

OUTRAGED BY COMPENSATION: IMPLICATIONS FOR PUBLIC PENSION PERFORMANCE

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Research Motivation

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- **Big research question:** public employee pensions in the U.S. are (a) **very large** in terms of assets under management, and (b) **underfunded** by somewhere between \$934 billion and \$3.4 trillion, depending on the estimates used (Rauh, 2016; Pew Charitable Trusts, 2016)
 - ▣ Two worrying trends: increasingly generous pension benefits and accumulating pension funding shortfalls
- **Broad implications for society**
- **This paper:** Examines the impact on portfolio allocation and performance when politicized pension boards fear outrage when choosing market-level compensation for their investment managers

Main Results

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- Data: Global sample of 111 to 164 public pension funds (account for \$5.4 trillion in assets) from the U.S., Canada, Oceania, and Europe for 1995-2014
- **Result I**: Theoretical framework: Trustees of public pension funds internalize outrage over high compensation, leading to lower skill managers...distortions in portfolio allocation and weaker performance in the risky asset classes
- **Result II**: Empirical results: Outrage pay constraints on compensation impact fund performance and beneficiary welfare
 - ▣ If the average fund were to relax outrage: costs of approximately \$82,000; benefits: additional benefits of \$29 million in annual value-add

Overview of Discussion

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- Comment I: Paper's contribution
- Comment II: Limits of the compensation-performance nexus in asset management
- Comment III: Mechanisms driving results in the within-asset class performance
- Comment IV: Delegation decision within the public pension fund space

Comment I: Paper's Contribution - I

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- Broad research question is very important: self-evident with broad ramifications to various areas
 - ▣ Very useful as a sanity check during an age of rage we are living in
- Unlike existing literature, this paper takes an innovative approach to a new type of agency cost, arising from the political sphere, within public pension funds
 - ▣ Quantifying compensation outrage and measuring its impact on investment decisions
- Appropriate and careful empirical analysis: the counterfactual challenge is a massive challenge in this case and authors adopt the right approach

Comment II: Limits of Compensation

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- Major claim: pension funds' inability to attract top talent is behind sub-optimal decisions and performance

	Count	Mean	Standard Deviation	25th percentile	Median	75th percentile
Manager Compensation						
Manager Compensation (\$)	463	807,416	1,018,136	292,328	537,197	819,979
Log Manager Compensation	463	13.20	0.828	12.59	13.19	13.62

- Questions:
- What is the correct benchmark for the skill and compensation levels?
- Does higher compensation translate into higher performance in the asset management space?
- Is it simply/only compensation or discretion over risk-taking?

Comment II: Limits of Compensation

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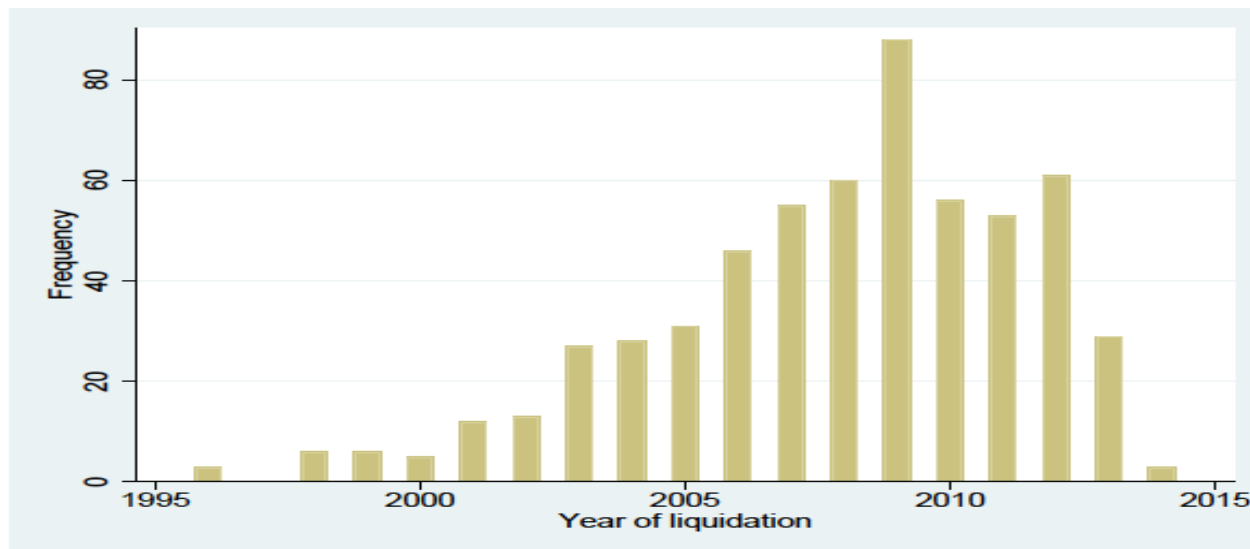
- Compare compensation within the pension fund space with the hedge fund space
 - ▣ Investigate the nexus between compensation and performance
- Compensation to the top three hierarchical levels in U.S. hedge funds
 - ▣ Ellul, Pagano and Scognamiglio (2018)

Job Level	Description	Average Compensation	Examples of job titles
6	CEOs	3,707,831	CEO, executive director, founder, managing director, managing partner
5	Top executives	1,590,858	CFO, CIO, COO, CRO, deputy CEO, partner, vicepresident
4	First/Mid Officers & Managers	158,150	director of sales, head of investor relations, investment manager

Comment II: Limits of Compensation

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- Liquidations of hedge funds in the last two decades



- Hedge fund literature shows hardly any **alpha** in this space
- Question: Is it simply compensation or discretion over the **manager's** ability to make investment decisions?
- Caution on results' interpretation

Comment III: Mechanisms

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- Impact of outrage pay constraints on within-asset class

	Equation I:	Equation II: Net Returns			
	Log Compensation	Portfolio	Alternatives	Public Equities	Fixed Income
Outrage-Predicted Log Compensation		0.00635** [0.00291]	0.0209* [0.0111]	0.00689* [0.00400]	-0.00441 [0.00370]

- Impact appears to be larger in the case of “Alternatives,” quite strong in “Public Equities” and inexistent in “Fixed Income”
- Need to understand better what drives these results
 - ▣ Compensation vs. Constrained investment choices
- In the Equity space: Why do these funds not adopt a passive investment strategy?
- In the Alternatives space: The skill dimension emerges here but cannot be the only hypothesis

Comment IV: Delegation Decision

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- **Delegation of investment decisions:** results are very interesting
- Question: again, what is the benchmark against which we should interpret results?
- Goyal and Wahal (2008): Plan sponsors hire investment managers after superior performance but on average, post-hiring excess returns are zero
 - ▣ Plan sponsors fire investment managers for many reasons, including but not exclusively for underperformance
 - ▣ Post-firing excess returns are frequently positive and sometimes statistically significant

Conclusions

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- Innovative aspect of paper: investigating **agency costs arising from the political dimension** of public pension funds
 - ▣ Outrage over compensation leading to lower skill at investment managers level

- **Well executed** (not easy, given the **counterfactual problem**) and convincing in establishing the core result

- **Suggestions:**
 - ▣ Interpretation of results is problematic: skill-compensation nexus vs. constrained investment decisions by the political influence
 - ▣ Mechanism behind the within-asset class results should be explained better