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Why More Public Pensions Are Taking a Chance on Alternative Investments

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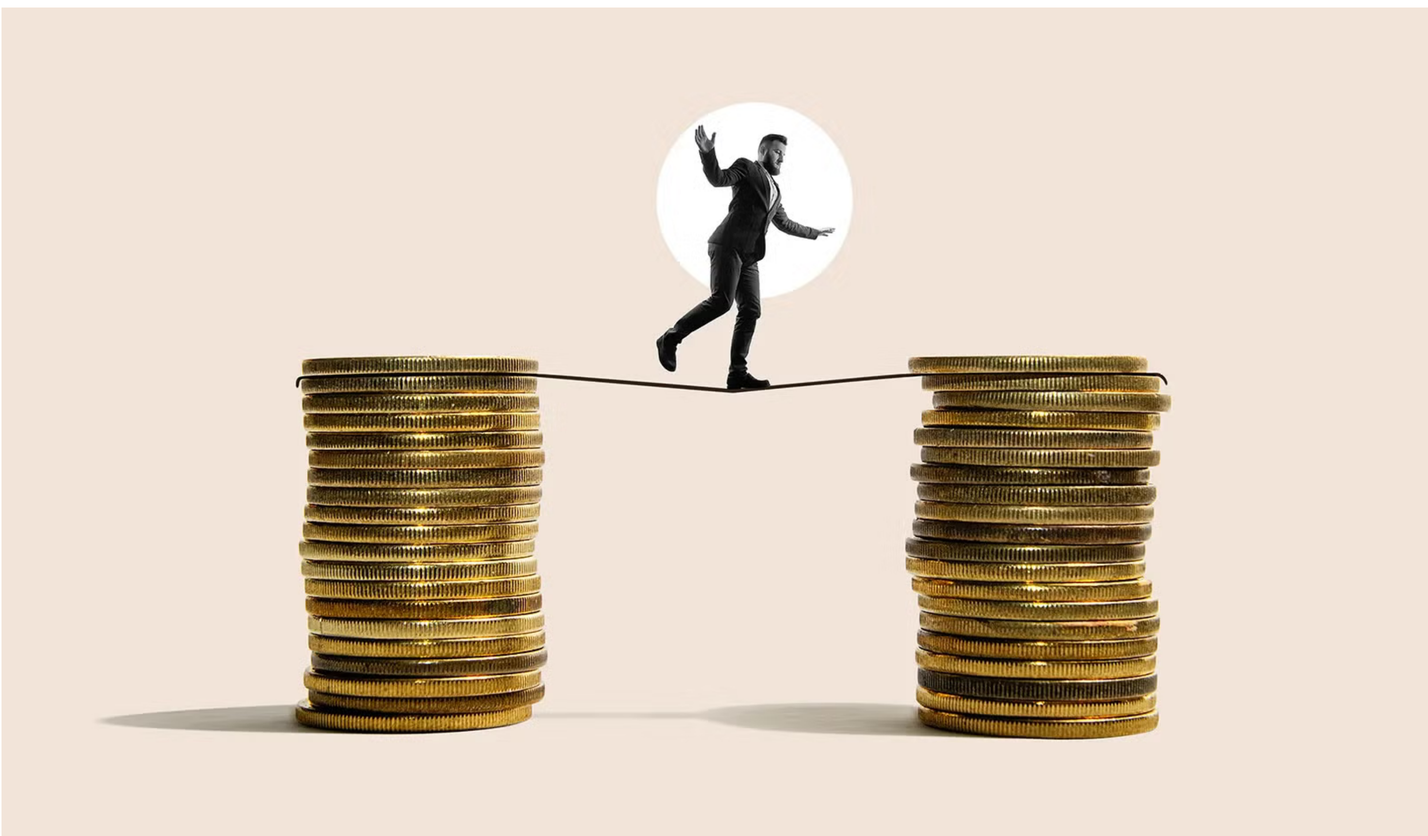

The biggest public retirement plans in the U.S. have plowed money into private equity, real estate, and hedge funds. | iStock/SvetaZi

In March 2024, the board of the United States' largest public pension fund endorsed a strategy to ramp up its investments in private markets by over $30 billion. The California Public Employees' Retirement System, which now manages more than $500 billion in retirement funds, said it planned to shift more of its portfolio away from stocks and bonds and toward private equity and private debt. Two years earlier, CalPERS acknowledged that its choice to steer clear of private equity had potentially caused it to miss out on up to $18 billion in returns over the previous decade.

CalPERS is far from alone. The biggest public retirement plans in the U.S. have plowed money into alternative assets like private equity, real estate, and hedge funds. Since 2001, for every dollar they've withdrawn from fixed-income assets, they have invested $2.60 in alternatives, according to a recent study by Stanford Graduate School of Business finance professor Juliane Begenau, PhD candidate Pauline Liang, and Emil Siriwardane of Harvard Business School. Between 2001 and 2021, allocations to alternative assets went from 14% of pensions' "risky" investments to 39%.

The researchers say the main reason for this shift is pension managers' belief that alternative investments can yield superior returns — so-called alpha — compared to traditional investments. "Beliefs have played a central role in this crazy, giant shift in investment portfolios toward alternative assets," Begenau says. "This goes against what many people thought: Because public pensions are underfunded and are facing a low return investment environment, they are taking on more risks and gambling with retirement savers' money."

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Instead, pensions are shifting to alternative assets because they're seeking market-beating returns, Begenau and her colleagues find. (CalPERS has said that private equity was its best-performing asset class in the decade before 2023, bringing home annual returns of nearly 12%, against 8.9% from public equities and 2.4% from fixed income.) Furthermore, these bullish beliefs stem from the powerful role of investment consultants, who advise almost all U.S. public pensions.

Studying capital market assumptions reports published by major investment consulting firms, the researchers found that advisors' beliefs about the potential relative returns from alternative investments have consistently increased, rising by about 68 basis points since 2001. This "consultant effect" is large enough to account for the entire increase in the share of alternative investments in public pension portfolios.

Moreover, the research found a strong connection between consultants' animal spirits and the share of alternative investments in their clients' portfolios, even after controlling for factors like the financial health and size of the pension funds. “Consultants have some influence on the beliefs of their clients, though it’s also possible that pensions choose investment advisors based on their already-held assumptions,” Begenau says.

The authors find that pensions that invested in equities later in the 1990s, just ahead of the dot-com bubble, increased their alternative investments by more than pensions that had invested in equities earlier. This is likely due to the low returns on stocks in the late 1990s. This experience led these pensions to view alternative investments more favorably and adjust their portfolios in the 2000s. When pensions decided to invest in public equities explained about one-fifth of the differences across pensions in their shift toward alternatives from 2002 to 2021.

Following the Herd

Supply-side factors might also have played a role in the increase of alternative investments by public pensions. For instance, investors now have better access to privately owned companies through private equity limited partnerships. And the availability of alternative investments has grown, from 2% of all global “risky” assets in 2000 to 8% in 2020.

The researchers also found that pensions exhibit herd mentality, tending to invest similarly to their nearby peers when choosing between alternative investments and stocks. The most likely reason is that pension managers learn from local colleagues about the risks and rewards of alternative assets, perhaps by sharing information or attending the same conferences. “Even pensions with little pressure to follow the herd still invest similarly to other retirement plans nearby," Begenau says.

However, her study found little evidence that the desire for risk-taking explains pensions' turn toward alternative assets. For example, a drop in pension funding from 2002 to 2020 — a key indicator of higher risk tolerance — only accounted for about 1% of the reasons pensions were choosing to pour capital into more illiquid and opaque classes of assets.

Furthermore, the paper shows that the rise in alternative investments has been primarily driven by a shift in the types of risky assets held in portfolios rather than a broader increase in all types of risky assets. For instance, while corporate retirement plans in the U.S. and the United Kingdom have seen an increase in their proportion of alternative assets since the early 2000s, their overall proportion of risky investments has decreased.

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