OUTRAGED BY COMPENSATION: IMPLICATIONS FOR PUBLIC PENSION PERFORMANCE

Discussant: Andrew Ellul
Bar Ilan University

December 2019
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

<table>
<thead>
<tr>
<th>Manager Compensation</th>
<th>Count</th>
<th>Mean</th>
<th>Standard Deviation</th>
<th>25th percentile</th>
<th>Median</th>
<th>75th percentile</th>
</tr>
</thead>
<tbody>
<tr>
<td>Manager Compensation ($)</td>
<td>463</td>
<td>807,416</td>
<td>1,018,136</td>
<td>292,328</td>
<td>537,197</td>
<td>819,979</td>
</tr>
<tr>
<td>Log Manager Compensation</td>
<td>463</td>
<td>13.20</td>
<td>0.828</td>
<td>12.59</td>
<td>13.19</td>
<td>13.62</td>
</tr>
</tbody>
</table>

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)

<table>
<thead>
<tr>
<th>Job Level</th>
<th>Description</th>
<th>Average Compensation</th>
<th>Examples of job titles</th>
</tr>
</thead>
<tbody>
<tr>
<td>6</td>
<td>CEOs</td>
<td>3,707,831</td>
<td>CEO, executive director, founder, managing director, managing partner</td>
</tr>
<tr>
<td>5</td>
<td>Top executives</td>
<td>1,590,858</td>
<td>CFO, CIO, COO, CRO, deputy CEO, partner, vicepresident</td>
</tr>
<tr>
<td>4</td>
<td>First/Mid Officers &amp; Managers</td>
<td>158,150</td>
<td>director of sales, head of investor relations, investment manager</td>
</tr>
</tbody>
</table>
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

<table>
<thead>
<tr>
<th></th>
<th>Equation I: Log Compensation</th>
<th>Equation II: Net Returns</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Outrage-Predicted Log</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Compensation</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Outrage-Predicted Log</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Compensation</td>
<td></td>
</tr>
<tr>
<td></td>
<td>0.00635**</td>
<td>0.0209*</td>
</tr>
<tr>
<td></td>
<td>[0.00291]</td>
<td>[0.0111]</td>
</tr>
<tr>
<td></td>
<td>0.00689*</td>
<td>0.00400</td>
</tr>
<tr>
<td></td>
<td>[0.00400]</td>
<td>[0.00370]</td>
</tr>
<tr>
<td></td>
<td>-0.00441</td>
<td></td>
</tr>
</tbody>
</table>

- 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