

JOE DEAR IS giving a pep talk to more than two dozen colleagues at the California Public Employees' Retirement System. As Dear paces before his people on this July afternoon in Sacramento, he implores them to shake off the funk of the pension fund's recent troubles. For the next three hours, he says, they're going to figure out how to solve some of the most daunting problems dogging Calpers, the largest public pension fund in the U.S., with \$200 billion in assets. Dear, its chief investment officer since March 2009, wants results on his desk in 100 days.

"We can take control of our destiny," Dear, 59, says as a lunchtime band in the plaza outside plays the rock anthem "Freebird." "We can make concrete improvements. Let's get to work."

Dear, an impatient man who trots down Calpers's halls to meetings, is racing to rebuild an institution that lost \$70 billion in the credit wipeout of 2008 and 2009. Rather than rely on safe bets such as U.S. Treasury bonds, Dear is embracing investments in private equity, emerging nations, hedge funds and public works projects in his pursuit of market-beating profits. He's even going a step further by asking Calpers's governing board of administration to adopt a strategy that could lead to trading exchange-traded funds and derivatives on a greater scale than it does now. As the steward of the largest pool of investment capital in the U.S., Dear has the clout to shape how the asset management industry adapts to a volatile, post-crash global market, says Andrew Lo, a finance professor at Massachusetts Institute of Technology. "This could mark a

By EDWARD ROBINSON and MICHAEL MAROIS

Photograph by ERIC MILLETTE

CLEANING UP CALPERS

After the largest U.S. pension fund lost \$70 billion and got embroiled in an influence-peddling scandal, new investment chief Joe Dear says the only way out of this mess is to take more risk.



Joe Dear aims for a market-beating 7.75 percent return for Calpers.

sea change, and not just for Calpers but for every other pension fund out there,” Lo says.

Calpers is at the forefront of a national crisis as public pension funds struggle to meet their obligations to more than 19 million active and retired firefighters, police officers, teachers and other state workers. In 2000, more than half of the 50 states had the funds to cover what they owed. By 2008, that number had shrunk to four—Florida, New York, Washington and Wisconsin—as total unfunded liabilities reached a record \$1 trillion, according to a February 2010 report by the Pew Center on the States that uses the latest available data.

CALPERS MADE A SERIES of disastrous bets on real estate after letting its internal risk controls break down and ceding too much control to outside investment advisers during the housing bubble. The pension fund has earned an annualized 2.88 percent return on its assets through the 10 years ended on June 30, far below the 7.75 percent it must collect every year to meet its obligations to 1.6 million beneficiaries. Calpers’s unfunded liabilities amounted to \$240 billion as of 2008, leaving it with only half of the assets it needs to make its required payouts, according to a Stanford University study released in April.

Calpers's campus, with a tree-shaped glass tower, cost \$265 million.

On top of the fiscal mess, Calpers is also caught up in a corruption scandal involving middlemen who help money managers win investing assignments from pension funds. In May, the California attorney general’s office sued Alfred Villalobos, a Calpers board member from 1993 to 1995 who became a so-called placement agent, accusing him of trying to improperly influence Calpers personnel to favor Apollo Global Management LLC and other private-equity clients. “My client has always followed the rules,” said Neal Stephens, Villalobos’s lawyer, in an e-mail. In 2009, Calpers approved new rules requiring investment firms to disclose when they hire placement agents, how much they are paid and what services they perform.

“It became an extremely arrogant institution, and its leadership went off the rails,” says Richard Koppes, who served as Calpers’s deputy executive officer and general counsel, among other posts, from 1986 to 1996. “Now they have to look at their entire governance structure and ask, ‘How did we let this happen?’ As the big gorilla, everyone is looking at Calpers and how it addresses these issues.”

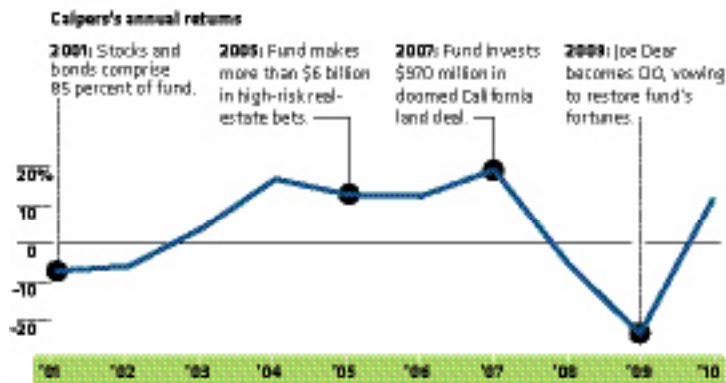
Dear is determined to overcome the perils of investing billions in private equity, emerging markets and other hazardous areas. He’s directing investment officers from Calpers’s various asset



ERIC MILLETTE

Costly Gamble

Calpers's push into highly leveraged real-estate investing hurt its overall performance.



For fiscal years ended on June 30. Source: Calpers

management teams to work together on tasks such as lowering fees from private-equity managers. In the past, Dear says staffers rarely spoke with their counterparts, let alone collaborated. And he wants Calpers to take a cue from hedge funds and consider fending off risk by using short-term, tactical trading in equities, bonds, currencies and commodities. “It would be a serious change in the system, but that’s the direction we’re headed,” says J.J. Jelincic, an investment officer at the pension fund and member of Calpers’s board, which authorizes its asset allocation policies. The pension fund’s assets jumped 11.6 percent in value in the 2010 fiscal year ended on June 30, its first positive performance since 2007.

Calpers should retreat from making high-risk bets and accept that it won’t outperform the Standard & Poor’s 500 Index and other key benchmarks over the long haul, says Frederick Rowe, the former chairman of the Texas Pension Review Board, a body that oversees that state’s public retirement systems. For years, pensions have spent billions in fees on Wall Street’s latest market-beating innovations with little to show for it, Rowe says. As a group, state retirement systems earned a median 3.4 percent annualized return for the 10 years ended on June 30, according to Wilshire Associates Inc., a Santa Monica, California-based investment consulting firm. That about matches the performance of U.S. Treasury bonds.

“It’s folly to think a \$200 billion pension fund is going to do better than the economy,” says Rowe, chairman of Greenbrier Capital Partners Ltd., a Dallas-based investment firm. “To move out on the risk spectrum to beat the market is imprudent; it’s like running your retirement from Las Vegas.”

Dear says he can’t earn 7.75 percent every year without spreading his bets across global markets and on different investment strategies. “We are in a period of extraordinary pessimism, and we have to be really

careful about the kind of risk we take on,” says Dear, seated in his corner office at Calpers’s campus with a thick black binder labeled Investment Strategy Group lying on his desk. “But do I think it’s unrealistic to search for returns in the 7.5 to 8 percent range? No, I don’t. It’s really hard to imagine a worldwide market system not providing a return to riskier sources of capital.”

DEAR IS RIGHT to push new methods to capture profits and hedge risks in an unstable global marketplace, says Laurence Fink, chairman and chief executive officer of BlackRock Inc., the No. 1 global investment management firm, with \$3.2 trillion in assets. “The whole model of asset allocation is being reviewed by investors,” says Fink, whose firm manages \$1 billion in assets for Calpers. “The world is moving toward global investing with multiple products, and Joe is adapting Calpers to that model—and I don’t think this is way out there. This is mainstream thought today.”

Even if pensions do exploit the latest financial engineering and hit their 8 percent annualized return target, many will run out of money in the next 20 years, beginning with Illinois in 2018, says Joshua Rauh, an associate professor of finance at Northwestern University near Chicago. California would run dry in 2030, he says.

The Securities and Exchange Commission is now probing the pension fund turmoil. On Aug. 18, the SEC accused New Jersey of misleading municipal bond investors by not disclosing how it was underfunding its two largest pensions. The state, which didn’t admit or deny wrongdoing, agreed to cease the practices.

‘It became an extremely arrogant institution,’ a former Calpers general counsel says.

The fiscal plight of pension funds is also sparking a political backlash. Republican lawmakers such as New Jersey Governor Chris Christie contend overgenerous benefits are worsening budget shortfalls. Democrats and labor leaders such as David Low, director of government relations for the California School Employees Association union, counter that police officers,



teachers and other government workers deserve their guaranteed benefits and are being scapegoated. With states running record deficits—California has a \$19 billion shortfall—Washington may have to bail them out if they divert ever-larger sums to their pension systems.

“The federal government would have to consider these state systems too big to fail,” Rauh says. “Taxpayers could eat this problem.”

Dear is an unlikely candidate to refashion Calpers’s investment approach. In contrast to past CIOs, he doesn’t have a Ph.D. in economics or experience in managing money on the Street. He’s a one-time labor official who came up through the hurly-burly of state politics in Washington. When Calpers’s board was searching for a new CIO during the nadir of the credit crisis in late 2008, it wanted a leader who could shore up the pension’s demoralized, 250-person investment staff. “We didn’t need another investment professional; we needed a manager,” says Rob Feckner, president of Calpers’s board.

Dear, a slight man whose boyish features make him look years younger than 59, grew up in a publishing family in Bethesda, Maryland. His father, J.A. Dear, ran a chain of small-town newspapers in North Carolina, Illinois and other states, and his mother, Anne, was a journalist who worked in the Washington office of *Reader’s Digest* magazine. Conversation at the dinner table jumped from the civil rights struggle to the Vietnam War.

He moved west in 1974 to attend Evergreen State College, a liberal arts school in Olympia, Washington. Dear led a two-day classroom strike in 1975 to win

Andrew Lo says Calpers must chase returns with futures and ETFs.

more student input in shaping the curriculum. For all his activism, Dear’s friends say he had little use for ideology. “Joe was always careful not to get caught up in the rhetoric,” says John Burbank, a Seattle-based community activist and former classmate of Dear’s. “He was much more oriented toward solving actual problems. He’s a pragmatist.”

After graduating with a bachelor’s degree in political science in 1976, he went on to work as research director for the Washington State Labor Council of the AFL-CIO. In 1985, he made his name as an able negotiator when he became head of the Department of Labor and Industries, the state’s workplace safety watchdog. He induced trade groups to improve workplace safety by giving them rebates on untapped workers’ compensation insurance premiums, which lowered costs. And labor leaders were pleased because the deal staved off a push by industry associations for private insurance in Washington. Dear also served as a trustee on the Washington State Investment Board, which manages the retirement investments for public workers. There he saw how Wall Street was playing a growing role in providing retirement security for government employees. His thinking changed.

“When I was in college, I thought I was a socialist,” says Dear with a chuckle, “but as I began to grasp what price signals did in terms of motivating behavior, my respect for the market system went up. I developed a keen interest in investment.”

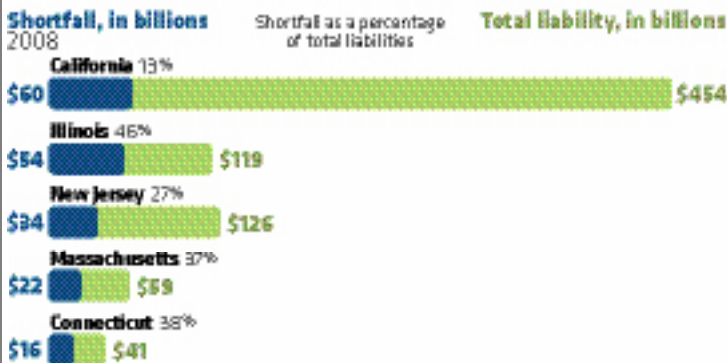
PRESIDENT BILL CLINTON nominated Dear to be head of the Occupational Safety and Health Administration in Washington in 1993. Four years later, Dear returned to Olympia to become chief of staff for Governor Gary Locke, a Democrat. In Locke, Dear found a fellow “management geek” obsessed with making government more efficient. The two men directed cabinet officers to set 90-day targets for reducing costs and improving their departments’ services, which yielded \$240 million in savings, Dear says. He would go on to use the same approach 13 years later at Calpers. “Joe hammered away

JASON DROW

‘It’s folly to think a \$200 billion pension fund is going to do better than the economy,’ Frederick Rowe says.

Pensions in Peril

Public retirement systems are struggling to meet their obligations.



Source: Pew Center on the States

on performance goals,” says Locke, now the U.S. Secretary of Commerce.

Eager to work in investing, Dear didn’t stick around for Locke’s second term. In November 2002, the one-time campus firebrand found himself doing business with Henry Kravis and other Wall Street kingpins as the new executive director of the Washington State Investment Board. Dear worked 70-hour weeks and met individually with each of WSIB’s 40 private-equity managers. On camping trips in the Cascade Mountains, he lugged along finance tomes such as Emanuel Derman’s *My Life as a Quant* (Wiley, 2004). “We told Joe he ought to get a life,” says Gary Bruebaker, the board’s CIO since 2001.

Dear became a true believer in the so-called endowment approach, which locked up capital for years in pricey private-equity funds and real estate to reach for bigger returns. WSIB, along with Calpers and the Oregon Public Employees Retirement System, had pioneered public pension investing in leveraged-buyout funds in the early 1980s. The board also broke new

‘This could mark a sea change, not just for Calpers but for every pension fund,’ Andrew Lo says.

ground by using real-estate operating companies, or REOCs, to invest in property deals. In these vehicles, the board owned 98 percent of a company and supplied all of the capital, giving the board far more management control over its assets than it had as one of many limited partners in a fund, Dear says.

By the time the credit markets started cracking in

the second quarter of 2008, the board’s assets had increased to \$62 billion from \$39 billion in 2002 and its five-year annualized return of 13 percent bested the S&P 500’s 7.5 percent annualized performance.

So when Dear quit in February 2009 to join Calpers, his colleagues were stunned. “He had a job for life and instead he went to work in the pits of Hades,” says a Washington trustee. “But Joe always did like a challenge.”

IN SACRAMENTO, DEAR found the giant retirement fund reeling as the credit crash exposed weakness on several fronts. In 2008, the pension, which loaned shares to broker-dealers and short sellers for a fee, was forced to dump huge blocks of its own stock holdings to raise cash as clients redeemed their loans, Dear says. In the third quarter of 2008, Calpers sold 2.3 million shares of Apple Inc. for about \$370 million, a stake that would have been worth \$600 million as of Aug. 9. “We had to sell equities when it was not a time to sell equities,” Calpers board member George Diehr says.

Calpers exacerbated the damage by failing to manage risk and leverage in its real-estate portfolio. The unit’s 48 percent drop in fiscal 2009 was rooted in a shift by the board in the late 1990s to give outside advisers more control over decision making with property deals, according to former Calpers investment officers. Up until about 2002, Calpers’s real-estate team used relatively little debt on deals and concentrated on conservative investments such as malls and office buildings to generate rental income. A staff committee evaluated every deal before making a recommendation, and those greater than about \$50 million had to be approved by the board.

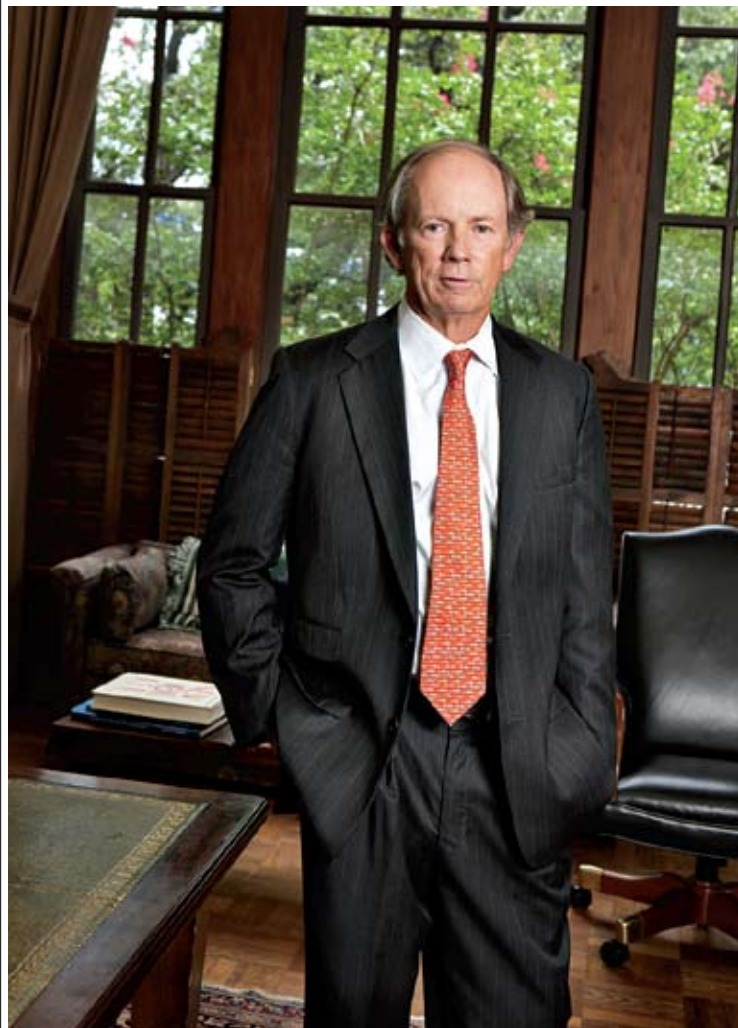
As real estate started to surge in 2002, the balance of power swung toward outside investment advisers. Unlike Washington’s REOCs, Calpers preferred to use joint ventures in which it put up most of the capital and largely left management of the asset to its outside partner. The board wanted to give its investment advisers the flexibility to jump on deals in a hot market without getting tied up in red tape, says Michael McCook, the real-estate team’s senior investment officer from 2002 to 2006. The board relaxed its review process and bestowed its partners with the discretion to execute leveraged deals worth hundreds of millions of dollars.

“We were in an environment where everything was growing, and we had to put our money to work,” says McCook, who now advises real-estate investors in India. “We wanted our partners to bring us the best deals no matter what.” Those partners enjoyed a windfall: Calpers paid its outside investment advisers in real estate \$2.8 billion in fees from fiscal

year 2004 to 2009, the most of any investment group in the fund.

Calpers's portfolio soon brimmed with exotic assets, from pinot noir vineyards in Oregon to an entire town built from scratch east of San Francisco called Mountain House. In January 2007, the pension fund invested \$970 million in an entity called LandSource Holding Co. that held 15,000 acres (6,070 hectares) of residential land in Los Angeles County. It went bankrupt in 17 months. Calpers lost a \$500 million investment in Stuyvesant Town–Peter Cooper Village, a mini-city of 56 apartment buildings on Manhattan's Lower East Side that was acquired in 2006 by BlackRock's realty unit and Tishman Speyer Properties LP for \$5.6 billion. The ownership group gave control to their lenders in January after failing to convert the rent-controlled dwellings into higher-income properties. In July 2009, BlackRock's Fink personally apologized to the Calpers board for endorsing the deal. Board members kicked themselves for losing grasp of the scale, and leverage, of their wagers during the bubble.

Frederick Rowe says Calpers shouldn't act like a Las Vegas gambler.



“The board didn’t have enough knowledge of what commitments had been made,” Diehr says.

SO DEAR’S FIRST order of business was to stabilize the real-estate situation. Dear is axing underperforming outside investment advisers and shifting their assets to those with superior records. In October 2009, Victor McFarlane, a San Francisco-based developer who helped put the LandSource deal together, resigned as a Calpers adviser. McFarlane declined to comment for this article.

Working with Ted Eliopoulos, the real-estate group’s senior investment officer since 2007, Dear is unwinding property deals and taking losses to lower the portfolio’s debt level below 60 percent from 64 percent. Calpers has set a cap of 10 percent for recourse debt, which isn’t backed by collateral and had exploded to 40 percent of the portfolio’s net asset value. In the first nine months of fiscal 2010, real-estate assets lost another third of their value. “I don’t believe we’re going to write it all down and then we’re going to get a bounce-back; that’s wishful thinking,” Dear says.

At a workshop on Calpers’s leafy campus, Dear directs his rank and file to rejuvenate their organization by solving one problem at a time. On July 7, about 30 men and women with name tags pinned to their open-collar shirts and blouses separate into three groups. Dear, flanked by two screens bearing the words “Rapid Results” in black letters, nods as the second squad announces its challenging assignment: persuading private-equity firms to reduce their fees.

As the staffers settle in at a large table, they discuss how to push back this powerful camp. Calpers paid \$1.5 billion in total fees to more than 118 leveraged-buyout and venture-capital firms such as Carlyle Group and TPG Capital from fiscal year 2004 to 2009, according to fund expense records. Kurt Silberstein, a senior portfolio manager who runs Calpers’s hedge-fund program, talks about how, earlier in the year, he led a Rapid Results team that managed to reduce hedge-fund fees by \$99 million. Doing the same with buyout firms is a tall order, says Sarah Corr, a portfolio manager in Calpers’s Alternative Investment Group, which oversees buyout and venture-capital bets. Private-equity firms commit their funds to lengthy turnarounds of distressed companies and lock their limited partners into ironclad agreements.

“How did we get into these egregious deals?” Silberstein asks.

“It was a different market environment,”

Corr replies.

“Are there any relationships where you could get

together with other LPs and stage a mutiny?” asks Jonathon O’Donnell, a fixed-income manager, referring to limited partners. Corr says that’s not realistic because Calpers tends to hold 5 percent stakes in buy-out funds and it would have to herd too many investors together.

“So in terms of capital committed, we’re screwed,” Silberstein says.

“I can’t reopen these deals,” Corr says.

After more than an hour of brainstorming, Corr and her colleagues do piece together about \$36 million in reductions, though half are one-time cuts. Standing before the entire workshop, Corr pledges her team will produce in 30 days a target list of funds in each of Calpers’s asset management groups ripe for trimming. And she says in 100 days they’ll establish a system to measure the cost-effectiveness of external managers across the pension and to track savings. “That’s fantastic,” says Janine Guillot, Calpers’s chief operating investment officer, as Corr’s colleagues clap.

ALMOST TWO WEEKS later, Dear is sitting in the ballroom of an Empire Suites hotel in San Rafael, California, listening to a provocative presentation by MIT’s Lo at a Calpers off-site meeting. The professor is a well-known quantitative finance scholar who developed the adaptive markets hypothesis, which holds that human behavior often trumps efficiency in the capital markets. Lo tells the Calpers board members that their long-standing practice of basing investments on the historical performance of different securities and strategies is designed for a stable and efficient marketplace that no longer exists. In global markets marked by extreme volatility and no small amount of fear, Calpers must become more active in chasing returns and hedging risk through trading, he says. That means going long and short selling ETFs, futures contracts, currency forwards and total return swaps on a daily basis, says Lo after his lecture. In other words, Calpers, a \$200 billion behemoth, must behave more like a hedge fund. Pointing to the upheaval of 2008 and 2009, Lo says standing pat poses more risk than exploiting complex financial instruments.

“When the environment becomes unstable, then it’s the height

‘The world is moving toward investing with multiple products,’ Larry Fink says.

of irresponsibility to keep a static portfolio,” says Lo, who’s also the chairman and chief investment strategist of AlphaSimplex Group LLC, a hedge-fund firm based in Cambridge, Massachusetts. “This notion of tactical risk management is going to become more important than ever before.”

While Calpers’s board is still exploring the ideas Lo raises, Dear agrees that the pension’s approach is out of synch with the times. “It’s really important to take stock of the investment environment and adjust our response,” Dear says. “And that could mean paradigm-shifting approaches to how we allocate assets and manage risks.”

This kind of talk alarms skeptics such as Rowe. He says retirement systems should break their dependence on Wall Street’s latest financial innovations. Instead of risking taxpayer-backed capital on bets that rarely deliver, Rowe says pensions should invest in ways that bolster the S&P 500 and other benchmarks. “The intelligent solution is not to take crazy chances to beat the averages but to get the performances of the averages themselves up,” he says.

Larry Fink apologized to Calpers for endorsing a bad real-estate deal.



Scoring in the capital markets has long driven the economics of these funds. By assuming investments will earn 7 to 8 percent every year, the elected officials and union leaders who run state retirement systems can ask for fewer upfront contributions from government workers and the agencies that employ them. In 1999, Calpers, flush with profits from the dot-com boom, won passage of legislation that retroactively boosted benefits for retirees at the same time it lowered contributions. The pension vowed to finance the higher payouts with investment gains. “You could get return without much risk—that was the seduction—and it wasn’t just Calpers that acted on that belief; it was public sector plans around the country,” says Teresa Ghilarducci, an economics professor at the New School in



Manhattan and author of *When I'm Sixty-Four: The Plot Against Pensions and the Plan to Save Them* (Princeton University Press, 2008).

As Calpers's returns faltered during the next decade, California taxpayers paid \$2.3 billion a year to cover the pension's benefits, more than five times the \$450 million originally projected in 1999, according to David Crane, Governor Arnold Schwarzenegger's senior economic adviser.

"It's perverse," Crane says. "Calpers could lose every penny tomorrow, but the only people who wouldn't be adversely affected are its beneficiaries because the state contractually owes them the money." He says Calpers should lower its investment return assumption to about 6 percent from 7.75 percent and adjust contributions and benefits accordingly.

California Treasurer Bill Lockyer, a Calpers board member, counters that the pension has earned an annualized 7.9 percent during the past 20 years. And Calpers has rebutted the Stanford University study that used the 10-year Treasury bond yield of 4.1 percent to calculate its 50 percent unfunded liabilities ratio. Utilizing the 7.75 percent assumption, Calpers

Calpers's property portfolio, including **Mountain House**, blew up in fiscal 2009.

says, it has the assets to cover 86 percent of its liabilities. "Their assumption is that a fund investing \$200 billion for 40 years ought to buy nothing but 10-year Treasuries," Lockyer says. "That doesn't make any sense. That would be a bad way to invest."

NOW DEAR is chasing profits at a time when U.S. gross domestic product is growing at 2.4 percent and the economy may be succumbing to deflation. Fink says Calpers and its ilk will need to invest more heavily in China, India and other fast-growing economies to garner the returns it needs to meet its liabilities. That means the largest sources of investment capital in the U.S., which are guaranteed by taxpayers, will be supporting companies and creating jobs outside the country during a time of acute economic stress. "Is that good for the U.S.?" Fink asks. "That's the dilemma. If they want to earn these larger returns, to do that with consistency is going to mean investing overseas to a greater extent."

For Dear, his job is to retool a vast retirement fund so it thrives in a perilous era, and his beneficiaries, and California taxpayers, are counting on him to succeed. His mission boils down to one essential element: "I have 7.75 burned in my brain, and I'm preoccupied with what we're doing to get it," he says. No matter how much discipline and industry Dear brings to bear, the task may be impossible. **B**

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Finding Pension Plan Data

You can use the Investment Plan Search (PLAN) function to find investment and related data on Calpers and thousands of other pension plans, endowments and foundations. **Type PLAN <Go>**, for example, then tab in to the ORGANIZATION field, enter *CALPERS*, press <Go> and type 1 <Go> 4 <Go> for an overview of Calpers, including information on the allocation of investments. Click on the Managers tab for a list of the firms overseeing money for Calpers, their investment style and the amount of money they're managing for the retirement system. To view a summary of Calpers's equity holdings as disclosed in its most recent regulatory filings, type FLNG <Go>, tab in to the COMPANY NAME field and enter *CALPERS*. Press <Go> and then type 4 <Go> to view the snapshot.

BETH WILLIAMS

BLOOMBERG TIPS

California Public Employees Retirement System (Calpers)		
California Public Employees Retirement System (Calpers)		
Entity Type: Public		
Company Description: The California Public Employees' Retirement System (Calpers) provides retirement and health benefit services to more than 1.4 million members and nearly 2,500 employers. Our membership consists of active, inactive and retired members from the State, school districts		
Address Information: Lincoln Plaza N 400 Q St Sacramento CA 95811 USA 908.225.7377 www.calpers.ca.gov		
Additional Information: Industry: Financial Services # of Employees: 1000-4999 Sales Volume: \$500 Million - \$1 Billion		
Asset Allocation:		
Total Assets:	241,166,637,898	2.14%
Defined Benefit Assets:	54,657,322,000	22.66%
Defined Contribution Assets:	130,095,421,000	53.94%
Welfare Benefit Assets:	49,414,867,000	20.50%
		Residuals/Other:

Calpers had more than half of its assets invested in equities as of mid-August, according to fund data available on PLAN.