While states have shown resilience in the face of current market volatility, pension dynamics will continue to be an important driver of their long term credit quality. (ddp)

Public pension plans tilt toward alternatives

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Over the last two decades, state and local government pension funds significantly increased allocations to alternative investments (from 9% in 2001 to 34% in 2022) while reducing exposure to more traditional asset classes like public equities and fixed income.

While alternative investments are a catch-all phrase for a wide variety of investments, they broadly comprise private equity, hedge funds, real estate, commodities, and private credit. The move toward alternatives picked up pace in the aftermath of the 2008–09 Global Financial Crisis, which saw extreme market volatility. This trend has accelerated over the last two years, as the pandemic took its toll on financial markets in 2020, and the Federal Reserve's aggressive monetary tightening has induced substantial asset price drawdowns and market volatility since the beginning of 2022.

The tilt toward alternatives has shown broad participation among public pension plans over the last two decades. Per estimates from the Center for Retirement Research at Boston College, more than 80 percent of state and local government pension plans allocated 20 percent or more of their assets to alternative investments in 2022. That is a sharp increase from 2001, when only about 10 percent of public pension funds had a similar level of allocation.

Large, prominent public pension funds recently announced significant long-term investments/allocation decisions to alternative investments. On 23 December 2022, New York Governor Kathy Hochul signed into law an expansion of the so-called "basket clause" in the state's Retirement and Social Security law. The basket clause covers non-traditional investments such as hedge funds and private equity. The law's "Legal list" covers traditional asset classes such as public equities and bonds. The expansion will allow the New York State Common Retirement fund, New York City Retirement system, and New York State Teacher's Retirement System to raise their alternative investment allocation from 25% to 35%.

Over on the west coast, the University of California entered into a long-term strategic relationship with Blackstone on 3 January 2023. UC Investments (the entity which manages the university's pension and endowment assets) will invest

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USD 4 billion in the Blackstone Real Estate Income Trust (BREIT), a USD 68 billion private real estate fund set up in 2017. The university's pension fund had USD 22 billion, (approximately 28% of assets), in alternative investments, prior to this new investment in BREIT.

The key rationale, often cited by pension fund managers, is the attractive risk-return profile of alternatives. They offer diversification benefits, owing to their lower correlation with traditional asset classes. The Center for Retirement Research at Boston College estimates that alternative investments had a small negative impact on returns over the last two decades, but also appear to have meaningfully reduced portfolio volatility. However, they caution that it is difficult to precisely estimate volatility reduction given the intrinsic difficulties in valuing alternative assets as well as the lag in data availability.

While the jury may be out on a precise estimate of the benefit alternative investments provide, one thing is clear: They will play a much more significant role in determining overall public pension portfolio characteristics and performance in the years to come, given their rising allocations. While states have shown resilience in the face of current market volatility, pension dynamics will continue to be an important driver of their long term credit quality.

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Appendix

Non-Traditional Assets
Non-traditional asset classes are alternative investments that include hedge funds, private equity, real estate, and managed futures (collectively, alternative investments). Interests of alternative investment funds are sold only to qualified investors, and only by means of offering documents that include information about the risks, performance and expenses of alternative investment funds, and which clients are urged to read carefully before subscribing and retain. An investment in an alternative investment fund is speculative and involves significant risks. Specifically, these investments

1. are not mutual funds and are not subject to the same regulatory requirements as mutual funds;
2. may have performance that is volatile, and investors may lose all or a substantial amount of their investment;
3. may engage in leverage and other speculative investment practices that may increase the risk of investment loss;
4. are long-term, illiquid investments, there is generally no secondary market for the interests of a fund, and none is expected to develop;
5. interests of alternative investment funds typically will be illiquid and subject to restrictions on transfer;
6. may not be required to provide periodic pricing or valuation information to investors;
7. generally involve complex tax strategies and there may be delays in distributing tax information to investors;
8. are subject to high fees, including management fees and other fees and expenses, all of which will reduce profits.

Interests in alternative investment funds are not deposits or obligations of, or guaranteed or endorsed by, any bank or other insured depository institution, and are not federally insured by the Federal Deposit Insurance Corporation, the Federal Reserve Board, or any other governmental agency. Prospective investors should understand these risks and have the financial ability and willingness to accept them for an extended period of time before making an investment in an alternative investment fund and should consider an alternative investment fund as a supplement to an overall investment program.
In addition to the risks that apply to alternative investments generally, the following are additional risks related to an investment in these strategies:

- Hedge Fund Risk: There are risks specifically associated with investing in hedge funds, which may include risks associated with investing in short sales, options, small-cap stocks, "junk bonds," derivatives, distressed securities, non-U.S. securities and illiquid investments.
- Managed Futures: There are risks specifically associated with investing in managed futures programs. For example, not all managers focus on all strategies at all times, and managed futures strategies may have material directional elements.
- Real Estate: There are risks specifically associated with investing in real estate products and real estate investment trusts. They involve risks associated with debt, adverse changes in general economic or local market conditions, changes in governmental, tax, real estate and zoning laws or regulations, risks associated with capital calls and, for some real estate products, the risks associated with the ability to qualify for favorable treatment under the federal tax laws.
- Private Equity: There are risks specifically associated with investing in private equity. Capital calls can be made on short no-tice, and the failure to meet capital calls can result in significant adverse consequences including, but not limited to, a total loss of investment.
- Foreign Exchange/Currency Risk: Investors in securities of issuers located outside of the United States should be aware that even for securities denominated in U.S. dollars, changes in the exchange rate between the U.S. dollar and the issuer's "home" currency can have unexpected effects on the market value and liquidity of those securities. Those securities may also be affected by other risks (such as political, economic or regulatory changes) that may not be readily known to a U.S. investor.