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## Public Pension Fund Investment.

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## Official Title and Summary Prepared by the Attorney General

**PUBLIC PENSION FUND INVESTMENT. LEGISLATIVE CONSTITUTIONAL AMENDMENT.** Constitution presently permits Legislature to authorize public pension and retirement funds to invest up to 25 percent in common stock of corporations meeting prescribed standards. This measure permits authorizing public pension and retirement systems to instead invest up to 60 percent in such common stock and, within the 60 percent, 5 percent in stock of corporations not meeting certain present standards. Permits Legislature, within both limitations, to authorize 0.5 percent investment in corporations whose assets are in nonpublicly traded equity instruments. Provides assets of public pension or retirement funds are trust funds. Prescribes fiduciary standards for their investment. Summary of Legislative Analyst's estimate of net state and local government fiscal impact: If implemented, could result in opportunities for increased earnings through higher dividends and capital gains, accompanied by greater risk to the participating public pension or retirement funds, which could entail capital losses to the funds.

## FINAL VOTE CAST BY THE LEGISLATURE ON SCA 21 (PROPOSITION 6)

Assembly—Ayes, 65  
Noes, 3

Senate—Ayes, 27  
Noes, 10

## Analysis by the Legislative Analyst

**Background:**

The State Constitution authorizes the Legislature to permit any public pension or retirement fund to invest up to 25 percent of its assets in common stocks, and up to 5 percent of its assets in preferred stocks of corporations which meet prescribed standards. (Preferred stocks are guaranteed priority by the issuing corporation over common stocks in the payment of dividends and the distribution of assets.) The standards established by the Constitution are as follows:

- The stock must be registered on a national securities exchange (except for preferred stock and the stock of certain banks and insurance companies);
- The corporation must have total assets of at least \$100 million unless it is a specified mutual fund company;
- The outstanding bonds of the corporation must be qualified for investment under the law governing investments for the public retirement funds;
- There can be no delinquency in dividend payments on the preferred stocks; and
- A cash dividend shall have been paid on common stock in at least 8 of the last 10 years preceding the date of investment, the corporation must have paid an earned cash dividend in each of the last 3 years, and aggregate net earnings available for dividends on common stock shall have been equal to the amount of those dividends during that period.

The Constitution further provides that a public pension or retirement fund's stock investment in any one company may not exceed 5 percent of the company's common stock shares outstanding. The Constitution also specifies that no single common stock investment by a pension or retirement fund may exceed 2 percent of the total assets in the fund, based on cost.

**Proposal:**

This measure would permit the Legislature to make various changes in the investment authority of public pension or retirement funds. Specifically, it would permit the Legislature to:

1. Increase the limit on investments in common stocks from 25 percent of a public pension or retirement fund's total assets to 60 percent of the fund's total assets, subject to the existing constitutional requirements governing these investments;
2. Permit investment of up to 5 percent of a public pension or retirement fund's assets in common stock or shares of publicly traded corporations which do not meet some, or all, of the qualifying requirements currently specified in the State Constitution (any such investments would count toward the total 60-percent limit); and
3. Authorize investment of 0.5 percent of a public pension or retirement fund's assets in limited partnerships or corporations where the majority of the assets are securities which are not traded publicly (any such investments would count toward both the 5-percent and 60-percent limitations).

The measure places in the State Constitution a declaration that assets of public pension and retirement funds are trust funds and must be held exclusively for specified purposes.

The measure also would establish in the State Constitution certain guidelines and objectives for investing assets of public pension or retirement funds. These guidelines and objectives call for assets to be invested in a prudent, diversified manner, so as to minimize risks of large losses and maximize the potential for earnings.

**Fiscal Effect:**

The proposed expansion of investment authority in stocks, if implemented by the Legislature, could result

in opportunities for increased earnings through higher dividends and capital gains, accompanied by greater risk to the participating public pension or retirement funds, which could entail capital losses to the funds.

The gain or loss in investment earnings resulting from any expansion in investment authority would depend on how public pension or retirement funds utilize the expanded authority.

### Text of Proposed Law

This amendment proposed by Senate Constitutional Amendment 21 (Statutes of 1982, Resolution Chapter 38) expressly amends the Constitution by amending a section thereof; therefore, existing provisions proposed to be deleted are printed in ~~strikeout type~~ and new provisions proposed to be inserted or added are printed in *italic type* to indicate that they are new.

#### PROPOSED AMENDMENT TO ARTICLE XVI, SECTION 17

SEC. 17. The State shall not in any manner loan its credit, nor shall it subscribe to, or be interested in the stock of any company, association, or corporation, except that the state and each political subdivision, district, municipality, and public agency thereof is hereby authorized to acquire and hold shares of the capital stock of any mutual water company or corporation when such stock is so acquired or held for the purpose of furnishing a supply of water for public, municipal or governmental purposes; and such holding of such stock shall entitle such holder thereof to all of the rights, powers and privileges, and shall subject such holder to the obligations and liabilities conferred or imposed by law upon other holders of stock in the mutual water company or corporation in which such stock is so held.

Notwithstanding provisions to the contrary in this section and Section 6 of Article XVI, the Legislature may authorize the investment of moneys of any public pension or retirement fund, not to exceed ~~25~~ *60* percent of the assets of such fund determined on the basis of cost, in the common stock or shares and not to exceed 5 percent of assets in preferred stock or shares of any corporation; provided:

a. Such stock is registered on a national securities exchange, as provided in the "Securities Exchange Act of 1934" as amended, but such registration shall not be required with respect to the following stocks:

1) The common stock of a bank which is a member of the Federal Deposit Insurance Corporation and has capital funds, represented by capital, surplus, and undivided profits, of at least fifty million dollars (\$50,000,000);

2) The common stock of an insurance company which has capital funds, represented by capital, special surplus funds, and unassigned surplus, of at least fifty million dollars (\$50,000,000);

3) Any preferred stock;

b. Such corporation has total assets of at least one hundred million dollars (\$100,000,000);

c. Bonds of such corporation, if any are outstanding, qualify for investment under the law governing the investment of the retirement fund, and there are no arrears of dividend payments on its preferred stock;

d. Such corporation has paid a cash dividend on its common stock in at least 8 of the 10 years next preceding the date of investment, and the aggregate net earnings available for dividends on the common stock of such corporation for the whole of such period have been equal to the amount of such dividends paid, and such corporation has paid an earned cash dividend in each of the last 3 years;

e. Such investment in any one company may not exceed 5 percent of the common stock shares outstanding; and

f. No single common stock investment may exceed 2 per-

cent of the assets of the fund, based on cost.

*Notwithstanding provisions to the contrary in this section and Section 6 of Article XVI, the Legislature may authorize the investment of moneys of any public pension or retirement fund, not to exceed 5 percent of the assets of such fund determined on the basis of cost, in the common stock or shares of any publicly traded corporations which do not meet some or all of the provisions of subdivisions (a) through (d) of the second paragraph of this section provided, however, that the total investment in the common stocks and shares, together with the total investment made pursuant to the second paragraph of this section in common stocks and shares of all other corporations, may not exceed 60 percent of the assets of the fund determined on the basis of the cost of the stocks or shares.*

*Notwithstanding provisions to the contrary in this section and Section 6 of Article XVI, the Legislature may authorize the investment of moneys of any public pension or retirement fund in corporations or limited partnerships, the majority of the assets of which are nonpublicly traded equity instruments, provided, however, that the total investment of the moneys may not exceed .5 percent of the assets of the fund determined on the basis of cost, that the total investment of the moneys, together with the total investment made pursuant to the third paragraph of this section in common stocks or shares of certain corporations, may not exceed 5 percent of the assets of the fund determined on the basis of cost, and that the total investment of the moneys, together with the total investment made pursuant to the third paragraph of this section in common stocks and shares of certain corporations and the total investment made pursuant to the second paragraph of this section in common stocks and shares of all other corporations, may not exceed 60 percent of the assets of the fund determined on the basis of the cost of the stocks or shares and partnership interests.*

Notwithstanding provisions to the contrary in this section and Section 6 of Article XVI, the Legislature may authorize the investment of moneys of any public pension or retirement fund, in stock or shares of a diversified management investment company registered under the "Investment Company Act of 1940" which has total assets of at least fifty million dollars (\$50,000,000); provided, however, that the total investment in such stocks and shares, together with the total investment made pursuant to the second paragraph of this section in common stocks and shares of all other corporations, may not exceed ~~25~~ *60* percent of the assets of such fund determined on the basis of the cost of the stocks or shares.

*The assets of public pension or retirement funds are trust funds and shall be held for the exclusive purpose of providing benefits to participants in the pension or retirement plan and their beneficiaries and defraying reasonable expenses of administering the plan, and shall be invested, whether pursuant to this section or pursuant to other authority:*

*(a) With the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims.*

*(b) By diversifying the investments of the plan so as to minimize the risk of large losses and by maximizing the rate of return, unless under the circumstances it is clearly prudent not to do so.*

## Argument in Favor of Proposition 6

California's public pension funds *can* earn more money safely and should be allowed to do so.

Public pension funds—the Public Employees' Retirement System, the State Teachers' Retirement System, and local government retirement funds—promise secure retirement to many tens of thousands of Californians. Yet the investment flexibility needed to keep that promise is restricted by outdated provisions of the State Constitution. Pension managers are *unable* to make the most productive investments. Retirees and taxpayers both suffer.

Retirees are penalized when there is not enough money to pay promised benefits. Taxpayers suffer when state and local governments make higher payments to supplement investments which do not earn enough.

Proposition 6 amends the State Constitution to give pension managers the flexibility they need to make the wisest and most profitable investments:

1. It raises the limit on pension fund assets that may be invested in common stock to levels found in private pension plans.

Current law, with heavy emphasis on fixed-income investments, is a strong deterrent to obtaining the best investment results. Careful research of the last 60 years shows that, during every five-year period except one, the rates of return from stocks have far exceeded those of bonds.

Proposition 6 permits pension managers to select the best investment—stocks or bonds—in time to respond to rapidly changing economic conditions.

2. It allows a small percentage of assets to be invested in younger, faster growing companies.

Up to 5 percent of assets could be invested in firms with less than \$100 million in assets. Up to ½ percent of

pension fund assets could be invested in nonpublicly traded firms. These changes bring public pensions into line with private pension management practices.

Smaller companies have historically produced the very highest returns, making them attractive investments for the funds. Further, capital provided by these investments stimulates economic growth and provides more jobs in California.

*None* of these investments is *required*. Proposition 6 simply guarantees that pension managers will have broader discretion to make the best possible investments.

Proposition 6 also constitutionally guarantees specifically, for the first time, that public pension assets "*are trust funds and shall be held for the exclusive purpose of providing benefits to the participants.*" It requires specifically that pension managers meet standards of skill and prudence necessary to maximize returns.

This proposal is fiscally sound. It is supported by the major public pension funds, investment advisers, public employee unions, and the California Taxpayers' Association. Passage of Proposition 6 will result in higher yields on investment and better returns to the funds. A "yes" vote on Proposition 6 will provide security for those who depend on retirement funds in their later years, and protection for the taxpayers who will support them if the funds can not.

**BARRY KEENE**

*Democratic State Senator, 2nd District*

**LARRY STIRLING**

*Republican Member of the Assembly, 77th District*

**DR. BRIAN M. NEUBERGER**

*Professor of Finance, San Diego State University  
PERS Member*

## Rebuttal to Argument in Favor of Proposition 6

Las Vegas, here we come!

The proponents of this proposition are advocating increased speculation of public pension funds to allow for a larger rate of return. They fail to mention that this type of investing is accompanied by a high degree of risk. There is no such phrase as "guaranteed return" in the stock market vocabulary. Isn't it wiser to place these funds in stable investments for a prudent "mix" to safeguard the financial interests of our state's retirees rather than a stock market crapshoot?

Proposition 6 supporters claim that the pension managers need "flexibility" to make the wisest investments. Under this proposal the PERS Board, as appointed by the Governor, will cast the dice on billions of retiree dollars which they may dole out to any company or cause as they see fit. There are no guidelines for investing this money. We can ill afford these board

members, who are short on financial investment experience and long on political friendships, making financial decisions based upon social and ideological criteria.

Many individuals supporting Proposition 6 fail to realize that these funds are workers' savings and *not* state money. Questionable investment strategies could well jeopardize the fiscal security of our state's retirees. And, of course, we all know who will pay the bill for any losses incurred through poor investments—that's right, the taxpayer!

Do we really want Governor Moonbeam's political appointees making such vital economic decisions? Let's not gamble with our state retirees' hard-earned money. Vote *NO* on Proposition 6.

**H. L. RICHARDSON**

*State Senator, 25th District*

### Argument Against Proposition 6

The proponents of Proposition 6 believe that a larger portion of public pension funds, being saved for public employees' retirement, should be "innovatively" invested. The supporters of this proposal would lead you to believe that investing these funds is necessary in order to protect the retirees' contributions. What they fail to point out is that with these investments there is a greater amount of risk involved, and so increases the danger of loss. This dangerous investing could seriously endanger the fiscal security of the retirees who contribute.

Assets of public pension funds should continue to be placed in a *prudent* "mix" of investments to safeguard the long-term financial needs of those pension systems. The entire 13-year record of performance by PERS stands as undeniable proof that any increase in the authorized position of retirement system assets is a serious mistake. The California Public Employees' Retirement System is having a difficult enough time generating sufficient earnings on investments. In these difficult and fluctuating economic times, we hardly need to allow the imposition of a questionable fiscal practice

dreamed up by the Governor's bizarre advisers.

As to who will make the investment decision, the PERS Board members, as appointed by the Governor, will have that responsibility. These board members, who have little or no financial investment experience, will decide where billions of retiree dollars will be invested. Current economic times are such that even knowledgeable investment brokers are experiencing difficulty in today's market.

Approval of Proposition 6 will be a costly mistake. Not only will the contributors suffer, but the participating public agencies and the California taxpayers as well, for all will have to help recover any losses incurred due to poor investments. Don't gamble with the future of our state's retirees who have worked hard for their retirement.

**VOTE NO ON PROPOSITION 6!**

**H. L. RICHARDSON**  
*State Senator, 25th District*

**JAKE PETROSINO**  
*President, PERS Retirement Betterment Committee Inc.*

### Rebuttal to Argument Against Proposition 6

Public pension funds aren't earning what they should to give retirees what they deserve.

Even the opponents of Proposition 6 acknowledge that public pension funds are having a hard time earning money on their investments. Other jurisdictions have adopted the practices outlined in Proposition 6, and private pension funds have used these investments to make more money for years. Why should California's public pension funds be restricted to earning less?

Retired employees have worked long and hard for security in their retirement years, only to see their pension benefits gutted by inflation. The ability of the retirement funds to earn more money on investments is the best hope for an increase in benefits to help retirees to keep pace with inflation.

The opponents acknowledge that these investments should be made *prudently*. Proposition 6 puts that requirement of prudent investment into the Constitution for the first time, to make *absolutely sure* that the investments are sound.

The opponents question who will be making the investment decisions. Proposition 6 is quite clear. It is the pension managers—not the Governor, not the Legislature, and not special interests—who will be making those decisions. These pension managers are bound by strict rules of legal responsibility. They *must* invest only for the benefit of the members of the system.

Failure to pass Proposition 6 will leave the public pension funds hobbled by outdated investment rules and will leave retirees with little hope for benefits that grow with inflation.

**VOTE YES ON PROPOSITION 6!**

**BARRY KEENE**  
*Democratic State Senator, 2nd District*

**LARRY STIRLING**  
*Republican Member of the Assembly, 77th District*

**DR. BRIAN M. NEUBERGER**  
*Professor of Finance, San Diego State University*  
*PERS Member*