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CalPERS' image takes a hit

Shrinking assets and the taint of ties to so-called placement agents threaten to erode the California Public Employees' Retirement System's reputation as a leader among public pension funds.

By Tom Petrino and Stuart Pfeifer

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For much of the last decade the California Public Employees' Retirement System cultivated the image of a cutting-edge pension fund -- pouring billions of dollars into potentially lucrative but high-risk investments, hounding companies to rein in executive pay and championing financial security for government workers.

Now, CalPERS finds itself caught in a maelstrom of troubles that threatens its reputation as the gold standard for public pension funds.

Slammed by huge investment losses in last year's meltdown of financial markets, the nation's largest public retirement plan faces questions about its long-term ability to make good on the benefits it owes more than 1.6 million workers, retirees and their families.

All Californians have a stake in the fund's performance: If CalPERS' \$200-billion portfolio comes up short, and state and local governments refuse to cut workers' benefits, the bill falls to taxpayers -- many of whom have no guaranteed pension benefits of their own.

Already, CalPERS has notified state and local government authorities that their contributions to the fund will have to rise beginning in 2011 or 2012, reflecting the steep drop in the system's assets during the markets' crash.

CalPERS also has been tainted by its involvement with so-called placement agents, middlemen who lobby pension funds on behalf of big money managers.

One well-known middleman, former Los Angeles Deputy Mayor Alfred J.R. Villalobos, has raked in at least \$70 million in fees over the last decade from investment firms eager to pitch their services to the fund.

To a large degree, CalPERS' woes are issues for all major public pension systems in the wake of the dive in financial and real estate markets since late 2007. Fear of future shortfalls in funding is dogging funds large and small nationwide.

But CalPERS' troubles have stood out because of the fund's size and its longtime status as a pacesetter for the pension field:

* Despite the fund's vaunted moves to diversify into real estate, corporate buyouts, commodities and other investments apart from plain-vanilla stocks and bonds -- a strategy aimed at boosting overall investment returns -- CalPERS' portfolio now lags its peers over the last decade.

The fund performed worse than the average big public pension fund over the last year, five and 10 years ended June 30, according to CalPERS' financial consultant, Wilshire Associates. CalPERS' portfolio sank 23.5% in the last fiscal year, while the average large pension fund dropped 18.8%.

* Some high-profile bombs in CalPERS' real estate portfolio have raised questions about the fund's ability to choose intelligently among the countless deals it is offered by Wall Street money managers.

CalPERS lost nearly \$1 billion after betting in 2007 on the mammoth Newhall Ranch housing development north of Los Angeles. Now in jeopardy is the fund's \$500-million investment in 2006 to buy a piece of a massive apartment complex on the east side of Manhattan.

Here too, CalPERS has fared worse than its peers: Its real estate portfolio overall lost an average of 8.6% a year in the last three years, compared with an annualized decline of 4% for the average public pension fund's real estate investments.

Rob Feckner, the president of CalPERS' board, concedes that the fund made mistakes with some of its property investments. "We've learned some things in the last few years, and we've tightened our policies as a result of that," he said.

* The placement-agent investigations have caused critics to focus on the broader issue of political influence over CalPERS' massive pool of money -- the question of who gets the ears of the fund's board and staff, and whether investments are made on their merits or because of heavy lobbying.

It's no secret in Sacramento that CalPERS board members routinely are taken to lunch or dinner by money managers or their agents.

George Diehr, who has been on the 13-member board since 2002 and now chairs the investment committee, estimated that he had been out to eat with money managers 10 times this year.

"A lot of it is understanding the opportunities that are out there and how these investments work," Diehr said. But when it comes to deciding whether to choose a particular manager or idea, "those decisions . . . are really driven by the staff," he said.

Critics aren't mollified -- and the Villalobos affair has sharpened their attacks.

"The fact of the matter is that investment products salesmen should not be meeting the board members," said Dave Elder, who chaired the California Assembly's public employees committee for a decade until retiring in 1992. Salespeople, he said, "need to be meeting the investment staff. If the investment staff screws up, they can be fired."

As for the role of placement agents like Villalobos, CalPERS notes that their fees come out of the pockets of the money managers who contract with them, not from the pension fund. But some pension experts say it's inevitable that those managers expect to make back those fees via what they charge CalPERS for their services.

"Obviously it's a cost of doing business for the firms," said state Treasurer Bill Lockyer, a CalPERS board member. "Somewhere or other it's internalized from expenses."

To be sure, despite the turmoil buffeting the 77-year-old pension fund, CalPERS' finances are in no immediate danger. The fund's sheer size is an advantage in the short term.

"Retirees need to know that the security of their benefit checks is without question," said Joseph A. Dear, CalPERS' chief investment officer, who took the post in March after serving as chief of the state of Washington's pension fund.

CalPERS paid out \$11.85 billion in retirement benefits in the last fiscal year, or less than 6% of the fund's current assets. And even as the fund's value plunged \$55.2 billion for the year, CalPERS raked in \$10.8 billion in contributions from workers and from state and local governments.

Still, last year's losses were so severe that the rules governing CalPERS' finances required the fund to tell government employers to plan on making higher contributions beginning in 2011.

The city of Fullerton, with an annual budget of \$225 million, has been told by CalPERS to plan on a \$5.5-million increase in its worker retirement-account contribution to the fund, said City Manager Chris Meyer.

"The increase we're going to be seeing is directly related to their investment losses," Meyer said. "It's frustrating to all of us in the business of city management. At the end of the day, this is going to result in a smaller government providing fewer services."

Some CalPERS critics say the state's decision a decade ago to sharply expand worker retirement benefits was a time bomb that's now detonating.

Prodded by public-workers unions, and with CalPERS flush with gains from the late-1990s stock market boom, the Legislature in 1999 approved a bill allowing local governments to negotiate steep pension increases.

One change, for example, provided a 50% boost in retirement pay to California Highway Patrol officers. The change meant that officers with 30 years of service could retire after age 50 at 90% of their base pay for life -- a scenario virtually unheard of in the private sector.

Keith Richman, a former Republican Assemblyman from Northridge, has been fighting for years to cap what he asserts are out-of-control benefit costs. A group he founded, the California Foundation for Fiscal Responsibility, has filed an initiative for the November 2010 ballot that would pare benefits for newly hired state and local workers.

"My view is that we have to reform it or there will be numerous cities, counties and school districts that are going to go bankrupt," Richman said.

CalPERS, unaccustomed to being on the defensive about its finances, last month launched a public relations campaign to "separate fact from fiction" about pensions. The fund said its average worker pension amounts to about \$25,000 a year and that just 1% of the current 492,000 CalPERS retirees receive annual pensions of \$100,000 or more.

On one key point, CalPERS and its critics agree: Historically, almost 75 cents of every dollar in pension checks has come from the fund's investment returns. That makes it critical that CalPERS earn a high-enough return to cover its obligations.

The fund's long-term target rate of return for its overall portfolio is 7.75% a year -- about what it earned over the last 20 years. That is a more conservative return assumption than the 8% to 8.5% rates used by most public pension funds, according to the National Assn. of State Retirement Administrators.

But with the U.S. economy potentially facing slow growth for years to come after the latest recession, and with interest rates on high-quality bonds at relatively low levels, many Wall Street pros believe that even 7.75% is too high a return for a pension fund to count on.

Bill Gross, the bond market guru at investment titan Pimco in Newport Beach, has warned clients that a 4% to 5% annualized return on investments "is about all they can expect" in the next few years.

CalPERS believes it can do better than that by maintaining or increasing its bets on so-called alternative investments such as private-equity deals -- funding corporate buyouts, for example -- and real estate.

"Right now we see some great opportunities" in private equity and real estate deals, Diehr said.

But Ted Siedle, the head of Benchmark Financial Services, an independent pension plan auditing firm in Florida, believes CalPERS is delusional.

Just as most stock fund managers can't beat the average market return over time, the odds that Wall Street private-equity managers will produce returns that justify their rich fees in the long run "is probably 1 in 10," Siedle asserts.

Taxpayers, however, may have little choice but to root for CalPERS: If the fund can't meet its target, the public could get the tab.

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