

**Monkey Cage**

# Why pension funds go to risky investments

**By Michael McCarthy** October 19, 2014

The American government faces a fiscal crunch. Infrastructure is crumbling from years of disrepair, social programs are being targeted, and state and local governments complain that they can't afford to pay their retirees. Deprived of revenue sources, governments struggle to meet their financial obligations.

It's widely known that other advanced democracies levy higher taxes to operate social programs and maintain infrastructure. What is less known is that some governments also rely on another source of social investment: retirement funds. For example, in Quebec, the Levesque government created the [Solidarity Fund](#) in 1983 to channel retirement assets into the provincial economy while also saving for the Québécois. The fund invests in small and medium enterprises that operate within the province. According to their calculations, by 2012, the Solidarity Fund's investments created 86,624 new jobs and kept 81,993 more from moving overseas.

Pension funds could play a similar role in America, but they don't. Instead, U.S. pension funds mimic Wall Street investment practices. In recent years, this led them to follow everyone else into the toxic sub-prime mortgage market. With \$11 trillion of assets on the eve of the Great Recession, pensions

helped bankroll risky investments that undermined the financial security of their own beneficiaries – the very people they were bound to protect.

Neither of the usual policy suspects, lack of regulatory oversight or poor enforcement, explains why pension funds are channeled into risky investments and don't play a greater role in social investment. In fact, [my research](#) shows that the opposite is true. Tighter, not looser, regulations led to more speculative use of America's retirement savings. First, the Taft-Hartley Act of 1947, led to the corporate control of pension boards. Second, the Employee Retirement Income Security Act of 1974 hamstrung social investing.

After World War II, in the midst of the largest strike wave in our history to that point, John Lewis and the United Mine Workers established a pension and welfare fund financed on a pay-as-you-go basis according to mining output. The union also controlled asset management.

This raised red flags for members of Congress. In a 1946 testimony, Virginia senator Harry Byrd warned, "I am endeavoring to strike against the attempt of representatives of labor to use such payments in establishing funds over which no one but the labor representative would have any control. I assert that if such a condition were allowed to take place, labor unions would become so powerful that no organized government would be able to deal with them."

As president of the United Labor Bank before the 1929 stock market crash, Lewis understood the power of finance. But union plans for harnessing it were short-lived. One of the least discussed provisions of the 1947 Taft-Hartley Act restricted unions from controlling more than 50 percent of the boards that managed pension funds. Sponsoring employers, however, were allowed to control all the seats.

In its statement on Taft-Hartley, the House Committee on Education and Labor concluded, “Certainly, it is not in the national interest for union leaders to control these great, unregulated, untaxed funds derived from exactions upon employers.” And this sentiment was not completely unfounded: Hoffa’s Teamsters did end up using some of their pension money to fund casino construction projects with mob ties.

But the same rules also gave firms a stronger hand on the boards. Employers turned assets over to money managers who mimicked Wall Street trends. Had Taft-Hartley not been passed, the massive pension funds later established by unions like the United Auto Workers and the United Steel Workers would have had more opportunity to experiment with social investment.

By the mid-1950s, armed with an analysis that would be formalized by Markowitz into [modern portfolio theory](#), fund fiduciaries in the private sector rapidly changed their investment strategies. They moved pension investments out of government securities and bonds and into the stock market. In 1950, corporate equities were just 18 percent of total pension investments. By the eve of the 1973 recession, nearly 74 percent of pension portfolios were in equities, and about 25 percent of all American corporate equities were controlled by pension funds.

Then, in 1974, the Employee Retirement Income Security Act, or ERISA, clarified what is known now as the “prudent person rule.” It stipulates that investments have to be made for the exclusive benefit of plan beneficiaries. Up to the mid-20th century, most states interpreted this to mean lower risk. But in the 1950s, General Motors challenged this interpretation by shifting auto worker investments into equities. The ensuing risks could be managed, GM executives argued, through diversification.

ERISA turned this interpretation of prudence into a federal requirement and made clear that the only criteria that can be considered by fiduciaries are financial — not other objectives that might be in the broader interest of beneficiaries, such as the investment's impact on the economy or the environment.

And so pension funds have mainly followed the herd. These funds were directed into real estate when prices were skyrocketing in the 1980s, then into increasingly speculative junk bonds in the 1990s and ultimately into the sub-prime mortgages that triggered the financial crisis.

Pension funds could have been a major source of social investment into infrastructure or other public goods. Instead they remain an untapped resource, guided solely by financial imperatives. But this was not due to any lack of regulation. Not only did the regulations encourage risk, they eventually required it.

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