
three-year	-0.0961	19	-0.3979	0.6957
five-year	-0.0746	11	-0.2245	0.8274
seven-year	0.2753	8	0.7013	0.5094
nine-year	0.4752	6	1.0802	0.3408

Note: National Wage Index is taken from the U.S. Bureau of Labor Statistics. The returns on the S&P 500 Index, the 10-year Treasury note and the 20-year Treasury bond were obtained from the Center for Research in Security Prices (CRSP).

**Table 3****Time Series of Average Asset Allocations, Tracking Error Volatilities, and Funding Ratio**

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
<b><u>Asset Class Allocations:</u></b>										
US Equities	0.3996	0.4174	0.3966	0.4261	0.4363	0.4322	0.4172	0.3957	0.3378	0.3299
Non-US Equities	0.1231	0.1197	0.1303	0.1348	0.1497	0.1534	0.1743	0.1848	0.1802	0.1880
US Fixed Income	0.2796	0.3258	0.3306	0.3162	0.2769	0.2757	0.2648	0.2629	0.2588	0.2486
Non-US Fixed Income	0.0156	0.0144	0.0141	0.0122	0.0116	0.0114	0.0087	0.0085	0.0143	0.0090
US-Real Estate	0.0314	0.0372	0.0418	0.0405	0.0396	0.0434	0.0520	0.0553	0.0647	0.0524
Private Equity	0.0378	0.0427	0.0419	0.0456	0.0429	0.0432	0.0454	0.0499	0.0715	0.0659
Hedge Fund	0.0000	0.0000	0.0000	0.0000	0.0002	0.0013	0.0089	0.0082	0.0115	0.0238
Other	0.0091	0.0027	0.0037	0.0087	0.0269	0.0235	0.0286	0.0267	0.0342	0.0303
<b><u>Tracking Error Volatilities for Benchmark:</u></b>										
Nominal Liabilities	0.1697	0.1661	0.1651	0.1691	0.1753	0.1756	0.1778	0.1779	0.1751	0.1755
Real Liabilities	0.1372	0.1338	0.1327	0.1363	0.1419	0.1421	0.1438	0.1437	0.1406	0.1406
Nominal Liabilities Demographically Adjusted	0.1687	0.1651	0.1634	0.1678	0.1742	0.1746	0.1761	0.1764	0.1732	0.1748
Real Liabilities Demographically Adjusted	0.1363	0.1329	0.1312	0.1351	0.1408	0.1410	0.1422	0.1423	0.1389	0.1396
Average Asset Allocation of Peers	0.0195	0.0187	0.0185	0.0173	0.0157	0.0159	0.0163	0.0162	0.0171	0.0143
<b>Funding Ratio</b>	1.0852	0.9226	0.7912	0.7775	0.8250	0.8454	0.8618	0.9336	0.7831	0.5832
<b>Return on Investments</b>	-0.0129	-0.0524	-0.0723	0.2093	0.1304	0.0807	0.1429	0.0678	-0.3067	0.1881

Note: Sample average over 125 state pension plans for eight different asset allocations, various tracking error volatilities, funding ratios (market value of assets divided by actuarial value of liabilities), and return on investments. The returns on investments were estimated as the product of their asset-class allocation weights and the returns earned by each of the asset classes.

**Table 4****Tracking Error Minimizing Allocations**

	<b>Nominal Liabilities</b>			<b>Real Liabilities</b>				
	No Constraints	No Private Equity & Hedge Funds	No Short Sales	No Constraints	No Private Equity & Hedge Funds	No TIPS	No TIPS and No Short Sales	No Short Sales
US Equities	-0.0886	-0.1259	0	0.0794	-0.1320	0.0094	0	0
Non-US Equities	-0.0109	-0.0285	0	0.1109	0.0669	-0.0160	0	0
US Fixed Income	1.5991	1.3586	1	-0.0005	0.1702	0.6048	0.6998	0.1367
Non-US Fixed Income	-0.0103	-0.1719	0	-0.1405	-0.1131	0.1814	0.2143	0
US-Real Estate	-0.0662	-0.0322	0	-0.0167	-0.0037	0.0395	0.0034	0
Private Equity	0.2442	-	0	-0.3460	-	-0.2021	0	0
Hedge Fund	-0.6673	-	0	-0.0725	-	0.3830	0.0824	0
TIPS	-	-	-	1.3859	1.0117	-	-	0.8633
Tracking Error Standard Deviation	0.04054	0.05004	0.06444	0.02945	0.06613	0.06444	0.06583	0.04436

Note: The entries are the pension asset portfolio weights that minimize a typical pension fund's tracking error volatility. This typical fund's liabilities have a 15-year duration and a ratio of active to total participants of 66.6%.

**Table 5**  
**Regression Variable Summary Statistics**

Variable	Observations	Mean	Std. Dev.	Minimum	Maximum
<b><u>Dependent Variable; Tracking Error Volatility:</u></b>					
Nominal Liabilities	1121	0.1726	0.0177	0.0658	0.2074
Real Liabilities	1121	0.1392	0.0142	0.0703	0.1725
Nominal Liabilities Demographically Adjusted	903	0.1712	0.0209	0.0746	0.2163
Real Liabilities Demographically Adjusted	903	0.1380	0.0154	0.0741	0.1734
Average Asset Allocation of Peers	1121	0.0171	0.0132	0.0026	0.1294
<b><u>Primary Explanatory Variables:</u></b>					
Funding Ratio	1121	0.8528	0.1970	0.1908	1.7520
Return on Investments	1121	0.0345	0.1463	-0.3891	0.2529
<b><u>Governance Variables:</u></b>					
Participants to Total Board Members	921	0.5646	0.2227	0	1
Dummy for Separate Investment Council	930	0.3839	0.4866	0	1
Dummy for Legal Restrictions	930	0.3086	0.4622	0	1
<b><u>Other Control Variables:</u></b>					
Natural log of Market Value of Assets	1121	22.6602	1.3605	19.2661	26.2487
Payroll to Actuarial Liabilities	1121	0.2360	0.2029	0.0085	2.6248
Discount Rate	1121	0.0801	0.0039	0.07	0.09
Dummy for Teachers Fund	930	0.5065	0.5002	0	1
Dummy for General State Fund	930	0.6226	0.4850	0	1
Dummy for Police and Fire Fighters Fund	930	0.4441	0.4971	0	1

**Table 6 Tracking Error Regression Results**

Dependent Variable: Tracking Error Volatility

Tracking Error Volatility Benchmark	Liabilities Unadjusted				Liabilities Demographically Adjusted				Average Asset Allocation of Peers	
	Nominal Liabilities		Real Liabilities		Nominal Liabilities		Real Liabilities			
Lag Funding Ratio	-0.004 (.29)	-0.0115 (.02)	-0.0038 (.25)	-0.0105 (.01)	-0.0051 (.20)	-0.0108 (.04)	-0.0043 (.20)	-0.0096 (.04)	0.006 (.04)	0.0167 (.00)
Lag Return Relative to Peer Average	-0.0942 (.00)	-0.0975 (.00)	-0.0804 (.00)	-0.0807 (.00)	-0.0923 (.00)	-0.0997 (.00)	-0.078 (.00)	-0.0821 (.00)	0.015 (.07)	0.0289 (.00)
Lag of Ln Market Value of Assets	0.0006 (.59)	0.0079 (.09)	0.0007 (.43)	0.007 (.10)	0.0005 (.74)	0.0068 (.18)	0.0008 (.43)	0.0055 (.22)	-0.0007 (.48)	-0.0157 (.00)
Lag Discount Rate	1.3779 (.00)	1.0515 (.00)	1.1758 (.00)	0.916 (.00)	1.2486 (.00)	1.2819 (.00)	1.0842 (.00)	1.0936 (.00)	-0.2521 (.11)	0.0088 (.96)
Lag Payroll to Actuarial Liabilities	-0.0062 (.22)	-0.0023 (.75)	-0.0058 (.16)	-0.0024 (.71)	0.0072 (.19)	-0.0035 (.63)	0.0036 (.41)	-0.0039 (.55)	0.0008 (.86)	0.0004 (.94)
Participants to Total Board Members	0.0125 (.04)		0.0107 (.02)		0.0192 (.01)		0.0152 (.00)		-0.0022 (.70)	
Dummy for Teachers Fund	0.0016 (.63)		0.001 (.70)		0.0027 (.50)		0.0012 (.65)		0.0003 (.91)	
Dummy for General State Fund	-0.0009 (.78)		-0.0008 (.75)		0.0004 (.92)		-0.0005 (.84)		0.0025 (.40)	
Dummy for Police and Fire Fighters Fund	-0.0039 (.22)		-0.0031 (.19)		-0.0036 (.35)		-0.0031 (.24)		0.0001 (.97)	
Dummy for Separate Investment Council	0.0000 (.99)		0.0002 (.91)		-0.0023 (.51)		-0.0012 (.61)		0.0021 (.43)	
Dummy for Legal Restrictions	0.0013 (.66)		0.0009 (.69)		0.0028 (.45)		0.0017 (.50)		-0.0022 (.44)	
Fund Fixed Effects	No	Yes	No	Yes	No	Yes	No	Yes	No	Yes
N	811	986	811	986	787	795	787	795	811	986
R <sup>2</sup>	0.34	0.089	0.36	0.1	0.28	0.079	0.32	0.13	0.064	0.000053

Note: Each regression includes time (year) fixed effects. Numbers in parenthesis are p-values. The dependent variable in all regressions is tracking error volatility. In columns (1) and (2) tracking error volatility is constructed assuming 15-year duration nominal liabilities with no demographic adjustments. In columns (3) and (4) tracking error volatility is constructed assuming 15-year duration real liabilities with no demographic adjustment. In columns (5) and (6) tracking error volatility is constructed assuming 15-year duration nominal liabilities with demographic adjustment for the ratio of active to total participants. In columns (7) and (8) tracking error volatility is constructed assuming 15-year duration real liabilities with demographic adjustment for the ratio of active to total participants. In columns (9) and (10) tracking error volatility is constructed assuming a benchmark equal to the average sample asset allocation of peer public pension funds.