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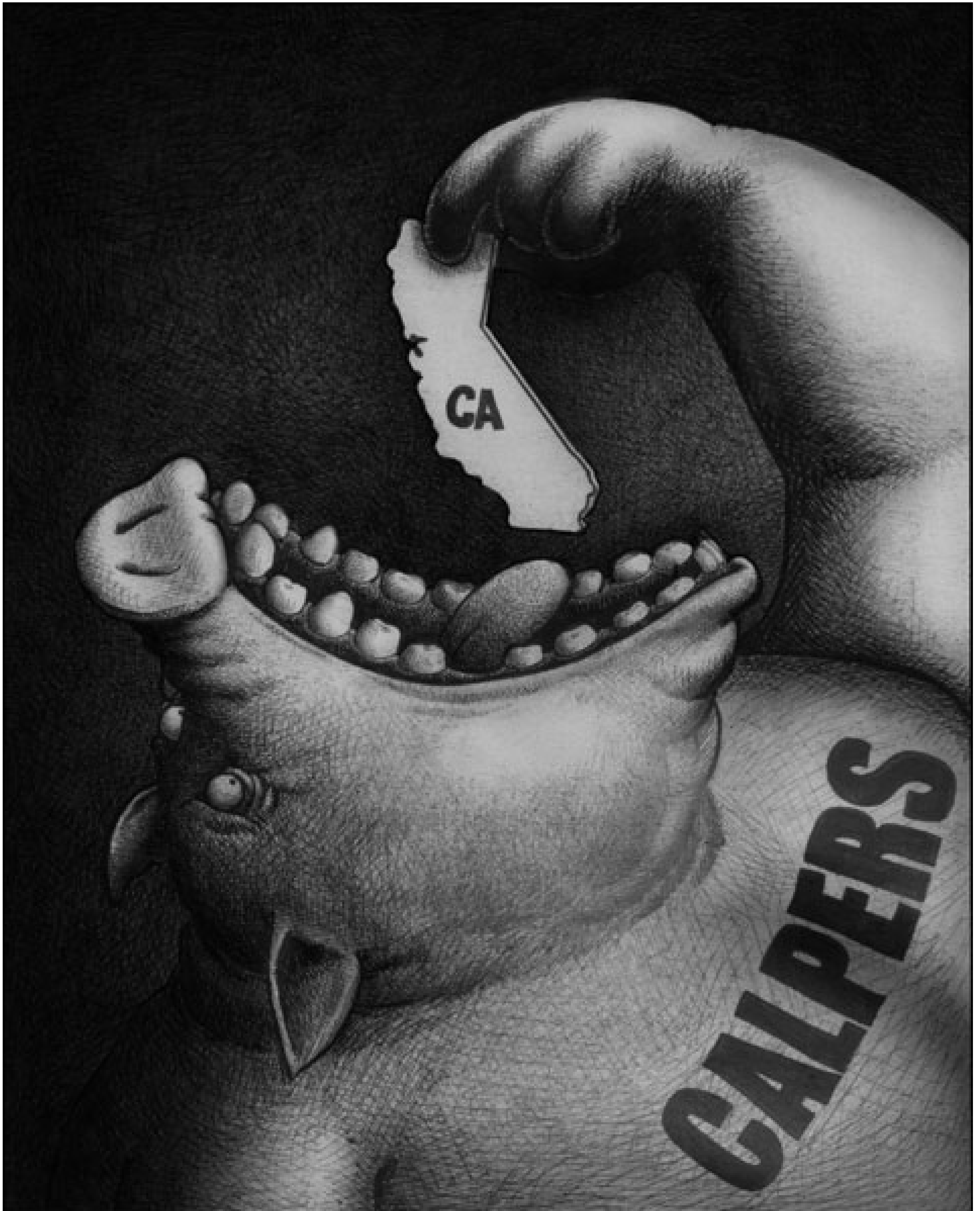
The Pension Fund That Ate California

CalPERS's corruption, insider dealing, and politicized investments have overwhelmed taxpayers with debt.

Steven Malanga

After spending years dogged by unpaid debts, California labor leader Charles Valdes filed for bankruptcy in the 1990s—twice. At the same time, he held one of the most influential positions in the American financial system: chair of the investment committee for the California Public Employees' Retirement System, or CalPERS, the nation's largest pension fund for government workers. Valdes left the board in 2010 and now faces scrutiny for accepting gifts from another former board member, Alfred Villalobos—who, the state alleges, spent tens of thousands of dollars trying to influence how the fund invested its assets. Questioned by investigators about his dealings with Villalobos, Valdes invoked the Fifth Amendment 126 times.



ILLUSTRATIONS BY SEAN DELONAS

California taxpayers help fund CalPERS's pensions and ultimately guarantee them, so they might wonder: How could a financially troubled former union leader occupy such a powerful position at the giant retirement system, which manages roughly $230 billion in assets? The answer lies in CalPERS's three-decade-long transformation from a prudently managed steward of workers' pensions into a highly politicized advocate for special interests. Unlike most government pension funds, CalPERS has become an outright lobbyist for higher member benefits, including a huge pension increase that is now consuming California state and local budgets. CalPERS's members, who elect representatives to the fund's board of directors, ignored concerns over Valdes's suitability because they liked how he fought for those plusher benefits.

CalPERS has also steered billions of dollars into politically connected firms. And it has ventured into "socially responsible" investment strategies, making bad bets that have lost hundreds of millions of dollars. Such dubious practices have piled up a crushing amount of pension debt, which California residents—and their children—will somehow have to repay.

When California's government-employee pension system was established in 1932, it was a model of restraint. Private-sector pensions were still rare back then, but California lawmakers had a particular reason for wanting a public-sector pension system: without one, unproductive older workers had an incentive to stay on the job and just "go through the motions" to get a paycheck, as a 1929 state commission put it. Pensions would encourage those workers to retire. The commission cautioned, however, against setting a retirement age so low that it would "encourage or permit the granting of any retirement allowance to an able-bodied person in middle life."

Accordingly, California set its initial retirement age for state workers (and, beginning in 1939, for local-government employees) at 65, at a time when the average 20-year-old entering the workforce could expect to live for another 46 years, until 66. The system's first pensions were modest, though far from miserly. An employee's pension equaled 1.43 percent of his average salary over his last five years on the job, multiplied by the total number of years he had worked. That formula typically provided workers with pensions equal to half or more of their final salaries, noted California's Little Hoover Commission, a government agency,

in a 2010 study. For example, a state worker who retired at 65 after 40 years on the job would qualify for a pension equal to 57.2 percent of his average final salary (that's 40 times 1.43). If that salary was $50,000, his pension would be nearly $29,000.

The pensions were funded by three sources: contributions from employers (that is, state and local governments); contributions from employees (though some governments opted to cover that expense); and money that the pension fund would gain by investing those contributions. With the 1929 stock-market crash in mind, California opted for a cautious investment approach, allowing the fund to buy only safe federal Treasury bonds and state municipal bonds. "An unsound system," the 1929 commission warned, would be "worse than none." The employees' contributions were fixed, so if investment returns weren't sufficient to fund the promised pensions, the employers' contributions would have to increase to make up the difference.

In 1961, California enhanced non-public-safety state workers' retirement packages by enrolling them in federal Social Security, a program that's optional for state and local government employees. But the state made few other changes to the pension system over its first 30 years.

Then came the late sixties, a time of rapidly growing public-sector union power. In 1968, the California state legislature added one of the most expensive of all retirement perks, annual cost-of-living adjustments, to CalPERS pensions. Other enhancements followed quickly, including, in 1970, a far more generous pension formula: a worker's pension was calculated from 2 percent, not 1.43 percent, of his average final salary, and he could start getting his pension at 60, rather than 65. Thus, an employee who worked for 40 years and retired at 60 with an average final salary of $50,000 could collect an annual pension equal to 80 percent of that sum, or $40,000; if he kept working for another five years, his pension fattened to 90 percent of his final average. In 1983, public-safety workers got an even better pension formula: 2.5 percent of average final salary for every year worked, which could be taken starting at 55. A police officer or firefighter who began work at 20 and retired 35 years later with a final average salary of $50,000 now qualified for a yearly pension of almost $44,000.

As benefits increased, so did pressure to pay for them by boosting CalPERS's investment returns. The shift started in 1966 when voters approved Proposition 1, a measure, promoted by CalPERS, that let it invest up to 25 percent of its portfolio in stocks. The timing wasn't ideal, since the long economic stagnation of the late sixties and seventies had left equity markets struggling for gains. But by the early eighties, markets were roaring again, and CalPERS asked for permission to invest up to 60 percent of its portfolio in stocks. Voters rejected that ballot initiative but approved another, Proposition 21, in 1984, which likewise let CalPERS expand its investments —and didn't specify a percentage limit. Instead, Prop. 21 supposedly protected taxpayers with a clause that held CalPERS board members personally responsible if they didn't act prudently. The proposition received the enthusiastic backing of government unions and CalPERS board president Robert Carlson, former head of the powerful California State Employees Association. CalPERS's conservative investment approach, Carlson and other supporters argued, was shortchanging the state's taxpayers. After all, the better the investment returns were, the less state and local governments would need to pay into the pension fund.

Despite the new investment strategy, the costs of the enlarged pensions weighed heavily on California's budget. In 1991, with the nation mired in a recession and the state in a fiscal crisis, the California legislature closed the existing pension system to new workers, for whom it created a second "tier." This less expensive plan no longer required the worker to make a pension contribution, and it lowered the value of his pension to 1.25 percent of his final average salary for every year he had worked; further, he could begin to receive the pension only at 65. A 40-year veteran with a final average salary of $50,000 would thus qualify for a $25,000 pension, plus Social Security benefits.

The state's public-sector unions hated the new tier, of course, and their growing influence over CalPERS's board of directors meant that it, too, was soon lobbying against the 1991 reform. Six of the board's 13 members are chosen by government workers, and as union power grew in California, those six increasingly tended to be labor honchos. Two more members are statewide elected officials (California's treasurer and controller), and another two are appointed by the governor—so by 1999, when union-backed Gray Davis became governor and union-backed Phil Angelides became state treasurer, the CalPERS board was wearing a "union label,"

noted the *New York Times*. As the newspaper added, critics worried that the board had become so partisan that its "ability to provide for the 1.3 million public employees whose pensions it guarantees" was in doubt.

The critics were right to worry about CalPERS's bias. In 1999, the fund's board concocted an astonishing proposal that would take all the post-1991 state employees and retroactively put them in the older, more expensive pension system. The initiative went still further, lowering the retirement age for all state workers and sweetening the pension formula for police and firefighters even more. Public-safety workers could potentially retire at 50 with 90 percent of their salaries, and other government workers at 55 with 60 percent of their salaries.

CalPERS wrote the legislation for these changes and then persuaded lawmakers to pass it. In pushing for the change, though, the pension fund downplayed the risks involved. A 17-page brochure about the proposal that Cal- PERS handed to legislators reads like a pitch letter, not a serious fiscal analysis. The state could offer these fantastic benefits to workers at no cost, proclaimed the brochure: "No increase over current employer contributions is needed for these benefit improvements." The state's annual contribution to the pension fund—$776 million in 1998—would remain relatively unchanged in the years ahead, the brochure predicted.

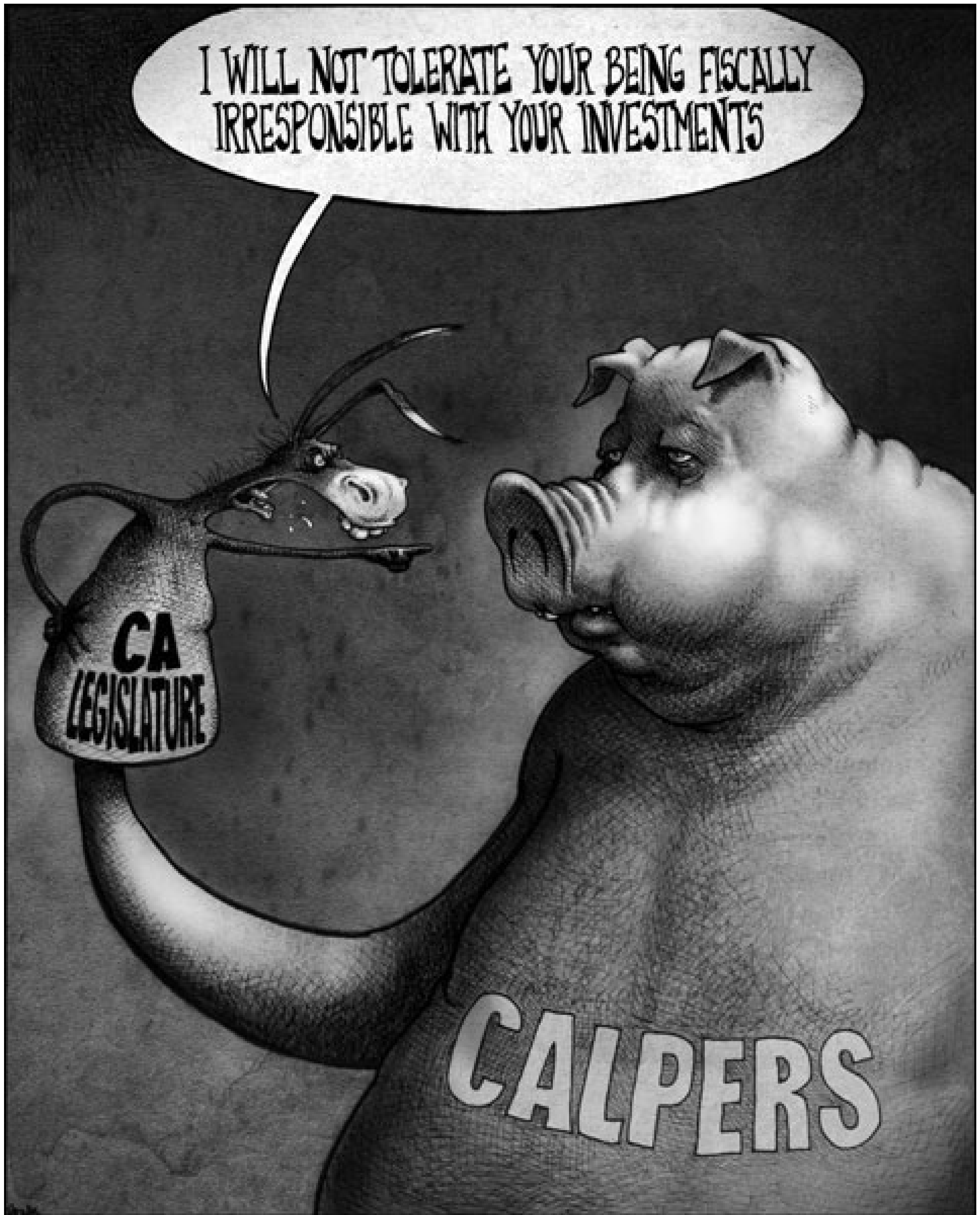
CalPERS board members also minimized the plan's risks. Board president William Crist contended in the press that the bigger benefits would be covered by the pension fund's market returns. Labor leader Valdes blasted critics who warned about potential stock-market declines, saying that they were trying to deny workers a piece of the good times. What the board members didn't mention was that California law protected government pensions, so that taxpayers would be on the hook for any shortfall in pension funding. In essence, the CalPERS position was that government workers should carry zero risk, sharing the bounty when the fund's investments did well but losing nothing when the investments went south.

But the board members knew that there was a downside. CalPERS staff had provided them with scenarios based on different ways the market might perform. In the worst case, a long 1970s-style downturn, government contributions to the fund would have to rise by billions of dollars (which is basically what wound up

happening). CalPERS neglected to include that worst-case scenario in its legislative brochure. And though the board later claimed that it had offered a full analysis to anyone who asked, key players at the time deny it. Even the state senator who sponsored the law, Deborah Ortiz, says that lawmakers received little of substance from the fund's representatives. "We probed and probed and asked questions 100 times," she told the *San Jose Mercury News* in 2003. "The CalPERS staff assured us that even in the worst-case scenario the state's general fund would take a $300 million hit," a manageable sum in a $99 billion state budget. (The actual cost to the state budget, it turned out, was more than ten times that estimate—and it's still climbing.)

CalPERS also misled legislators and the press about the 1991 pension tier that it was pushing to repeal. In its brochure, the fund implied that the retirement pay that rank-and-file service workers got under the 1991 plan was tantamount to poverty. It didn't mention that many state workers also received Social Security payments, which add substantially to retirement income.

California lawmakers easily passed the new pension deal in 1999. The bill, signed by Governor Davis with little fanfare, immediately generated pressure on local governments to match the new benefits for their own employees. In 2001, legislators passed a measure allowing municipal workers covered by the CalPERS system to bargain for the same benefits that the state workers had just won. Like state legislators, many local officials believed that CalPERS surpluses would pay for the benefits. Expensive new benefits spread across the state "like a grass fire," Tony Oliveira, president of the California State Association of Counties, remembered in 2010.



That frenzy to expand benefits took place even though the air was already

coming out of the economy. The tech-stock bubble deflated in the spring of 2000, shattering the NASDAQ market and driving down the Dow Jones Industrial Average. The American economy plunged into recession the following year, a slowdown made far worse by the terrorist attacks of September 11. By the close of trading on September 17, 2001, the Dow stood at 8,920.70, down nearly a quarter from its early-2000 all-time high of 11,722.

CalPERS has the exclusive power to determine the size of state and local governments' contributions into the fund. As its investments tanked, it quickly boosted those contributions to compensate. By mid-decade, local officials were frantically telling the California press that the contributions were squeezing out other forms of spending. Glendale, a Los Angeles suburb, watched its annual pension bill rocket from $1.3 million in 2003 to $13.7 million in 2007—nearly a tenfold increase. San Jose's tab almost doubled, from $73 million in 2001 to $122 million in 2007, and then rose even faster over the next three years, hitting a jaw-dropping $245 million in 2010. San Bernardino's annual pension obligations rose from $5 million in 2000 to about $26 million last year. The state budget took a massive hit, too, its pension costs lurching from $611 million in 2001 to $3.5 billion in 2010.

Even those sums understated the problem. As a backlash grew to the larger bills that it was sending to municipalities and the state, CalPERS used a series of fiscal gimmicks to limit the immediate impact on balance sheets. Typically, to protect governments from violent swings in contributions every year, pension funds like CalPERS average their investment returns over three years, hoping that good years offset bad years. In 2005, CalPERS extended the performance average to 15 years, an extraordinarily long period that blended the fund's losses in the 2000s with its gains way back in the 1990s—thus reducing state and local governments' immediate costs, which remained overwhelming nevertheless. Then, in 2009, CalPERS told governments that they could pay off the higher bills from the previous year's scary market drop over the next three decades, pushing the bill for the financial meltdown to the next generation. The pension fund made a similar move in 2011: after revising downward its absurdly optimistic predictions of future investment gains, it gave governments 20 years to finance the higher resulting costs.

Both Governor Arnold Schwarzenegger and his successor, Jerry Brown, scorched CalPERS for the tricks. "The state should decline to participate in any effort to shift more costs to our children," said Schwarzenegger, who offered to give CalPERS $1.2 billion more out of his budget for pensions. Still trying to minimize the impact on current budgets, the fund declined and took a $200 million hike instead.

CalPERS contended that the state's escalating pension costs shouldn't be blamed on the expensive 1999 legislation. The real culprit, it claimed, was the stock market's slump, which hurt investment returns. But back when it was promoting the legislation in 1999, CalPERS had hyped Pollyannaish projections of 8 percent average annual returns, which proved crucial to getting the change through the legislature.

Another reason not to buy CalPERS's stock-market excuse is that its losses have been far worse than they should have been, thanks to a number of overly risky investment practices. Wilshire Consulting reported last year that CalPERS's returns over the past five years have trailed those of 99 percent of large public pension funds.

Why? Recall that back in 1984, Proposition 21 gave CalPERS's board greater latitude in allocating investments. Initially, the shift seemed to bolster the fund's assets: CalPERS's investment income rose from $1.5 billion in 1982 to $3.3 billion in 1985 to $6.1 billion in 1990. Even more spectacularly, CalPERS earned $68 billion during the tech boom of 1994 through 1998. But those rich gains had an unforeseen consequence: they prompted the call for higher benefits that resulted in the lavish new pension deal of 1999, which, in turn, led to a search for even greater investment returns in progressively riskier investment strategies.

CalPERS's investments in real estate, which had begun cautiously in the 1960s, exemplify the wrong turn. The fund started expanding its real-estate portfolio during the 1990s tech boom. Then, as its stock investments slid at the turn of the millennium, it chased even higher returns in real estate. Between 2004 and 2006, as the country's real-estate bubble was inflating, CalPERS pumped $7 billion into the sector, most of it in a few places that later became ground zero for the housing bust. By 2008, the fund owned 288,000 homes and lots, 80 percent of them in property-bubble states California, Florida, and Arizona. The fund's real-estate

portfolio grew from 5 percent of its assets in mid-2005 to 10 percent by June 2008, even as real estate was already collapsing in CalPERS's biggest markets.

The portfolio included a $500 million bet on two large apartment complexes in New York City—Peter Cooper Village and Stuyvesant Town—that went bust in a high-profile default. There was also an investment of nearly $1 billion in Landsource Communities, which planned to develop some 15,000 acres in California's Santa Clarita Valley but eventually filed for bankruptcy. By 2011, the value of the fund's real-estate holdings had declined by 49 percent, resulting in $11 billion in losses.

Desperate for higher returns, CalPERS also bought the riskiest portions of collateralized-debt obligations, accumulating $140 million of them by 2007. These were the packages of debt, largely subprime mortgages, whose defaults helped trigger the 2008 financial meltdown. According to a 2007 story by Bloomberg News, CalPERS bought these investments, known as "toxic waste" on Wall Street, from Citigroup, one of the sinking firms that the government later bailed out. "I have trouble understanding public pension funds' delving into equity tranches, unless they know something the market doesn't know," Edward Altman of New York University told Bloomberg about the CalPERS buys. "If there's a meltdown, which I expect, it will hit those tranches first."

The decline in property values also squeezed CalPERS's cash flow, forcing the fund to sell off weakened stocks "at exactly the wrong time," concludes a study by Andrew Ang, a professor at Columbia University's business school, and Knut Kjaer, an investment manager. Their paper on Cal- PERS's panic selling in 2008 notes that the cash-hungry fund sold 2.3 million shares of Apple Inc. for $370 million; those shares would be worth nearly $1.5 billion today.

Prop. 21 had another effect that proved disastrous for CalPERS's performance: turning the fund into a mammoth would-be activist. The initiative passed at a time when many companies were closing down their own corporate-directed pension funds and switching to defined-contribution plans, in which the assets are directed by the wishes of individual employees, not concentrated in a single fund. As a consequence, the newly empowered CalPERS was left one of the biggest shareholders in America. And over time, the CalPERS board started using its

newfound power to enforce its own political agenda, often without meeting its fiduciary responsibility to invest the fund's money wisely.

Leading the charge after becoming state treasurer in 1999 was Phil Angelides, who announced that he wanted to "mobilize the power of the capital markets for public purpose." During Angelides' tenure, according to a *Sacramento Bee* analysis, a third of his office's press releases concerned his actions on the boards of CalPERS and of CalPERS's sister fund, the California State Teachers' Retirement System (CalSTRS). For example, soon after Angelides took his board seats, he persuaded CalPERS and CalSTRS to divest shares in tobacco companies. Depressed at the time, those shares soon began to rise; a 2008 CalSTRS report estimated that the funds missed $1 billion in profits because of the divestiture. CalPERS also banned investments in developing countries like India, Thailand, and China because they didn't meet Angelides' labor or ethical standards. A 2007 CalPERS report calculated that its investments in developing markets underperformed an international emerging-markets index by 2.6 percent. Cost to the fund: $400 million.

Angelides wasn't alone. Union officials and other CalPERS board members pursued their own political agendas, demanding, for instance, that the fund not invest in firms and countries that lacked worker-friendly labor policies. By 2011, according to a Mercer Consulting report, CalPERS had adopted 111 different policy statements on the environment, social conditions, and corporate governance, all dictating or restricting how its funds could be invested.

CalPERS leaped into "social investing" at exactly the wrong time. That trend had gained currency in the 1990s with an emphasis on buying into environmentally "clean" companies. Tech firms were high on the list, so the 1990s Internet start-up boom made social investing seem like a sound financial strategy. But when CalPERS debuted its Double Bottom Line initiative in 2000—so called because it would supposedly produce both good returns and good social policy—the tech bubble had already popped.

Many socially conscious investors then turned their attention to another industry that didn't pollute: finance. One social-investing research firm named Fannie Mae the leading corporate citizen in America from 2000 through 2004. Other finance firms that attracted big cash from social investors included AIG, Citigroup, and

Bank of America, according to an analysis by American Enterprise Institute adjunct fellow Jon Entine. When the market for shares of these firms imploded in 2008, so did the performance of social investors.

Yet another feature of CalPERS that has cost taxpayers is double-dealing by the board, ranging from awarding contracts to political donors to alleged outright corruption. In 2010, Jerry Brown, California's attorney general at the time, launched a lawsuit accusing Alfred Villalobos of trying to bribe current board members (including Charles Valdes) to win investment business for his clients, mostly large financial firms that wanted a piece of the huge CalPERS portfolio. Villalobos pulled in $47 million as a go-between, the suit charged. A month after the lawsuit was announced, Villalobos filed for personal bankruptcy, temporarily blocking the suit. In 2011, the Internal Revenue Service accused him of intentionally depleting his assets while in bankruptcy, including gambling some away in Nevada casinos. News reports revealed that Villalobos had previously filed for bankruptcy, a decade before serving on the CalPERS board.

The lawsuit also accused former CalPERS chief executive Fred Buenrostro of accepting gifts from Villalobos. Separately, a Securities and Exchange Commission lawsuit filed last year accused Buenrostro of forging a document to help Villalobos win a big payment from a client. An internal CalPERS investigation quoted Buenrostro's wife as calling her husband a "puppet" of Villalobos. The report also pointed out that Buenrostro often intervened with the CalPERS staff on behalf of his acquaintances in the investment world—"friends of Fred," as the staffers called them.

Buenrostro and Villalobos have denied any wrongdoing, and investigations continue. In December 2011, after more than a year's delay, a judge finally ruled that the state's case against Villalobos could proceed, his bankruptcy filing notwithstanding.

These blockbuster allegations of influence-peddling came after nearly a decade of warnings of apparent conflicts of interest within CalPERS, prompting *Businessweek* to observe "an unpleasant whiff of pork-barrel politics rising from the board." One example involved Ron Burkle, a major political donor in California. Burkle was a significant giver to Angelides' campaign for treasurer, and he employed another

board member, former San Francisco mayor Willie Brown, to do legal work for him. But Burkle's closest ties were with Governor Gray Davis: he gave $600,000 to Davis's gubernatorial campaign and appointed Davis's wife to the board of directors of one of his companies. CalPERS invested some $760 million in Burkle's private equity funds from 2000 through 2002.

Another disturbing case involved board member Sean Harrigan, also an officer of the United Food and Commercial Workers International Union. Between 2000 and 2004, the *Sacramento Bee* reported, Harrigan openly solicited donations for a union campaign fund from various investment companies that won multimillion-dollar deals from CalPERS. The companies ponied up $300,000. A CalPERS spokesperson said that the fund was unaware that Harrigan was soliciting donations from firms that did business with it, adding that there was no prohibition within CalPERS against the practice.

Criticized for scandals and for its staggering long-term pension debt, CalPERS

has endorsed a series of minor reforms. They include an assessment of the board's performance every two years by an independent auditor and the online posting of board members' and staffers' travel expenses. CalPERS also now limits to $50 the gifts that board members can receive from anyone doing business with the fund. However, Governor Brown's proposal to reform the CalPERS board by adding two new members with financial expertise failed to make it past the union-friendly state assembly, which argued that any changes to the board's composition should be negotiated between government unions and the state. For now, it seems, CalPERS will remain under union control.

CalPERS and its legislative allies keep resisting the one reform that would truly free California taxpayers from this ruinous pension system: moving it toward a 401(k)-style defined-contribution plan, as other states and municipalities, including Utah and Rhode Island, have done. In a defined-contribution plan, the government's commitment ends after it makes its annual required contribution into a worker's retirement account; the taxpayer's liability also ends there. Under the CalPERS regime, by contrast, employees are guaranteed benefits even if the government hasn't put aside money to pay for them, placing all the future liability on the taxpayer. Defined-contribution systems like Utah's also aren't as easy to manipulate politically as CalPERS-style pension plans because the money goes into workers' individual accounts, not into a massive portfolio controlled by a politically appointed or an elected board of directors.

Right now, the pension bill that Californians owe because of CalPERS is enormous. In a December 2011 study, former Democratic assemblyman Joe Nation, a public finance expert at Stanford University, estimated that CalPERS's long-term pension debt is a sizable $170 billion if CalPERS achieves an average annual investment return of 6.2 percent in years to come. If the return is just 4.5 percent annually—a rate close to what more conservative private pensions often shoot for—the fund's long-term liability rises to a forbidding $290 billion. By contrast, CalPERS itself estimated its long-term unfunded liability at merely $80 billion, using a lofty projected annual investment return of 7.75 percent. (The fund has recently cut that estimate to 7.5 percent.)

Last August, California did pass modest pension reforms, which apply mostly to new workers hired starting this year. Nation estimates that the reforms cut the

state's long-term pension debt by 10 percent at most. Clearly, the state needs to do much more. In the last five years, three California municipalities—Vallejo, Stockton, and San Bernardino—have filed for bankruptcy, each citing retirement costs as a significant factor. But bankruptcy may not afford cities any relief from pension costs; CalPERS argues that cities have no right in federal bankruptcy court to reduce pensions, since the fund is not a creditor of these municipalities but an arm of state government. Vallejo, which has already emerged from bankruptcy, did nothing to reduce its pension costs in Chapter 9, and its employee costs remain sky-high. To employ a cop in Vallejo still requires $230,000 a year, including $47,000 in annual CalPERS costs.

Meanwhile, CalPERS's rejoinders to its growing chorus of critics continue to mislead. Responding to a September 2012 opinion piece by Gary Jason, a California State University professor, about the impact of pension costs on municipal bankruptcies, CalPERS claimed that pensions were only a small part of the problem, accounting for just 10 percent of Stockton's budget, for instance. But in 2011, when Stockton declared a fiscal emergency, it listed $29 million in payments to CalPERS and $7 million to repay previous pension borrowings, which together equaled 21 percent of its total general-fund spending of $168 million. In a March 2011 analysis of its fiscal plight, city officials blamed "uncontrolled pension, health, and other benefit cost increases."

CalPERS also understates the growing financial stress caused by pension obligations. This past August, for instance, board member Rob Feckner published a disingenuous op-ed in the *Sacramento Bee* responding to critics of Cal- PERS's most recent poor investment performance. Feckner said that the media misunderstand the fund's investment strategy, which focuses not on a single year but on long-term results. He noted that over the last 20 years, the fund had hit its investment targets more frequently than it had missed them. Yet he ignored the sharp increases in taxpayer contributions that CalPERS demanded when it missed its targets, as well as the fiscal smoothing gimmicks that it wielded to keep contributions from rising even more.

CalPERS's advocacy for higher benefits and its poor investment performance in recent years have locked in long-term debt in California and driven up costs, problems for which there are no easy solutions. As former Schwarzenegger

economic advisor David Crane, a California Democrat, has said of the fund's managers and board: "They are desperate to keep truths hidden."

Steven Malanga is the senior editor of **City Journal** *and a senior fellow at the Manhattan Institute. His latest book is* **Shakedown: The Continuing Conspiracy Against the American Taxpayer.**

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