UN-MEASURED IS UN-MANAGED

A Story About UNCOMPENSATED RISK

Part Three -- The Proof is in the Pudding - Act One

Case study: The California State Employees' Pension Plans Published in the AICPA Tax Adviser June 2017

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We reviewed the Investment Policy Statements of 37 California public retirement defined benefit plans: the California Public Employees' Retirement System (CALPERS), the California State Teachers Retirement System (CALSTRS), the 20 member counties of the State Association of County Retirement Systems (SACRS), the seven California cities with separate plans, the six district and regional plans, the University of California Retirement System Plan, and the Bay Area Rapid Transit (BART) Investment Plan. These 37 entities have approximately $750 billion in market value of assets.

Of the 37 IPSs reviewed, only four plans mentioned uncompensated risk, nonsystematic risk, or diversifiable risk. Of the four plans that mentioned Uncompensated Risk (UCR) in their IPSs, only one county discussed the reduction of uncompensated or nonsystematic risk in any depth. However, all four relied on the false assumption that the more investments they have the less uncompensated risk they have in the portfolio (if the added investments were correlated with the existing assets they acerbate UCR). They also discussed that the managers should not travel far from their benchmark to reduce uncompensated risk, but in doing so they failed to follow the edicts of the *Restatement(Third) of Trusts* by not having a procedural process to determine if uncompensated risk has been eliminated to a reasonable level. Since they do mention uncompensated risk as important, the question becomes whether they are in "violation of both the duty of caution and the duties of skill and care"(*Restatement (Third) of Trusts* §227, "Comment on Basic Duties of Prudent Investor,"pg.23) and therefore in breach. http://precisionfiduciary.com/restatement/

However, there is no doubt concerning the remaining 33 pension plans that account for 99% of the money in the 37 plans. It is possible that they are not only in breach, but that the statute of limitation regarding this issue has not started to run, and until an acceptable procedural process is included in their IPS and implemented, it never will.

The other concern is the amount of potential damages that can be claimed. Fama/Booth comparisons show that a well-diversified portfolio (at the overall portfolio level) will generate added diversification return of approximately 1% annually more than one that is not well diversified -- 1% annually over several years can add up to a very large amount.

See Part One and Two at http://precisionfiduciary.com/PartTwoUCR/

Watch for Part Four of Un-Measured is Un-Managed next week.

http://precisionfiduciary.com/services/

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Save the date for our AICPA webinar at 12:45 pm EDT on June 19, 2019←