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CalPERS tells managers to invest in their own products

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SACRAMENTO, Calif. — CalPERS wants its external money managers to eat their own cooking, but some managers might want to choose from a broader menu.

The board of the $165 billion California Public Employees' Retirement System, Sacramento, on March 15 adopted a sweeping code of ethics for the fund's external money managers and consultants, generated by the mutual-fund trading scandals. Other public funds are said to be looking at the policy.

But one controversial provision requires top management and portfolio managers at the investment management firms that work for CalPERS to invest a "material portion" of their current income or net worth in their firm's products. (CalPERS' consultants are exempt from this requirement.)

The idea is to better align the interests of the manager with its pension fund client by adopting a pay structure closer to those used by hedge funds and private equity managers, Christianna Wood, CalPERS' senior investment officer, explained to the board.

"We think it's appropriate for people who work on our account to have a portion of their capital, whether as a portion of deferred income or wealth generally," invested in company products, Ms. Wood said in an interview. "And we're finding that with the better firms, with better performance, they do this as a matter of course."

Top 5 targeted

In general, Ms. Wood said CalPERS officials would like the top five executives and portfolio managers running the pension fund's assets to have roughly 30% of their net income or wealth invested in their employer's investment strategies.

Some observers think the code — which also would require fair treatment of all clients, better disclosure on trading costs, and avenues to protect against conflicts of interest — might be hard for some managers to follow.

"I think they're trying to micromanage things. They need to be hiring firms that will manage themselves in an ethical way, and in a way that's client-centric," said one manager who runs CalPERS assets, who requested anonymity.

People interviewed for this story did not quibble with the general philosophy of aligning manager interests with those of their clients. However, some questioned whether a hedge fund-type structure was suitable for traditional long-only managers.

Campbell Harvey, a finance professor at Duke University's Fuqua School of Business, Durham, N.C., said there's a good reason for requiring hedge fund managers to invest in their own funds.

Lots of incentive

Given hedge fund managers' typical 1% management fee and 20% performance fee, they have a lot of incentive to take on excessive risk, he explained. They are rewarded when they do well, but are not penalized for poor performance. "If they are invested in the firm, this somewhat mitigates this incentive to take on a lot of volatility to get this big payoff," he said.

Mr. Harvey predicted some managers might choose not to do business with CalPERS because of such rules. "It's such a complex job to pick the best managers. To add on constraints like this is probably not the way to go."

At the board meeting, Ms. Wood said an informal survey of some of CalPERS' external managers did not find major problems with the code. "We don't believe it would discourage any manager from doing business with us," she said.

Some experts raised practical concerns. They questioned whether the policy would make sense for portfolio managers at a firm that offers a limited number of specialized strategies, say, emerging markets equities or currency overlay strategies, to invest a sizable chunk of their pay or wealth in that product.

"The company might not offer a product that is suitable for an individual," observed Jonathan Boersma, vice president of professional standards for the Association for Investment Management and Research, Charlottesville, Va.

In general, Mr. Boersma supported the CalPERS code, but, like several observers, noted: "The devil's in the details."

Mr. Harvey added: "For money managers' personal allocations, it may not be optimal to put 30% in whatever they are doing. The basic idea is a reasonable idea, but you don't need a rule for this."

Another problem is if a firm offers institutional-only portfolios. "What if a firm focuses on large institutional separate accounts and doesn't even offer mutual funds? Then what do you do?" asked one manager, who asked to be unnamed.

Ms. Wood disagreed: "I think it's very rare there wouldn't be an ability for a manager's employees to invest in their own products, either through a commingled vehicle, a trust vehicle, or setting up a partnership."

Large, multiproduct firms clearly will find it easier to comply with the code's requirements.

"Upon our initial review, we believe we substantially satisfy in principle all of CalPERS' list of best practices," wrote Lisa Gallegos, a spokeswoman for Franklin Templeton Investments, San Mateo, Calif., in an e-mail to this publication. Franklin Templeton manages a $769 million U.S. equity portfolio for CalPERS.

For smaller firms, compliance might be a lot tougher, especially for those in CalPERS' manager development program.

One exception

But there's an exception in the code for very small firms. Some of the rules may be modified if the cost to the firm of compliance would be prohibitive. Managers will have to negotiate directly with CalPERS to come up with alternatives, the code of ethics notes.

In addition, the code also provides flexibility for managers who supply niche investment strategies to CalPERS, allowing them to invest in any of the firm's products.

"We're willing to liberally say ‘any product of the firm,' " Ms. Wood said. Ideally, however, "We would like to see the portfolio manager invest in the product that he or she manages."

Managers can't try to meet the test through incentive pay or other ownership stakes in the firm. While incentive pay is favored by the code, that is no substitute for investing their own money in firm products, Ms. Wood said. Incentive pay rewards the firm's ability to act as an asset-gatherer — in part enhanced by having CalPERS as a marquee client, Ms. Wood said.

"We're not happy when firms gain too much of their wealth from gathering assets than generating performance," Ms. Wood said, adding that the two are linked.

Keith Ambachtsheer, president of K.P.A. Advisory Services Ltd., a Toronto-based consultant, praised the concept.

"The idea is very powerful, and I think it sends a strong signal that CalPERS understands the importance of the alignment of economic interests. In recognizing that principle, they're absolutely right. What they also need to do is to be flexible in how the principle is applied."

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