

OUTRAGED BY COMPENSATION: IMPLICATIONS FOR PUBLIC PENSION PERFORMANCE

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Politicization and Pension Performance

Public funds hold **\$21.5 trillion** in assets.

A lack of returns of public pensions:

- Real implications in worker payroll and retirement benefits for “main street”
- Municipal bankruptcies

Why? Possibly arises from politicization in public pensions

- Hochberg and Rauh (2013), Bradley, Pantzalis and Yuan (2016): overinvestment in local assets deliver lower returns
- Adonov, Hochberg and Rauh (2016): Pay-to-play-like behavior of politicians results in lower PE returns
- Ang, Chen, and Sundaresan (2012), Addoum, van Binsbergen, and Brandt (2012), Adonov, Bauer and Cremers (2017): Underfunding leads to risking-up

Our Contribution first an idea: *Politicization → Talent An Anecdote*

“Unspoken, but also politically inconvenient is the compensation to attract talent from the private sector.

The state's existing investment officers are some of the best paid public employees, making an average of \$200,000 a year. But Treasury officials quietly complain that staff is underpaid by industry standards...”

As Treasurer Read pleads: “If we have the talent, we will be able to make the decisions better.”

- *The Oregonian*

Contribution more broadly in model and quantification

- Neglected political agency channel:
 - Outrage of constituents about compensation of investment managers
 - Foundation: inequality aversion (e.g. Fehr, Schmidt (1999))
 - Especially if board structure reflects lower income workers
 - Especially in public pension given governance
- This outrage friction distinct from other frictions: Board hires inferior quality manager (offering an ex ante compensation package that will not trigger outrage) and thus faces inferior expected returns.
- Main empirical result: In global sample with funds with \$5.4 trillion in AUM find One s.d. higher exposure to outrage => \$82,000 lower investment manager compensation => \$29 million less annually in AUM from returns per fund
- Note: Rising Inequality exacerbates the problem of outrage. Pay for 1%-ers in financial services has risen. Yet incidence of performance matters more for more outrage-prone pensions.

Model

Combine agency model of hiring a manager with portfolio choice

Political Agency: Comes from Board

Board misrepresents beneficiaries in decision-making due to agency:

(i) Pay-to-play (or local-tilted) political investment,

- Distorts investment to sub-optimal investments via side payments to manager

(ii) Underfunding

- Distorts toward more risk to swing-for-the-fences (Ang et al)

(iii) *Concern over possibility of outrage*

- *Distorts optimal skill level in offering contract*

Model Frame

How repercussions work:

i. Investment Manager Skill (heterogeneous)

- Skill s = ability of manager to realize risk premium
- Outside opportunity of manager also increasing in s

ii. Assets

- Fixed Income r_f
- Risky MV Efficient Risky Asset: $E[R_{MV}] = r_f + s\varphi_{MV}$
- Political Risky Asset: $E[R_P] = r_f + s\varphi_P$
 - Dominated in Sharpe ratio but produces political gain

iii. Compensation contract

- Salary + pay for performance + transfer for political weight (part of pay for play)

Model Predictions

When outrage binds:

-
- Manager quality lower
 - Lower performance in risky asset classes
 - Should avoid risky assets classes
-

When board is more political:

-
- Returns to skill are lowered by investing in inferior risky assets.
-

When board is underfunded:

-
- More risk in portfolio
-

Data

CEM & Boston Univ CRR Databases

Assets under Management (\$billion)

| | Number of funds | Fund-Year Observations | Mean | 25th Percentile | Median | 75th Percentile |
|---------------|--------------------|---------------------------|--------|--------------------|--------|--------------------|
| Canada | 16 | 210 | 37.02 | 11.45 | 17.04 | 59.90 |
| Europe | 39 | 333 | 122.70 | 8.45 | 17.76 | 71.33 |
| Oceania | 17 | 163 | 15.11 | 6.61 | 12.84 | 19.13 |
| United States | 92 | 1150 | 27.65 | 6.88 | 12.81 | 32.03 |
| Total | 164 | 1856 | 44.66 | 7.59 | 13.70 | 35.55 |

Variation in Risky Asset Class and Delegation

| | Count | Mean | Standard Deviation | 25th Percentile | Median | 75th Percentile |
|--|-------|-------|-----------------------|--------------------|--------|--------------------|
| <i>Panel A: Allocations</i> | | | | | | |
| Weights: Full Sample | | | | | | |
| Alternatives | 251 | 0.229 | 0.175 | 0.125 | 0.197 | 0.273 |
| Public Equities | 304 | 0.598 | 0.184 | 0.485 | 0.571 | 0.669 |
| Fixed Income | 253 | 0.323 | 0.121 | 0.25 | 0.305 | 0.368 |
| Weights: Sample restricted to having data on all weights | | | | | | |
| Alternatives | 204 | 0.191 | 0.096 | 0.117 | 0.186 | 0.252 |
| Public Equities | 204 | 0.513 | 0.106 | 0.442 | 0.525 | 0.583 |
| Fixed Income | 204 | 0.296 | 0.075 | 0.243 | 0.297 | 0.350 |
| Delegation Fraction | | | | | | |
| Alternatives | 214 | 0.747 | 0.327 | 0.484 | 0.990 | 1.000 |
| Public Equities | 190 | 0.734 | 0.360 | 0.386 | 1.000 | 1.000 |
| Fixed Income | 180 | 0.500 | 0.468 | 0.000 | 0.488 | 1.000 |

Performance Statistics, as expected

| | Count | Mean | Standard Deviation | 25th Percentile | Median | 75th Percentile |
|------------------------------------|-------|--------|-----------------------|--------------------|--------|--------------------|
| <i>Panel B: Performance</i> | | | | | | |
| Gross Returns | | | | | | |
| Alternatives | 355 | 0.061 | 0.119 | 0.002 | 0.075 | 0.135 |
| Public Equities | 367 | 0.053 | 0.206 | -0.107 | 0.117 | 0.206 |
| Fixed Income | 337 | 0.061 | 0.049 | 0.034 | 0.055 | 0.080 |
| Portfolio | 463 | 0.042 | 0.096 | 0.000 | 0.033 | 0.113 |
| Net Returns | | | | | | |
| Alternatives | 251 | -0.008 | 0.101 | -0.053 | -0.004 | 0.046 |
| Equities | 304 | 0.005 | 0.020 | -0.004 | 0.003 | 0.013 |
| Fixed Income | 253 | 0.005 | 0.031 | -0.003 | 0.003 | 0.016 |
| Portfolio | 351 | -0.003 | 0.054 | -0.011 | 0.001 | 0.014 |
| Tracking Error Realized | | | | | | |
| Alternatives | 70 | 0.069 | 0.073 | 0.028 | 0.055 | 0.083 |
| Equities | 96 | 0.038 | 0.054 | 0.012 | 0.019 | 0.035 |
| Fixed Income | 92 | 0.021 | 0.016 | 0.009 | 0.018 | 0.028 |
| Portfolio | 110 | 0.030 | 0.023 | 0.014 | 0.024 | 0.045 |

Data Innovations

Pay: Investment Manager Comp vs Worker Wages

- Mean: \$807,416 \$47,811
- Median: \$537,197 \$45,345

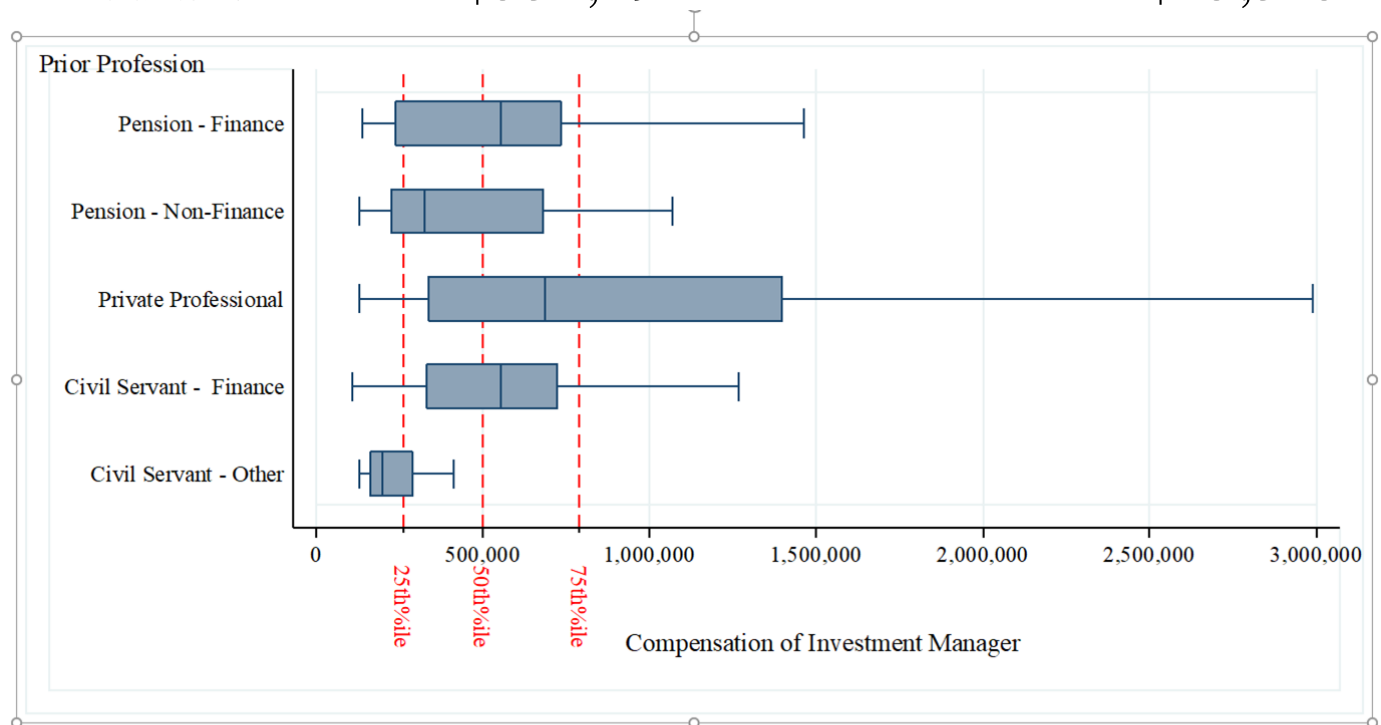


Figure 1: Compensation of Investment Manager by Prior Profession

Graphed are the distribution of investment manager compensation for each category of prior professions of the managers. The box plot displays the mean (box center line) as well as the first (box edges) and second (stem edges) standard deviations. The dashed (red) line indicates the overall sample 25th, 50th, and 75th percentiles. The distribution of the sample is as follows (also reported in Table 6, along with the more detailed titles of the professions under the categories): Pension – Finance (4.9%), Pension – Non-Finance (18.0%), Private Professional (31.1%), Civil Servant – Finance (29.5%), and Civil Servant – Non-Finance (16.4%).

Trustees, about half Beneficiaries, and half Civil Servants

Panel B: Trustees' Professions

| Occupation | Description | Professions Represented | % |
|---------------------------|---|--|-------|
| <i>Civil Servants</i> | | | |
| Politician | Includes any representative or elected official of municipal, state or federal government | Senator, House Representative, Mayor, Governor, Lieutenant Governor, Secretary of State, Attorney General, Assembly Speaker, State Representative, Secretary, Minister, Borough President, City Manager, Assistant Deputy Minister, Deputy Governor, Premier Deputy Chief of Staff, Deputy Minister, , City Council, County Commissioner, Deputy City Manager, Deputy General Counsel, | 6.4% |
| Finance Civil Servant | Civil servant with financial experience | Treasurer, Auditor, Accountant, Controller, Budget Officer, State Finance Director | 34.4% |
| Other Civil Servant | Civil servant without financial experience | Judge, Prosecutor, Clerk, Commissioner, Assistant Commissioner, Professor, Dean | 13.7% |
| <i>Non-Civil Servants</i> | | | |
| Teacher | Teachers | Teachers | 14.7% |
| Municipal Worker | Workers providing services to city residents, union labor | Police Officer, Fire Officer, Jail Worker, Railway , Steel , Construction, Electrician, Mail Employee, Librarian, Miner, Bus Driver, Chimney Sweep, Food Worker, Manufacturing Worker, Telecommunications | 7.7% |
| Professionals | Local private sector professionals and NGO executives | Financial Sector Expert, Doctor, Nurse, Dentist, Private Firm CEO, CIO, Chairman, Pharmacist, Journalist, Media Professional, Architect, NGO Chairman, Owner of Private Firm | 23.1% |

Empirical Methodology to test Predictions

Structural –Linear System of Equations

$$\begin{aligned} & \text{Log}(\text{Manager Compensation})_{it} \\ &= \alpha_1 \text{MunicipalWorkers}_i + \alpha_2 \text{Teachers}_i + \alpha_3 \text{LocalPublicFinances}_i \\ &+ \alpha_4 (-\text{LogConstituentWages}_{it}) + \alpha_5 \text{LogMunicipalIncome}_{it} \\ &+ \alpha_6 \text{Underfunding}_{it} + \alpha_7 \text{PoliticalBoard}_i + X_{it}^{\text{covariates}} \Gamma^{\text{eq I}} + \varepsilon_{it}^{\text{eq I}} \end{aligned}$$

System Equation II:

$$\begin{aligned} & \text{Performance} \\ &= \beta_1 \widehat{\text{Log}(\text{Manager Compensation})}_{it} + \beta_2 \text{Underfunding}_{it} \\ &+ \beta_3 \text{PoliticalBoard}_i + X_{it}^{\text{covariates}} \Gamma^{\text{eq II}} + \varepsilon_{f,t}^{\text{eq II}} \end{aligned}$$

Need: Exogeneity condition: Outrage only affects returns through the manager quality contracting

Outrage variables: Trustee occupations , local reference wages

System Equation I: Impact of Outrage on Compensation

Depend. Var: Log Compensation

- Variables to predict outrage (1st equation only)
 - Professions with low salaries (teachers, municipal workers)
 - Finance Civil Servants
 - Low regional wages
- Variables predict compensation & returns
 - Fund size, year effects
 - Political Chair
 - Underfunding

| | |
|--------------------------|----------|
| Municipal Workers | -1.082* |
| | [0.611] |
| Teachers | -0.405 |
| | [0.324] |
| Finance Civil Servants | -0.925** |
| | [0.374] |
| Log Regional Income | 0.783*** |
| | [0.193] |
| Log Worker Wages | 0.690** |
| | [0.293] |
| Political Chair | -0.199** |
| | [0.0971] |
| Underfunding Index (lag) | 0.0418* |
| | [0.0238] |
| Log Size (lag) | 0.164* |
| | [0.0836] |
| <hr/> | |
| Year Fixed Effects | Y |
| Observations | 426 |
| Number of Funds | 110 |
| R-Squared | 0.153 |

Implied Cost of Outrage for Compensation

Panel B: Economic Magnitude

| Change Evaluated | | \$ Impact on Compensation | Percentage Change |
|------------------|---|---------------------------|-------------------|
| 1 s.d. change = | 0.087 higher fraction of Municipal Workers | -76,033 | -9% |
| 1 s.d. change = | 0.144 higher fraction of Budget Civil Servnts | -107,627 | -13% |
| 10% change = | 4781 higher Regional Income (\$) | 63,221 | 8% |
| 1 std. change = | 0.586 greater likelihood of Political Chair | -94,209 | -12% |
| 1 std. change = | 1.303 higher Underfunding Index | 43,982 | 5% |

On average, relaxing the effect of outrage \Rightarrow higher wages of ~\$82,000.

Does Outrage-Predicted Compensation Affect Returns?

| <i>Dependent Variable:</i> | Portfolio | Alternatives | Public Equities | Fixed Income |
|------------------------------------|-------------------------|------------------------|------------------------|------------------------|
| <i>Equation:</i> | <i>System II</i> | <i>System II</i> | <i>System II</i> | <i>System II</i> |
| Outrage-predicted Log Compensation | 0.00635** [0.00291] | 0.0209* [0.0111] | 0.00689* [0.00400] | -0.00441 [0.00370] |
| Political Board | -0.00362** [0.00143] | -0.0155** [0.00777] | -0.00353* [0.00187] | -0.000123 [0.00219] |
| Underfunded Index(lag) | 0.000736 [0.00133] | -0.00117 [0.00544] | -0.000458 [0.00179] | 0.00297 [0.00199] |
| Controls: size | Y | Y | Y | Y |
| Observations | 303 | 243 | 285 | 243 |
| Number of Funds | 89 | 71 | 86 | 80 |

A lower compensation from outrage effects implies lower returns in the risky assets – alternatives and public equities

Does Outrage-Predicted Compensation Affect Returns?

| <i>Dependent Variable:</i> <i>Equation:</i> | Portfolio <i>System II</i> | Alternatives <i>System II</i> | Public Equities <i>System II</i> | Fixed Income <i>System II</i> |
|--|-------------------------------|----------------------------------|--|-------------------------------------|
| Outrage-predicted Log Compensation | 0.00635** [0.00291] | 0.0209* [0.0111] | 0.00689* [0.00400] | -0.00441 [0.00370] |
| Controls: size | Y | Y | Y | Y |
| Observations | 303 | 243 | 285 | 243 |
| Number of Funds | 89 | 71 | 86 | 80 |

Equation I Change Evaluated

Working through Equation II Effect

Resulting Change in Returns

1 s.d. increase in Municipal Workers =>

-\$76,033

change in Compensation =>

-0.060%

1 s.d. increase in Budget Civil Servants =>

-\$107,627

change in Compensation =>

-0.085%

10% increase in Regional Income =>

\$63,221

change in Compensation =>

0.050%

Relaxing outrage:

~\$82,000 higher manager wage

~6.5 bps higher returns

\$29m in returns per year

Does Compensation Affect Use of Delegated Asset Management

| <i>Dependent Variable:</i> | Portfolio | Alternatives | Public | Fixed |
|------------------------------------|----------------------|----------------------|--------------------|-------------------|
| <i>Equation:</i> | <i>System II</i> | <i>System II</i> | <i>System II</i> | <i>System II</i> |
| Outrage-predicted Log Compensation | -0.639*** [0.186] | -0.635*** [0.217] | -0.273* [0.165] | -0.310 [0.223] |
| Political Board | -0.198** [0.0962] | 0.0653 [0.0919] | 0.0665 [0.150] | 0.3 [0.218] |
| Underfunded Index(lag) | -0.0897 [0.117] | 0.152 [0.102] | 0.241 [0.171] | 0.179 [0.184] |
| Year Fixed Effects | Y | Y | Y | Y |
| Controls: size | Y | Y | Y | Y |
| Observations | 258 | 245 | 251 | 258 |

Relaxing outrage \Rightarrow 6.5% less delegation \Rightarrow **2.9bps** lower costs
44% of 6.5bps return change

Externally-managed costs: Gerakos, Linnainmaa, and Morse (2018)
Internally-managed costs: Dyck and Pomorski (2011).

Does Outrage-predicted Compensation Affect Realized Risk?

| <i>Dependent Variable:</i> | Portfolio | Alternatives | Public | Fixed |
|------------------------------------|----------------------|-----------------------|-------------------------|------------------------|
| <i>Equation:</i> | <i>System II</i> | <i>System II</i> | <i>System II</i> | <i>System II</i> |
| Outrage-predicted Log Compensation | 0.00843 [0.00731] | -0.0303 [0.0275] | 0.00179 [0.0216] | -0.00626 [0.00509] |
| Political Board | 0.00474 [0.00380] | -0.0135 [0.0146] | -0.0174*** [0.00674] | -0.00457* [0.00245] |
| Underfunded Index(lag) | 0.00205 [0.00238] | 0.000394 [0.00678] | 0.00804 [0.00544] | 0.000375 [0.00191] |
| Controls: size, weights | Y | Y | Y | Y |
| Observations | 112 | 70 | 97 | 94 |
| R-squared | 0.009 | 0.072 | 0.38 | -- |

The effect of a lower compensation from outrage effects reducing returns does not also imply reduced realized risk

Does Compensation Affect Allocation to Risky Asset Classes?

| <i>Dependent Variable:</i> <i>Equation:</i> | Alternatives | Public Equities | Fixed Income |
|---|-----------------------------------|---------------------------------------|------------------------------------|
| | Weight | Weight | Weight |
| | <i>Tobit System II</i> | <i>Tobit System II</i> | <i>Tobit System II</i> |
| Outrage-Predicted Log Compensation | 0.0355 [0.0144]** [0.0256] | -0.0666 [0.0179]*** [0.0314]*** | 0.0375 [0.0156]** [0.0344] |
| Political Board | 0.00009 [0.00962] [0.0145] | -0.0169 [0.0117] [0.0184] | 0.0177 [0.00960]* [0.0146] |
| Underfunded Index (lag) | 0.00904 [0.00587] [0.00843] | 0.00126 [0.00712] [0.00749] | -0.0101 [0.00584]* [0.00673] |
| Year Fixed Effects | Y | Y | Y |
| Controls: size, | Y | Y | Y |
| Observations | 197 | 197 | 197 |
| Two sets of standard errors are clustered & SUR | | | |

A lower compensation from outrage effects implies lower weights in alternatives, at expense of allocation weight in vanilla equities

Conclusion: Remedies

Punchline: We hope the paper become a policy-to-action piece. Likely affects the lowest income pensions the most. Pensions who cannot afford losing millions in foregone returns.

Remedies

1. Education + explicit profit/risk sharing
 - Beneficiaries and politicians appointing board member see and address return consequences
2. Skills-based board and chair rules for appointees
 - Not: Focus solely on beneficiary-elected board (Romano (1993)). Different friction, different solution: Some beneficiaries prone to outrage.

Not: Surface-obvious response: Hiding compensation disclosure

- Lack of disclosure of compensation encourages lack of disclosure elsewhere that can facilitate pay-to-play