

Political Representation and Governance: Evidence from the Investment Decisions of Public Pension Funds

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Politicians and the Governance of Organizations

Large literature shows that political connections of board members are valuable to firms:

- e.g. Fisman, 2001; Johnson and Mitton, 2003; Faccio, 2006; Acemoglu et al, 2016.
- Two main channels:
 1. Preferential awards of procurement contracts.
 2. Access to less expensive debt finance.

Less explored:

How do **political and personal incentives** of politicians affect the governance and decisions made by public organizations for whom they are fiduciaries or board members?

Setting: U.S. Public Pension Funds

U.S. PPFs: \$3.8T in assets at end of 2014 (Federal Reserve, 2015)

Third channel through which politicians may have impact: asset management

Public pension fund boards responsible for control and management of funds:

- *“The Teacher Retirement System of Texas was established pursuant to Article 16, Section 67 of the Texas Constitution, which requires Texas TRS to have a Board of Trustees to administer TRS and invest its funds.”*
- *“The CalPERS Board of Administration has exclusive control of the administration and investment of funds.”*
- Power and responsibility for investment decisions.

Variation in pension fund governance and board structure introduces differences in incentives across trustees of different pension systems:

- Main categories of trustees: Politicians, Participants, and Public.
- Considerable heterogeneity in the extent of political representation across boards:
 - Composition mostly fixed in time and set by statute decades in advance.
 - Only 20% of boards in our sample have changes in board structure since 1990.

Impact of Politicians on Board Governance

Our question: How do politicians use their power on asset management boards?

- For the benefit of the organization?
 - Politicians could use influence and expertise to gain access to (and direct assets into) higher performing investments.
 - Would be consistent the corporate literature.
- At the cost of the organization?
 - Conflicts of interest or lack of financial expertise could lead them to pursue political goals in their trustee capacity, at the expense of the financial returns on investments.
 - Would be consistent with the behavior of overtly political investors such as sovereign wealth funds (Bernstein, Lerner, and Schoar, 2013).

Context: Objectives of public pension funds

- Do they act in the public interest?
- Provide the benefits promised to participants as efficiently as possible for taxpayers.

Laboratory: Pension Fund Investments in Private Equity

Shift towards alternative investment classes such as buyout, real estate and venture capital:

- CalPERS allocation: in 2001 13% of portfolio; in 2016 20% of (\$276 billion) portfolio.
- As of 2017, alternative asset classes were 28% of public pension target portfolios (Andonov and Rauh, 2019).

Advantages of private equity focus:

1. Large inter-quartile spread in manager performance even within narrowly defined investment types.
2. Each investment has a clear vintage year: Can match precisely to board members in the year of investment.
3. Substantial heterogeneity in performance across public pension systems, despite supposedly shared objectives.

Two data sources for main analysis (Tables 3–9):

- 212 pension funds: board composition and names of trustees from annual reports (CAFRs).
- 13,559 private equity investments during 1990–2011 period from Preqin (2014 data).

Two data sources for additional evidence on mechanisms (Tables 10–11):

- Biographical information – generalized web search.
- Political contributions – Follow the Money (www.followthemoney.org).

Pension Fund Board Composition

Relative representation dictated by statutes and charters of pension systems

Categories of pension fund board members:

- State and local government officials: appointed, ex officio, elected
- Plan participants: appointed, ex officio, elected
- Members of the general public: appointed, ex officio, elected

Examples of state-exofficio:

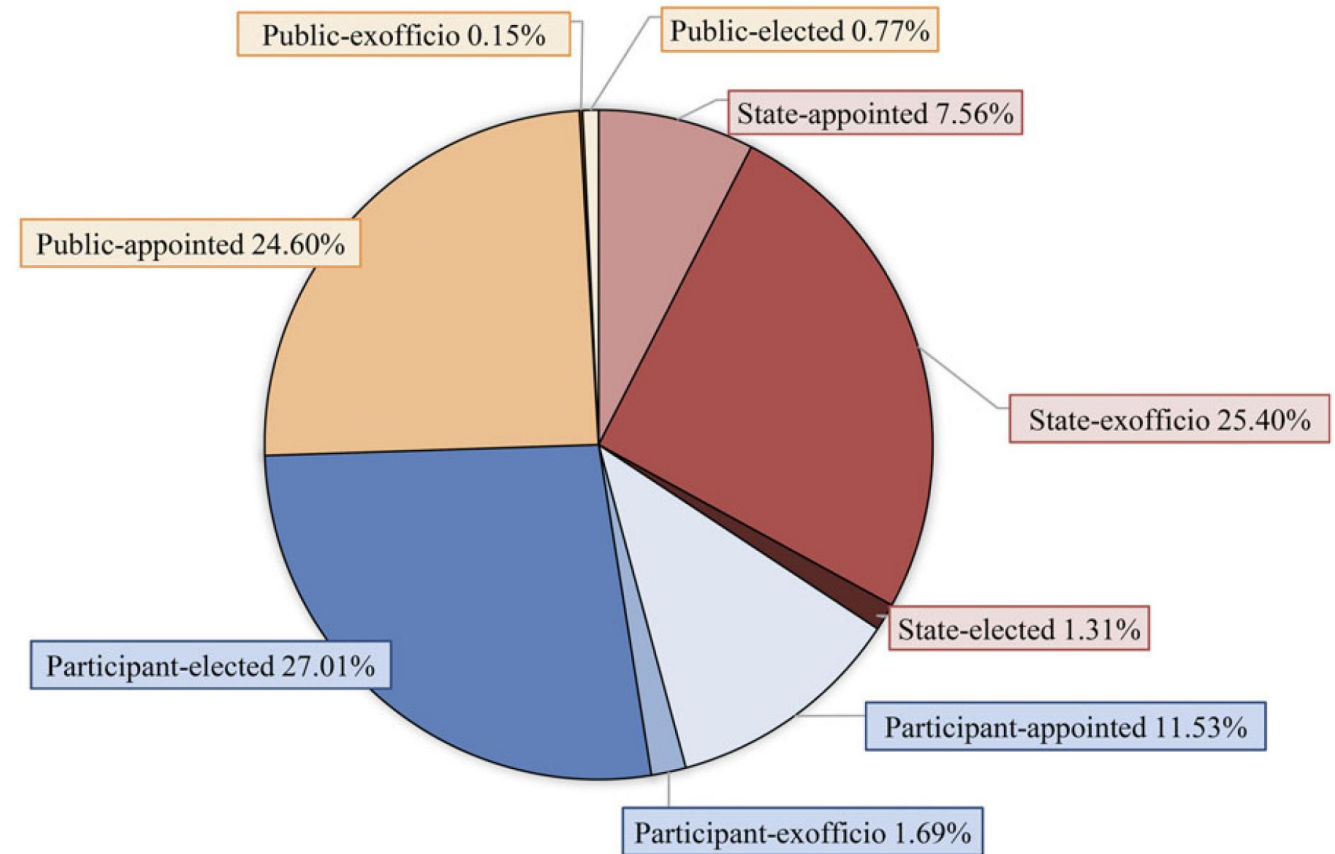
- State treasurer
- Controller / Comptroller
- Personnel Director
- Director of Finance, etc.

State-appointed trustees are appointed by:

- Governor / Mayor
- Speaker of House of Representatives
- President of State Senate

Examples of state-appointed:

- State senators
- State representatives
- Elected officials of local government
- School board representatives etc.



Average board composition
(weighted by number of private equity investments)

Heterogeneity in Political Representation on PPF Boards

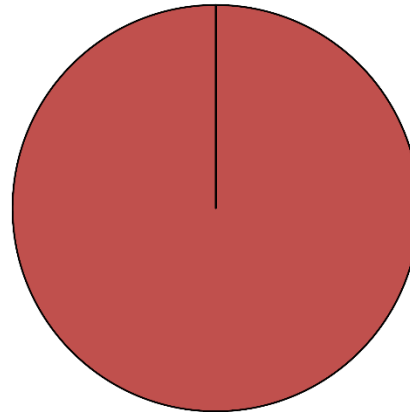
Board composition stable over time:

- Texas TRS board composition defined in 1974.
- New York State TRS in 1976.
- Florida SBA in 1970.

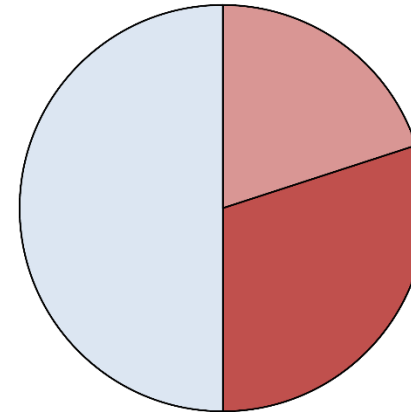
Board structures generally established long before PE became an important part of investor portfolios:

- Reverse causality is less plausible.
- Results robust to excluding PPFs with changes in the board structure.
- Also find performance responds to changes in board structure within LP.

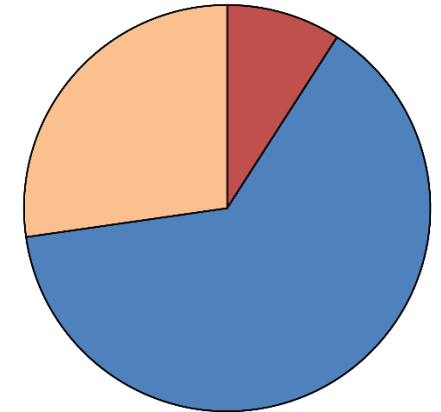
Minnesota State Board



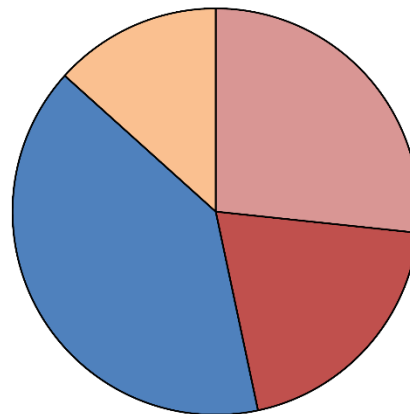
Washington SIB



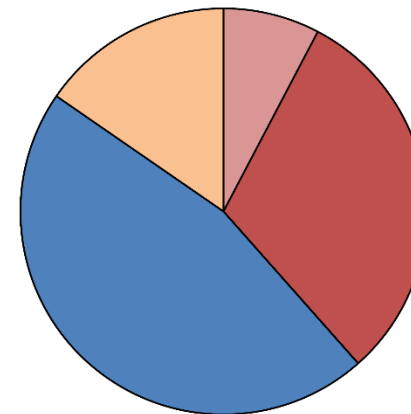
Ohio PERS



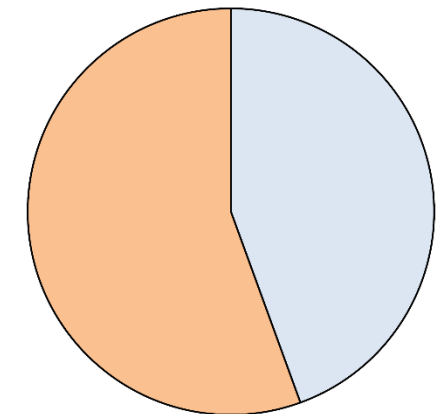
Pennsylvania PSERS



CalPERS



Virginia RS



■ State-appointed

■ State-exofficio

□ Participant-appointed

■ Participant-elected

■ Public-appointed

Main Results: Baseline Analysis

Each additional 10 percentage points of the board who are government officials reduces performance:

- By 0.91 net IRR points if the official is appointed by another government official.
- By 0.52 net IRR points if the official sits on the board by virtue of her office (*ex officio*).

Other trustees: An additional 10 pct pts of the board being made up of elected members of the pension plan (“rank and file”) reduces performance by 0.2-0.4 net IRR points.

Results are mirrored in analysis of cash-on-cash multiples and PME as a performance measures.

Robustness tests:

- Consultant fixed effects and investment board.
- Experience controls; focus on first time PE funds.
- Underperformance beyond economically targeted and local investments.

| From Table 4 | (1) | (2) | (3) |
|---------------------|----------------------|----------------------|----------------------|
| | Net IRR | | |
| State-appointed | -9.113*** [2.642] | -8.688*** [2.429] | -8.277*** [2.267] |
| State-exofficio | -5.246*** [1.582] | -6.765*** [1.534] | -5.622*** [1.003] |
| Participant-elected | -4.162*** [1.055] | -3.026*** [0.792] | -1.976*** [0.319] |
| Public-appointed | -2.486** [1.191] | -1.352** [0.660] | 0.063 [1.222] |
| LP size | 0.215 [0.176] | 0.331* [0.173] | 0.371 [0.434] |
| Board size | -0.058 [0.045] | -0.071 [0.051] | -0.060 [0.053] |
| Log%Commitment | | | 0.132 [0.755] |
| Other trustees | Yes | Yes | Yes |
| Vintage FE | Yes | Yes | Yes |
| LP state FE | No | Yes | Yes |
| Observations | 11,563 | 11,563 | 10,011 |
| R-squared | 0.088 | 0.093 | 0.093 |

Errors independently double-clustered by pension fund and vintage

Changes in Board Composition and Performance

Board composition is mostly fixed in time:

- Only **37** out of 2012 funds change board composition:
 - Ohio Teachers (2005): removes 2 state ex-officio, adds 3 public-appointed.
 - Maryland SRS (2004): removes 1 state ex-officio, adds 1 public-appointed.
- For **175** funds, no evidence that they changed board composition during period of PE investing.

There are **47 (larger) funds** whose composition has definitely not changed since at least **1985**.

Two possible reasons why pension funds did not change their board composition:

- Their performance was good: We should find no differences in performance in this subsample.
- They cannot change their board composition (sticky legislation beyond their control): differences in performance, but funds cannot respond to them.

| | (1) | (2) | (3) | (4) |
|---------------------|-----------------------|----------------------|---------------------|---------------------|
| | Net IRR | | | |
| | No Change | Old Board | Change | Change |
| State-appointed | -10.353*** [3.760] | -6.363** [3.051] | | -9.558 [6.684] |
| State-exofficio | -5.807*** [2.122] | -3.948*** [1.082] | | -7.853** [3.571] |
| State-political | | | -8.260** [3.609] | |
| Participant-elected | -3.084*** [1.150] | -2.683*** [0.951] | -9.913* [5.001] | -10.050* [5.068] |
| Public-appointed | -2.819** [1.375] | -0.922 [0.985] | | |
| LP size | 0.300 [0.218] | -0.127 [0.173] | 3.649* [2.074] | 3.653* [2.084] |
| Board size | -0.036 [0.054] | -0.104** [0.051] | | |
| Other trustees | Yes | Yes | No | No |
| Vintage FE | Yes | Yes | Yes | Yes |
| Pension fund FE | No | No | Yes | Yes |
| Observations | 7,782 | 5,397 | 3,781 | 3,781 |
| R-squared | 0.084 | 0.090 | 0.133 | 0.133 |

Is This Heterogeneity in Risk-Taking?

Difficult if not impossible to risk adjust PE returns as typical in other asset pricing settings. BUT:

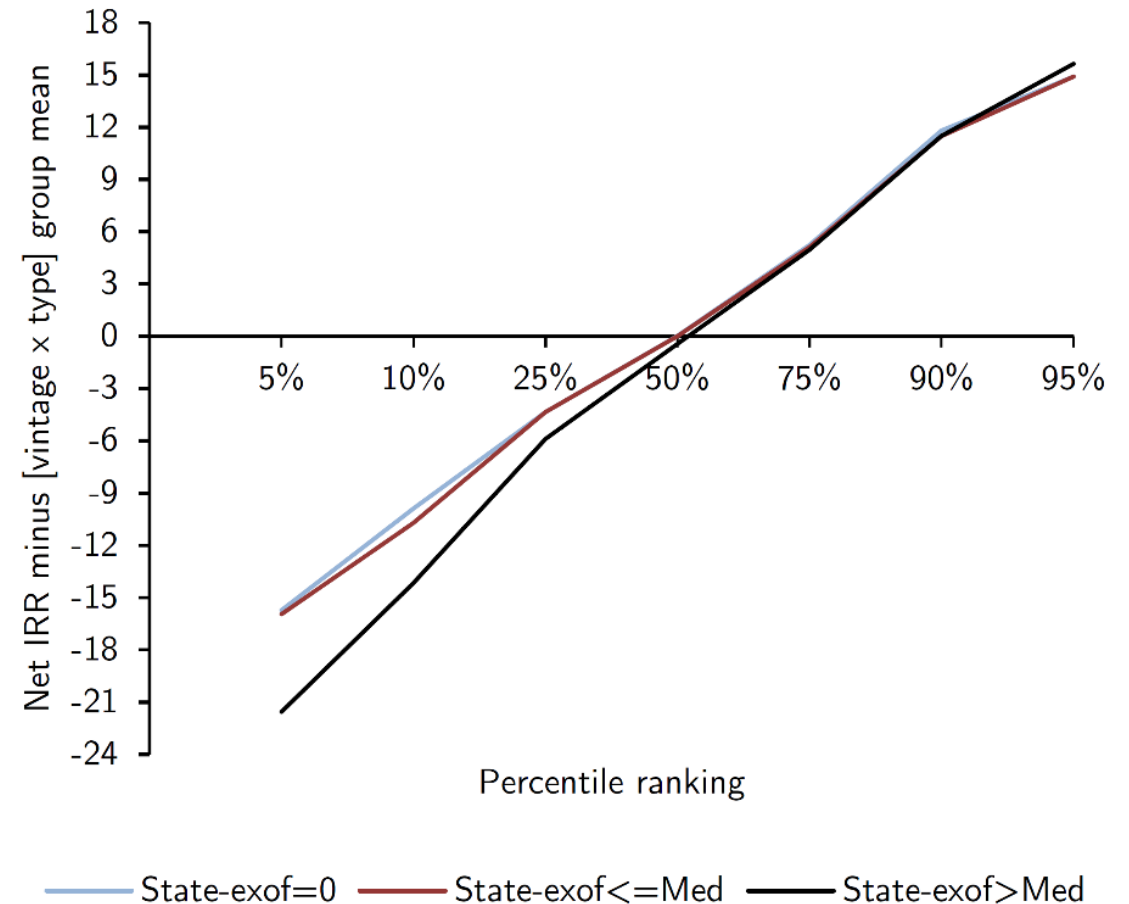
Pension funds with more state-appointed and state-ex officio board members invest more in risky asset classes:

- Andonov, Bauer, and Cremers (2016) and Bradley, Pantzalis, and Yuan (2016).

Can analyze of the distribution of returns (value-at-risk type analysis):

- Risk story: participant-appointed and public-appointed should have a higher likelihood of having funds in the lowest and highest performance percentiles.
- Actually, the reverse is true: If the board has more politicians, more likely to have funds in the tails.

Net IRR and state-exofficio



Why Might Political Trustees Underperform?

Three sources of poor decision-making on the part of state officials (Shleifer 1996):

- 1. Control:** political favoritism; direction of decisions in order to gain political support.
 - Through legislation, regulation, or other political action to advance the interests of industries, unions, or trade groups (e.g. Stigler 1971).
- 2. Confusion:** the use of incorrect models of the economy in making decisions (i.e. lack of knowledge, expertise or ability).
 - May apply to other categories of board trustees as well.
- 3. Corruption:** making sub-optimal decisions in return for quid pro quo, bribes or kickbacks:
 - Outright bribes, future jobs in the private sector, or political contributions to the extent such cash flows are used for personal gain (e.g. Shleifer and Vishny, 1994; Fisman, Schultz and Vig, 2015).

Board members receive limited remuneration: May not have an incentive to put effort and select well-performing investments.

1. Example: Control

Ohio public pension funds and Blue Chip Venture Company:

- 5 GP funds over 1993-2000 period: Blue Chip Capital Funds I, II, III, IV and Blue Chip Opportunity Fund.
- The only LPs appear to be Ohio pension funds, and one fund of funds.
- Focus on local investment, first Cincinnati-based GP.
- Average Net IRR -0.20%; average multiple: 0.99.

Retirement Systems of Alabama:

- Heavy focus on local golf courses and luxury hotels in real estate investments (15% of total portfolio).

Homepage of the Retirement
Systems of Alabama:

www.rsa-al.gov



- RSA CEO Bronner: “If we won't invest in ourselves, who the [...] will?” (2015).

Tests: Control – Local (In-State) Funds

Test: Evidence of politicians directing investments into in-state funds that can be perceived as beneficial to the state or local economy?

Dependent variable: Pension fund's excess share of in-state investments relative to benchmark representing share of investments in the state by out-of-state pension funds over preceding five-years.

Analysis and results:

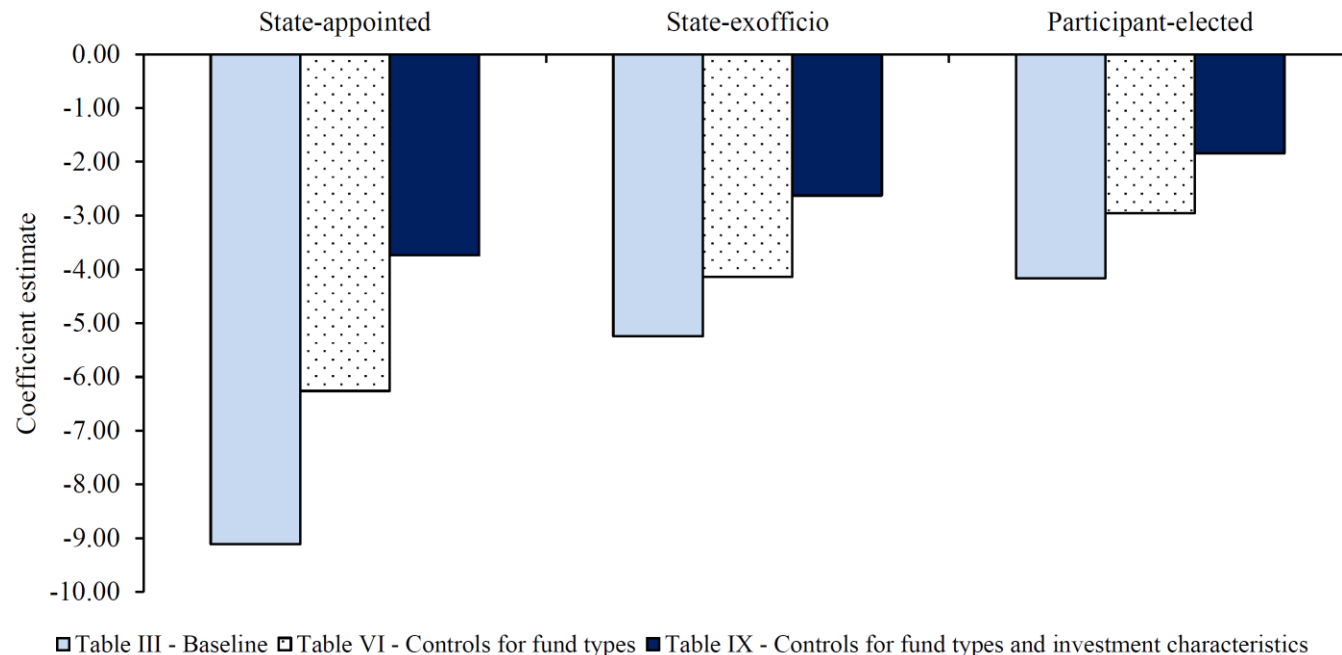
- Yes, government officials overweight local funds.
- The overweighting is concentrated in real estate and venture capital funds.

Explaining underperformance: Local investments have lower returns, but significant underperformance remains when excluding local investments.

| | All (1) | All (2) | BO (3) | VC (4) | RE (5) | Rest (6) |
|---------------------|---------------------|---------------------|--------------------|-------------------|---------------------|---------------------|
| State-appointed | 0.280** [0.126] | 0.269** [0.128] | -0.038 [0.086] | 0.287* [0.172] | 0.387*** [0.109] | 0.075 [0.144] |
| State-exofficio | 0.136** [0.055] | 0.141** [0.055] | 0.037 [0.040] | 0.180* [0.093] | 0.139*** [0.047] | -0.038 [0.071] |
| Participant-elected | 0.134*** [0.049] | 0.136*** [0.050] | 0.075 [0.047] | 0.151* [0.089] | 0.144*** [0.044] | 0.097 [0.070] |
| Public-appointed | -0.013 [0.057] | -0.006 [0.056] | -0.049 [0.044] | -0.112 [0.083] | 0.141** [0.056] | -0.053 [0.067] |
| LP Size | -0.016** [0.007] | -0.016** [0.008] | 0.016** [0.007] | 0.021* [0.012] | -0.015* [0.008] | 0.025*** [0.008] |
| Board Size | 0.002 [0.003] | 0.002 [0.003] | 0.003 [0.002] | -0.001 [0.005] | 0.001 [0.003] | -0.001 [0.003] |
| %VC | | 0.132** [0.056] | | | | |
| %RE | | 0.060* [0.034] | | | | |
| %NR | | 0.022 [0.064] | | | | 0.005 [0.032] |
| %FOF | | -0.018 [0.048] | | | | 0.056 [0.040] |
| %Other | | 0.028 [0.049] | | | | |
| Other Trustees | Yes | Yes | Yes | Yes | Yes | Yes |
| Vintage FE | Yes | Yes | Yes | Yes | Yes | Yes |
| Observations | 1,667 | 1,667 | 1,667 | 1,667 | 1,667 | 1,667 |
| R ² | 0.120 | 0.142 | 0.069 | 0.081 | 0.090 | 0.061 |

Tests: Control – Performance Across and Within Category

- Poor performance concentrated in categories that can be argued as related to economic development, within VC and real estate.
- Politicians invest more in smaller PE funds, funds with fewer investors, and funds with a lower sequence number.
- Explains approximately 50% of underperformance.



| From Table 11 | Net IRR | | | |
|---------------------|-----------|-----------|-----------|-----------|
| State-appointed | -3.703* | -4.051** | -3.560* | -3.892** |
| | [2.042] | [1.803] | [2.085] | [1.840] |
| State-exofficio | -2.657** | -4.250*** | -2.589** | -4.134*** |
| | [1.200] | [1.131] | [1.156] | [1.132] |
| Participant-elected | -1.775*** | -1.292** | -1.612** | -1.169* |
| | [0.647] | [0.617] | [0.669] | [0.627] |
| Public-appointed | -0.379 | -0.783 | -0.285 | -0.901 |
| | [0.890] | [0.850] | [0.835] | [0.866] |
| LP size | 0.101 | 0.123 | 0.014 | 0.018 |
| | [0.146] | [0.143] | [0.137] | [0.141] |
| Board size | -0.016 | -0.017 | -0.017 | -0.019 |
| | [0.044] | [0.045] | [0.042] | [0.046] |
| In-state RE | -3.434*** | -3.330** | -3.238*** | -3.211*** |
| | [1.307] | [1.298] | [1.232] | [1.229] |
| In-state PE-VC | -3.420** | -3.040** | -3.139* | -2.814* |
| | [1.681] | [1.531] | [1.679] | [1.525] |
| #Sequence | 0.167 | 0.162 | 0.126 | 0.123 |
| | [0.104] | [0.103] | [0.126] | [0.126] |
| #Investors | 0.036** | 0.036** | | |
| | [0.015] | [0.015] | | |
| Fund size | | | 1.035*** | 1.028*** |
| | | | [0.285] | [0.282] |
| Other trustees | Yes | Yes | Yes | Yes |
| Fund type FE | Yes | Yes | Yes | Yes |
| Vintage FE | Yes | Yes | Yes | Yes |
| LP state FE | No | Yes | No | Yes |
| Observations | 11,550 | 11,550 | 11,351 | 11,351 |
| R-squared | 0.112 | 0.115 | 0.115 | 0.118 |

2. Example: Confusion / Finance Skills

Illinois Teachers Retirement System: May 2014 board meetings

- 10 private equity investments were made.
- Board composition: 1 state ex officio, 6 public appointed, 6 participant.

Investment Committee: “A motion was made by **Sharon Leggett**... that the committee recommend to the board to commit up to \$20 million to Shasta Ventures IV, L.P. ... The motion passed by a unanimous voice vote.”

Bio: “**Sharon A Leggett** is a full-time middle school teacher at Evanston CCSD 65 school district, Chute Middle School. [...] Leggett has 37 years of experience as a middle school teacher, overseeing eighth grade students and below at Chute Middle School.”

Board of Trustees: “On a motion by **Mark Bailey**... it was resolved... [to] commit up to \$20 million to Shasta Ventures IV, L.P. ... Roll call resulted in affirmative voice votes from Trustees Bailey, Busby, Campbell, Harris, Klickna, O’Neill, and Leggett. Motion **carried**.”

Bio: “**Bailey** is the band director at Scott and River Woods schools in Naperville and has had a long career as a professional musician, music teacher and band director at private and public schools throughout the Chicago area. He holds a master’s degree in leadership and administration from North Central College in Naperville and a bachelor’s degree in instrumental music from Luther College in Decorah, Iowa.”

Percentage of Trustees with Relevant Experience

Asset management experience:

Prior experience in asset management, hedge funds, pension funds (investments, not administration), private equity, commercial real estate, or venture capital.

Financial experience:

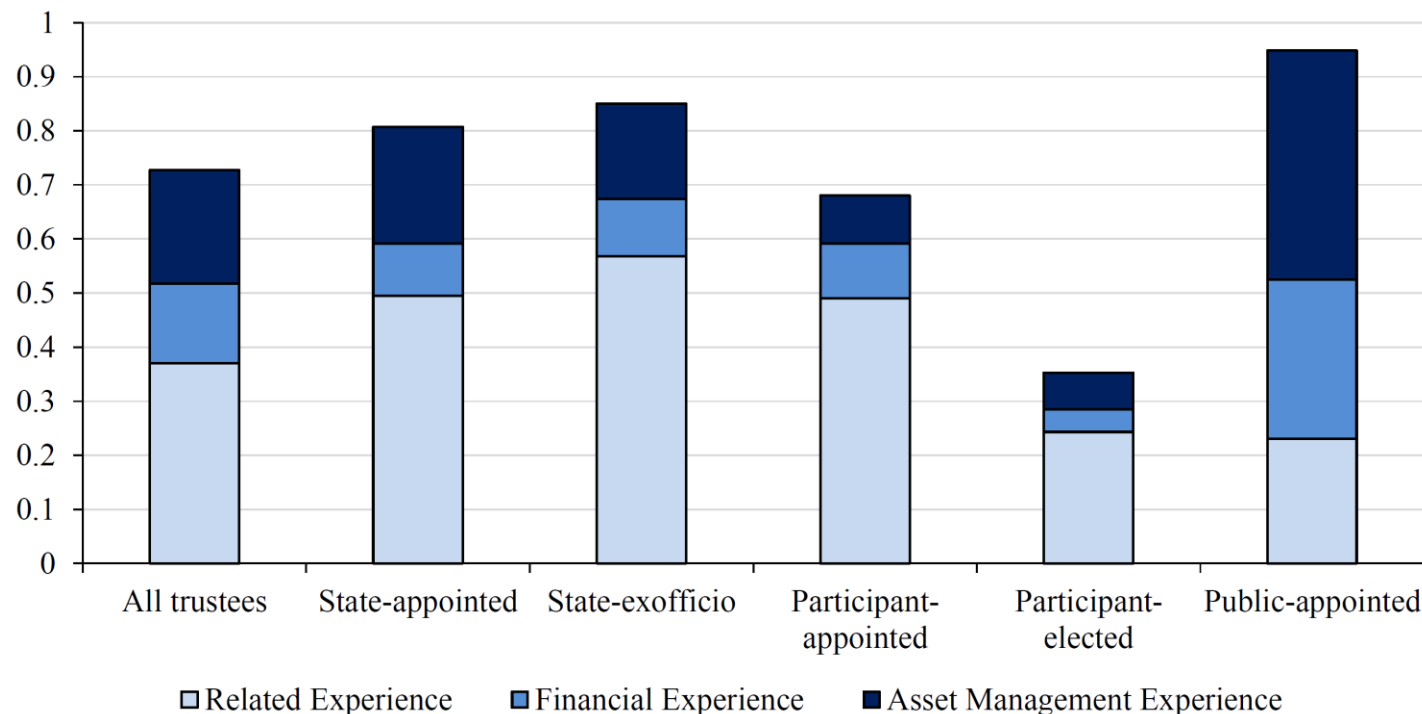
Prior experience in banking, risk management, insurance, serving as CEO/CFO/CIO in a large corporation, or practicing financial law

Related experience:

Prior experience in public finance (budget analyst, head of budget committee), as treasurer or similar position, actuarial experience, employee benefit management, or managing a credit union.

Data on experience and education of pension trustees:

- Focus on 46 largest pension funds (made 9,492 investments).
- Bios for 1,185 board members.



3. Example: Corruption (making sub-optimal decisions in return for quid pro quo, bribes or kickbacks)

Paul J. Silvester, a former Connecticut state treasurer:

- Holds a CFA, bachelor's degree in finance and MBA.
- Worked as an investment banker.
- Convicted in 2003 of taking bribes to direct PPF money to certain private equity funds:
 - During the testimony in front of Connecticut District Court, admitted that he *“devised a scheme to deprive the State of his honest services in connection with the investment of pension funds with a fund known as Keystone.”*
 - In 1998, CT PPFs invested \$27.5 million in Keystone Venture V fund.
 - Investment delivered a net IRR of -34.4% and a multiple of invested capital of 0.08.

Many examples of pay-to-play and improper kickbacks that have been exposed

- New Mexico: Steve Rattner (former “car czar”) made contributions to Gov Bill Richardson’s re-election campaign that were linked to New Mexico PPF investments in Rattner’s PE fund.
- Many examples from Illinois and Kentucky.

Tests: Confusion and Corruption

Confusion results:

- Higher relevant experience, higher returns.
- Lower performance of elected participant trustees is explained by their lower financial experience.
- Controlling for prior professional experience does not explain lower returns of state trustees.
- Education is dominated by experience variables.

Corruption variables and results: Political contributions to publicly elected official's (and board members) political campaigns from finance industry, 1999–2011 period.

- Matching tenure to simultaneous political activity.
- Relative to PPF's AUM (\$B).
- As a percentage of total contributions.
- An additional \$100,000 in financial contributions to the campaigns of politicians sitting on the PPF's Board that manages \$10 billion AUM is associated with a 0.24 percentage point worse IRR.

| | Net IRR | | | Multiple of Invested Capital | | |
|-----------------------------|-----------|-----------|-----------|------------------------------|-----------|-----------|
| | (1) | (2) | (3) | (4) | (5) | (6) |
| State-appointed | -7.219* | -8.058** | -4.098* | -0.463*** | -0.479*** | -0.300*** |
| | [3.679] | [3.374] | [2.139] | [0.148] | [0.124] | [0.092] |
| State-ex-officio | -5.043*** | -5.451*** | -3.821*** | -0.228*** | -0.219*** | -0.214*** |
| | [1.687] | [1.485] | [1.202] | [0.084] | [0.064] | [0.045] |
| Participant-elected | -3.907*** | -0.272 | -1.473 | -0.216*** | -0.039 | -0.080 |
| | [1.228] | [0.787] | [0.971] | [0.065] | [0.046] | [0.048] |
| Public-appointed | -2.468* | -4.556*** | -3.396** | -0.103 | -0.196*** | -0.169*** |
| | [1.406] | [1.554] | [1.408] | [0.072] | [0.067] | [0.053] |
| Asset Management Experience | | 7.967*** | 3.533* | | 0.273** | 0.141* |
| | | [2.934] | [2.055] | | [0.113] | [0.081] |
| Financial Experience | | 7.493*** | 4.052** | | 0.276*** | 0.212*** |
| | | [1.897] | [1.579] | | [0.075] | [0.077] |
| Related Experience | | 7.398*** | 2.537 | | 0.296*** | 0.103 |
| | | [2.707] | [1.614] | | [0.097] | [0.072] |
| Executive Experience | | 0.972 | 0.718 | | 0.144* | 0.106 |
| | | [1.618] | [1.417] | | [0.080] | [0.067] |
| Union Members | | -1.513 | -0.041 | | -0.057 | 0.000 |
| | | [0.947] | [1.193] | | [0.058] | [0.045] |
| Relevant Degree | | 0.185 | -0.228 | | 0.008 | -0.046 |
| | | [0.304] | [0.612] | | [0.037] | [0.029] |
| Log Contributions | | | 0.053 | | | 0.005** |
| | | | [0.055] | | | [0.002] |
| FinanceContrib / LP Size | | | -23.854** | | | -1.087** |
| | | | [10.373] | | | [0.486] |
| %Finance Contributions | | | -1.260 | | | -0.130 |
| | | | [2.892] | | | [0.123] |
| LP Size | -0.326 | -0.252 | -0.163 | -0.003 | 0.002 | -0.000 |
| | [0.272] | [0.239] | [0.238] | [0.011] | [0.010] | [0.009] |
| Board Size | -0.067 | 0.085 | -0.133 | 0.001 | 0.007* | -0.004 |
| | [0.079] | [0.115] | [0.091] | [0.004] | [0.004] | [0.003] |
| Other Trustees | Yes | Yes | Yes | Yes | Yes | Yes |
| Vintage FE | Yes | Yes | Yes | Yes | Yes | Yes |
| Observations | 8,295 | 8,295 | 7,404 | 8,391 | 8,391 | 7,495 |
| R ² | 0.081 | 0.084 | 0.094 | 0.111 | 0.113 | 0.082 |

Conclusion

- **Public pension funds governed by boards heavily populated by state-appointed and state-exofficio trustees invest in private equity funds that deliver lower performance.**
- **Findings suggest a role for two out of the three theoretically-posed channels for poor decision-making and policy on the part of political officials:**
 - Political favoritism towards certain state-economic-development-related investments (“Control”).
 - Potential quid pro quo (“Corruption”).
- **Politicians’ underperformance is not driven by a lack of financial expertise (“Confusion”):**
 - In contrast, however, much of the underperformance of boards with higher fractions of elected plan participants can be explained by lower expertise levels.
- **Politicians seem to harm financial performance of public asset management boards:**
 - Contrast to the help they provide to private corporate boards.
 - Parallel: Both benefits to corporate boards and costs to public boards are likely borne by taxpayers.

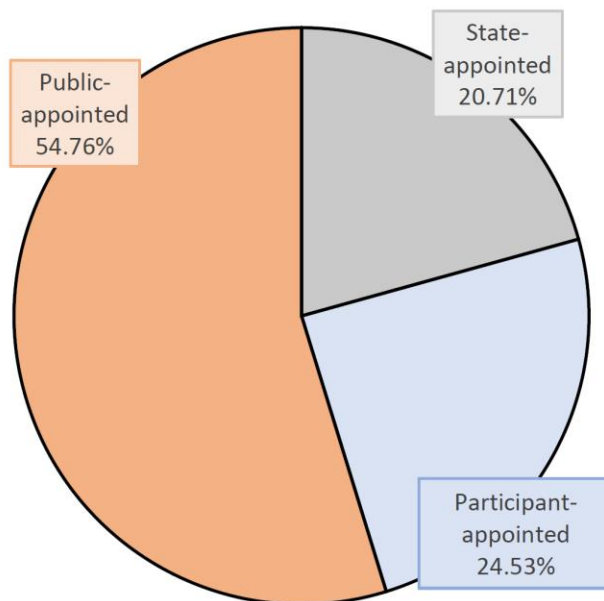
Implications: Board Composition in Other Countries

International data: 10 Canadian, 7 U.K., and 10 European (Denmark, Finland, France, Netherlands, Norway, Sweden and Switzerland) public pension funds.

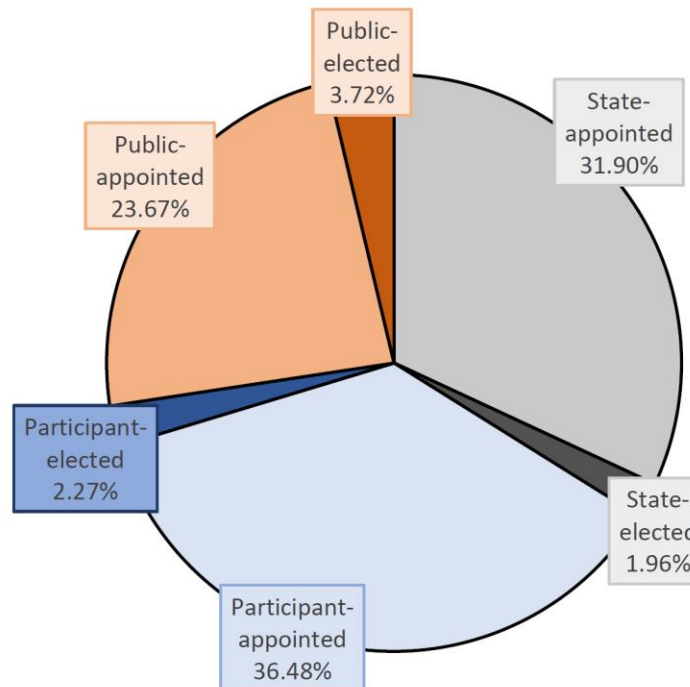
Differences from board composition of U.S. public pension funds:

- Ex officio positions do not exist in other countries.
- State appointed trustees are not always politicians in Europe and Canada, but in U.K. they are 100% politicians.

Canadian Pension Funds



European Pension Funds



UK Pension Funds

