OUTRAGED BY COMPENSATION: IMPLICATIONS FOR PUBLIC PENSION PERFORMANCE

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Research Motivation

- 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

- 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

- **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

- 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

- 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

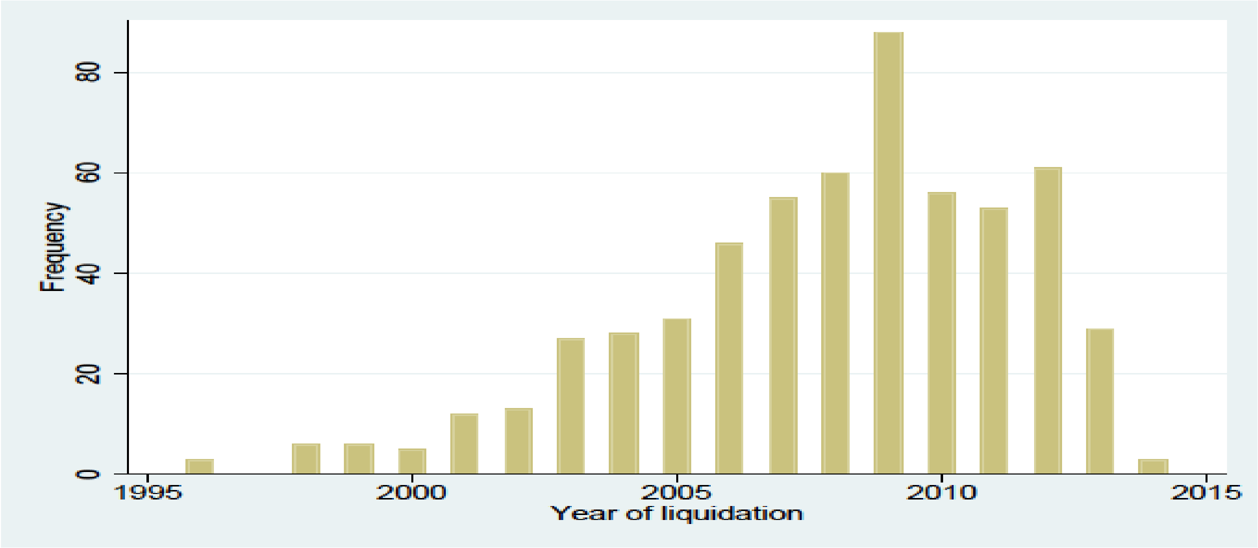
- Compare compensation within the pension fund space with the hedge fund space
  - Investigate the nexus between compensation and performance

- 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

- 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

- 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**	0.0209*	0.00689*	-0.00441
		[0.00291]	[0.0111]	[0.00400]	[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

- **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

- 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