



BEST PRACTICE

Public Employee Retirement System Investments (1993, 1995, 1997 and 2009) (CORBA)

Background. State and local government public employee retirement systems (PERS) manage assets that provide retirement income for millions of state and local government retirees through defined benefit plans. A significant percentage of the benefits these systems provide are paid from investment earnings as well as employer and employee contributions.

Subject to applicable federal, state, and local laws and judicial decisions, PERS investment programs are governed by investment policy objectives and constraints established by pension fund fiduciaries (individuals who are given the authority to hold assets for another party according to a trust agreement). For most public-sector pension plans, investment decisions are made by a PERS board of trustees comprising elected and/or appointed fiduciaries.

Pension fund fiduciaries must invest plan assets for the exclusive benefit of plan participants and beneficiaries. Fiduciaries must consider each investment, taking into consideration:

- the system's diversification plan (mixing a variety of investments in an effort to smooth out unplanned risk)
- liquidity (the ability to convert an asset to cash as needed)
- risk/return profile (the level of risk the system is willing to take on in return for the level of investment return)

Each of these criteria should be provided in the PERS investment policy.

Recommendation. The Government Finance Officers Association (GFOA) recommends that fiduciaries adhere to the following best practices regarding investments:

1. Pension fund fiduciaries should establish a written investment policy that lays out formal policies and procedures to regulate and monitor the system's investment program. The investment policy should:
 - establish the objectives of the investment program
 - define acceptable risk
 - establish liquidity requirements at a level that does not compromise the system's cash flow needs
 - describe diversification requirements
 - comply with applicable state and local statutes
2. Pension fund fiduciaries should regularly review individual investments and the plan's asset allocation strategy, which should state the proportional combination of equities, fixed income, cash equivalents, and alternatives the plan will invest in based on the plan's liabilities, expected rates of return, and risk tolerance in light of general market trends and valuations. (See the GFOA Best Practice on *Asset Allocation for Defined Benefit Plans*).
3. Plan fiduciaries should evaluate the role of passive or indexed investment strategies in the portfolio. The plan should also have appropriate strategies to minimize the costs of buying and selling securities, as well as making sure portfolio management and consulting fees are reasonable. Plan officials might want to consider pooled investments as a cost-saving measure.

4. To maintain their fiduciary obligations, fiduciaries should carefully review investment-related practices that could be questioned (soft-dollar services, brokerage-related or broker-compensated services, and unconventional investment strategies). Fiduciaries need to be especially careful about transactions that involve placement agents (agents a plan hires to find investors), ensuring that the finders' fees paid to these agents are appropriate.
5. A fund's investment guidelines should include formal and specific benchmarks for assessing the performance of the investment portfolio. Fiduciaries should regularly evaluate and document investment performance in a consistent way. Fiduciaries should also establish clear criteria and procedures that are related to specific benchmarks for terminating a portfolio manager, or any action that might lead to a termination (i.e., putting the manager on a watch list).
6. Fiduciaries should adhere to the following investment guidelines when considering investments with collateral benefits (broad social or economic benefits that go beyond the pension system's investment return):
 - All investments must yield a rate of return commensurate with the recognized level of investment risk.
 - Fiduciaries who evaluate investments on the basis of the collateral benefits they provide should at the same time consider alternate investments with similar risk/return characteristics.
 - The selected investment should be prudent on its own merit, regardless of the collateral benefits it offers.
 - Investments designed with below-market rates of return or other concessionary terms are not acceptable because they compromise established risk-return standards and conflict with fiduciaries' responsibility to invest the system's assets for the exclusive benefit of the participants.
7. Trustees and other fiduciaries should provide participants, plan sponsors, and other interested parties with regular, clear, and intelligible communications on the plan's investments.
8. Trustees, staff, and adviser selection processes should be designed to ensure competent fiduciary behavior at every level. Trustees and professional staff need to be familiar with prevailing investment practices and should receive appropriate training at reasonable cost.
9. The pension system should establish ethics policies that contain high standards for impartiality and that require trustees and staff to refrain from making investment decisions based on personal or political reasons, or appearing to do so.
10. The pension system should have a plan for recruitment and retention of competent investment expertise, both for its professional staff and independent advisors and consultants. A competitive selection process should be used when selecting outside service providers.

References

- *Pension Fund Investing*, Girard Miller, GFOA, 1987.
- *An Elected Official's Guide to Public Retirement Systems*, Cathie G. Eitelberg, GFOA, 1997.
- *1997 Survey of State and Local Government Employee Retirement Systems*, Paul Zorn, GFOA, 1998.
- *Investing Public Funds, Second Edition*, Girard Miller with M. Corinne Larson and W. Paul Zorn, GFOA, 1998.
- *A Guide for Selecting Pension Investment Consultants: Writing RFPs and Evaluating Proposals*, Rick Dahl, GFOA, 1999.
- GFOA Best Practice, *Asset Allocation for Defined Benefit Plans*, 2009.

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