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REVIEW & OUTLOOK

Cronyism at Calpers

How have the mighty fallen. And how quickly. For decades, Calpers, the giant California state pension fund, set a standard of excellence in investment performance and probity. Lately, however, Calpers has become the poster-plan for bad performance, cronyism and lousy corporate governance. And it's about to get worse.

Calpers's slide is a familiar tale of California politics, and one almost ordained given the makeup of Calpers's board of trustees. There are 13 members -- six elected by members of Calpers, four appointed by the Governor and three state officials designated by statute.

Since Governor Gray Davis has enormous influence over board membership, it's no surprise that a majority represents, or is supported by, labor or the Democratic Party. But Mr. Davis's choices to run the largest pension fund in the country are especially questionable. His most recent appointee, San Francisco Mayor Willie Brown, is a classic political favor-grantor and insider. And a great chum of Mr. Davis.

Under this board, investment strategy has become increasingly twisted toward what the board calls socially responsible investing, but what others see as the pursuit of the political dictates of its union-affiliated members. Some also detect an investment strategy designed to reward the Democratic faithful.

Last year Calpers invested \$100 million in a real estate partnership run by Richard Wollack, a major fund-raiser for Mr. Davis. Calpers also invested more than \$760 million in funds run by Ronald Burkle, a big contributor to Mr. Davis and to two state officials who served on the board, Treasurer Philip Angelides and Controller Kathleen Connell. Mr. Burkle has also contributed to the various campaigns of Willie Brown and has employed Mr. Brown to do legal work for his companies. Both Mr. Brown and Mr. Angelides (former state Democratic Party chairman) voted in favor of giving \$760 million to Mr. Burkle. The state's taxpayers deserve to know how this not-so-little investment turns out.

And then there are the conflicts of interest. Members of the board are allowed to own stock that is also held by Calpers. Mayor Brown not only held shares in firms owned by Calpers but also received campaign money from companies in which Calpers has invested.

The board of course has a fiduciary responsibility to the beneficiaries of the pension fund. While the persnickety might question these apparent conflicts of interest and cronyism, the less fastidious might argue that as long as investment returns stay robust, that fiduciary duty has been satisfied.

Well, during this period of increasing politicization Calpers's investment returns have taken a dive. Since 2000 the fund's investments have underperformed other large pension funds. In the three years ending September 30, 2002, returns posted a negative 2.5%. Between June 2000 and the end of October 2002, Calpers's assets dwindled to \$136.6 billion from \$172 billion -- a decline of more than 20%. If returns don't improve, the fund may show unfunded liabilities by the end of its fiscal year.

Diminishing returns leaves Calpers with two choices. Either contributions to the fund must be increased, in this case from employers, or the risk-return investment trade-off must be tilted toward higher risks, higher returns.

Calpers has decided to do both. The fund has already informed employers that they are on the hook; state school districts, for example, have been told will have to start contributing about 2.8% of payroll.

More interesting, however, is the Calpers portfolio allocation. Less risky fixed-income investments constitute about 28%, riskier equities log in at 62% and much riskier real estate accounts for 9.2%. The really risky allocation, alternative investments, accounts for 4.9% -- although when private equity is included, the share allocated to alternative investments leaps to 16%.

That's a very aggressive strategy for a public pension fund. Calpers says its benchmark return for these risky alternative investments is 15%, but those returns are now negative. In the year ending June 30, 2002, they were negative 7.1%.

Into this dangerously lethal mix of politics and desperation comes the election of a new president by the Calpers board next month. The first two candidates to declare themselves were Sean Harrigan, a boss of the Food and Commercial Workers Union who became a Calpers board member after Governor Davis appointed him to the State Personnel Board, and Bob Carson, a retired general counsel for the State Department of Transportation. Then a third candidate popped up -- with the support of Mr. Davis -- Mayor Brown.

If Calpers were a private investment fund, this would all be hilariously high comedy. But Calpers is a public fund. Ultimately the buck stops with the taxpayers of California. For them, it might turn out to be pure tragedy.

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