Fiduciary Responsibility
Getting Politics out of Pensions

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**About The Institute for Pension Fund Integrity (IPFI)**

Pensions are important benefits that guarantee greater financial stability for retirement. With billions of dollars invested across local, state and federal pension funds, it is imperative that fund managers adhere to the responsibility by which they are bound. The Institute for Pension Fund Integrity seeks to ensure that local, state and federal leaders are held responsible for their choices in investment, led not by political ideation and opinion but instead by fiduciary responsibility.

The Institute for Pension Fund Integrity knows that unfunded pension liabilities strain state finances and can even lead to municipal bankruptcy tolling taxpayers. We seek to end the irresponsible patterns that lead to these collapses, and instead seek profitable and stable long-term investments for these massive accounts. The Institute for Pension Fund Integrity relies upon reason over whim, truth over opinion and data over emotional investing, leaving account holders with well-managed, and more importantly, well-funded pension funds for their citizens.

**Acknowledgements**

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EXECUTIVE SUMMARY

As Baby Boomers retire daily and the American population continues to age, one thing becomes clear: public pensions are poorly underfunded. States and cities are facing an impending funding crisis that will burden future generations and taxpayers for years to come. Beyond this, pension fund fiduciaries are increasingly pressured by outside stakeholders to manage the funds based on political whims. While well-intentioned and admirable, pension funds should only be managed to create the greatest returns for fund participants. Detailed in this report is a clear explanation of fiduciary responsibility, a closer look at unfunded pension liabilities, and the politicization of pension funds. The final conclusion is clear: get politics out of public pension management.

- **Public Pensions:** There are approximately 6,276 (299 state-administered and 5,977 locally-administered) pensions across the U.S. Only about 30% of these are adequately funded using optimistic actuarial assumptions. When conservative actuarial assumptions are used, none are more than 63% funded.

- **Unfunded Liabilities:** Across the country, states alone are facing a $6 trillion unfunded liability that must be addressed, without including the thousands of public pensions on city and county levels.

- **Fiduciary Responsibility:** The IRS has clear guidelines for retirement plan fiduciary responsibilities. This includes:
  - Acting solely in the interest of the participants and their beneficiaries;
  - Diversifying plan investments

Public pensions have often been subject to decreased returns when stakeholders push for specific investment practices, without considering what will result in best return.

- **Connecticut, New York, and Illinois:** These three states represent some of the worst funded pensions across the country. Beyond that, all three have dealt with divestment campaigns to make their poorly funded pensions even less diverse and less likely to provide adequate returns to the fund participants.
  - Given the current liabilities, it is estimated that Connecticut will be paying off pension debt well into the 2040s.
  - In New York specifically, there has been a recent push to divest from energy companies. State Comptroller Tom DiNapoli has pushed for a more restrained approach and has urged for “engagement” over divestment. This type of strategy would involve using NYSCRF funds as leverage to encourage energy companies to address climate change.
  - Illinois’ state finances are in dismal shape and with the pension following along, it’s time to get the politics out of the management of Illinois’ pensions and instead focus on gaining the best returns possible.
• **Politically Driven Divestment:** As visible in some of the worst performing pension states, politically driven divestment is a growing movement across the country. Much of the push is for public pensions to divest from industries with negative externalities, including being damaging to the environment; being unhealthy; and otherwise being perceived as a social “bad.”

• **Diversity of funds, not divestment:** Despite the push for divestment from energy companies or nuclear weapons manufacturers, the numbers don’t lie: those companies have incredibly well-performing stocks and provide reliably strong returns, even during economic downturns.

In order to make sound investments for maximum returns, fund managers cannot divest from huge sectors of the economy, simply because politicians urge them to. Instead, they must be guided by prudent investment strategies and enforce a diverse investment fund without the influence of politics.
With millennials officially overtaking Baby Boomers and Gen Xers as the largest working generation, we face a stark reality. What was only conjecture previously is coming true: our pensions are not funded properly and the increasing number of Baby Boomers retiring daily is demonstrating this point. While private retirement funds have largely regained any losses from the Great Recession, public pensions remain woefully underfunded. States and cities are facing an impending funding crisis that will burden future generations for years to come. What can be done about this? The first and foremost item must be to get politics out of public pension management. If a fund manager is investing based on political decisions and not purely on the expected return, then they are weakening the fund. It is time to set a standard and establish rules prohibiting the involvement of politics in the managing of public pension funds.

INTRODUCTION

There are approximately 6,276 public pensions across all levels of government. These pensions are the retirement funds of our teachers, firefighters and police officers, elected officials, state employees and other government workers. Over generations various levels of government have promised varying benefits, which current governments are obligated to uphold, based on contract theory or explicit state constitution amendments. Of these 6,276 (299 state-administered and 5,977 locally-administered) pensions, only about 30% of public pensions are adequately funded using optimistic actuarial assumptions. To be adequately funded means having the pension fund at least 70% funded. Using more conservative actuarial standards (i.e., a risk-free rate of return), no states would be considered adequately funded. That means that across the country, states alone are facing a $6 trillion unfunded liability that must be addressed, without including the thousands of public pensions on city and county levels.

"Of these 6,276 (299 state-administered and 5,977 locally-administered) pensions, only about 30% of public pensions are adequately funded using optimistic actuarial assumptions."
As public pensions elude significant reforms, the positioning of elected officials in managerial and board posts has drawn sharp criticism from those serious about changing the way public pension systems operate. The politicization of public pension board positions can lead to a litany of accountability, transparency, and attention problems. This includes state treasurers, public pension boards appointed by governors, pension managers appointed by state legislators and other fund managers who are ultimately beholden to political parties and the whims of their supporters. This results in calls to invest in more ethical companies, or to divest from companies with negative externalities, impacting the financial return of the fund. Like their private fund counterparts, these public pension fund managers have a fiduciary responsibility, regardless of if they are elected, appointed, or self-selected, to manage the funds to gain the highest return benefitting their constituents. If the funds are managed in any other way, through emotion, politics, or otherwise, then the fund manager is not meeting his fiduciary responsibility and ultimately, it’s the retirees and other taxpayers who will suffer.

Detailed in this paper is a clear explanation of fiduciary responsibility, a closer look at specific unfunded liabilities across the country, and case studies on the politicization of pension funds. It becomes clearer and clearer that public pension funds must be managed apolitically to gain the best returns possible.
WHAT IS FIDUCIARY RESPONSIBILITY?

Simply stated, a fiduciary is a person who owes a duty of care and trust to another and must act primarily for the benefit of the other in a particular activity. In this instance, the particular activity is managing a public pension, and the beneficiaries are the retirees and current employees who have paid and are paying into the system. There are clearly defined responsibilities associated with being a fiduciary, according to the Internal Revenue Service (IRS):

- **Acting solely in the interest of the participants and their beneficiaries**; (emphasis added)
- Acting for the exclusive purpose of providing benefits to workers participating in the plan and their beneficiaries, and defraying reasonable expenses of the plan;
- Carrying out duties with the care, skill, prudence and diligence of a prudent person familiar with the matters;
- Following the plan documents; and
- **Diversifying plan investments** (emphasis added)

The two bolded responsibilities are of most interest to this situation given that politically elected fiduciaries of public pensions may be naturally swayed towards acting in the interest of the constituents, especially those who elected them, not just the plan participants. Beyond that, the emphasis on diversifying plan investments will be explored further in this paper, but it is widely recognized by financial investment experts that plans with diverse investments have greater returns.

In the U.S., public pensions are not governed the same as private pensions, which means that there are no set standards for public pension fiduciaries. For private pensions, the Employee Retirement Income Security Act of 1974 (ERISA) sets specific rules and regulations, including that it requires accountability of plan fiduciaries. Public pensions are instead regulated at the state and city level, with most states protecting pensions under

“**In order to make sound investments for maximum returns, fund managers cannot divest from huge sectors of the economy, simply because politicians urge them to. Instead, they must be guided by prudent investment strategies and enforce a diverse investment fund.**”

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11 https://www.investopedia.com/terms/e/erisa.asp
contract theory.\textsuperscript{12} Using this kind of regulation does not establish set rules or expectation, but instead uses precedence, meaning that there is a lack of explicitly stated regulations that public pension fund fiduciaries should follow. This has led to public pension plans being subject to public pressure exerted by outside stakeholders, not just plan pensioners. Because of this, public pensions have often been subject to decreased returns when stakeholders push for specific investment practices, without considering what will result in best return.

Public pension fund fiduciaries have a responsibility to make sound investments to optimize the return for their beneficiaries. There has been a growing movement in recent years, that started with the push to divest from tobacco companies in the '90s, to divest from “sin tax” companies, including soda, fossil fuel, gun companies and more. This will be explored in more detail below, but in the context of defining fiduciary responsibility, it is important to highlight. In order to make sound investments for maximum returns, fund managers cannot divest from huge sectors of the economy, simply because politicians urge them to. Instead, they must be guided by prudent investment strategies and enforce a diverse investment fund.

Complicating the responsible management of public pension funds further is the growing unfunded liabilities facing states and municipalities. States alone face at least $6 trillion unfunded pension liability. Current legal regulations prohibit governments from changing the benefits, so the only means of narrowing the gap is by placing the burden on new employees and taxpayers. However, states can work towards closing the gap by ensuring that pensions are not politicized and that they are managed with the goal of maximizing returns.

\textsuperscript{12} \url{http://www.governing.com/finance101/gov-pension-protections-state-by-state.html}
A CLOSER LOOK AT THE UNFUNDED LIABILITIES

Estimating the total amount of unfunded liabilities for public pensions is difficult at best, given that most of the public funds are calculated using a high assumed rate of return. Private funds’ ratios are calculated based on more conservative rates, around 4.5%. Because of that, overall pension liabilities are reported as anywhere from $1.3 trillion to over $6 trillion. Unfunded liabilities funding ratios are calculated by dividing total assets by total liabilities, and in the best-case scenario public pensions are about 71% funded. However, this is based off of the average assumed rate of return of 7.6%, when in fact, in 2015, the median rate of return on public pension investments was 3.6%. This gap between real rates of returns and the assumed rates of return is a huge contributor to underperforming pensions. Adding to the mess are politicians who have failed to adequately fund state contributions to the pension funds, while also playing politics with the investment rules.

The worst states based on funding ratios that are calculated using the reported assumed rate of return (ARR) published by each state are Kentucky (44%), Connecticut (47%), Illinois (47%), Missouri (54%), and New Jersey (57%). However, most ARRs are around 8%, which is on average at least 1% higher than actual rate of returns. Beyond that, a “risk-free” rate is around 2% (or equal to the rate of a US Treasury Bond). If the 2% return rate is used to calculate the funded ratios for each state, the picture gets even worse. The five worst states are the same, but they are now Connecticut (20%), Kentucky (21%), Illinois (23%), Missouri (24%), and New Jersey (26%). Conversely, the best funded state is Wisconsin, which reports a 100% funding ratio. But, again, if the risk-free rate is applied that drops to being only 62% funded - a stark difference. Below is a closer look at the issues affecting some of the worst states.

Connecticut

Connecticut is plagued with having the worst funded pension ratio, while also having the highest average income in the country. This perplexing dichotomy exists for a few reasons. First, while the state is home to some of the highest wage earners in the country, it also has high unemployment and poverty rates in its urban areas. Additionally, economic cornerstones like Aetna Health, are leaving the state in droves to relocate to more popular environments to find the young, skilled workers they need. Due to these issues, the tax revenue is much less than the state needs, and the state cannot afford another tax hike to supplement the loss.

Given the current liabilities, it is estimated that Connecticut will be paying off pension debt well into the 2040s.

15 https://www.thedailybeast.com/why-connecticut-is-collapsing?ref=scroll
On top of the decreasing tax revenue facing Connecticut, is the publicly stated $30 billion pension debt. However, using more conservative rates of return, the Connecticut public pension liability is closer to $68 billion, and some other think tanks estimate the liability to be more than $100 billion.\footnote{https://www.hoover.org/sites/default/files/research/docs/rauh_hiddendebt2017_final_webreadypdf1.pdf} \footnote{http://www.yankeeinstitute.org/2017/12/connecticut-pension-system-worst-in-the-nation-according-to-new-study/} This unfunded pension liability is disastrously high, and current policies are not doing enough to solve the problem. In 2016, Connecticut worked to refinance its pension liabilities. In the ten years leading up to this, the real rate of return for the state employee pension system was only 5.14%. However, during the same timeframe, the state was assuming an 8% rate of return. Given the current liabilities, it is estimated that Connecticut will be paying off pension debt well into the 2040s.\footnote{https://www.hoover.org/sites/default/files/research/docs/rauh_hiddendebt2017_final_webreadypdf1.pdf}

**New York**

As the nation’s fourth most populous state, the pension crisis in New York is of vital importance. Public pensions in New York are managed through the New York State Common Retirement Fund (NYSCRF). The NYSCRF has more than one million members, retirees, and beneficiaries taking part in the fund. The NYSCRF’s total value at the end of 2017 was almost $210 billion\footnote{https://www.bloomberg.com/news/articles/2018-02-27/new-york-city-albany-part-ways-on-divesting-fossil-fuel-stocks}, making it the third largest pension fund in the nation. Of those taking part in the system, approximately 60% are current employees while the other 40% are retirees and beneficiaries.

While state senators in Albany have been using very strong language when it comes to divestment, State Comptroller Tom DiNapoli has pushed for a more restrained approach. DiNapoli has often urged for “engagement” over divestment. This type of strategy would involve using NYSCRF funds as leverage to encourage energy companies to address climate change.

The publicly stated unfunded liabilities of the NYSCRF total almost $55 billion. However, when recalculated using a market-based approach, this number rises to upwards of $284 billion.\footnote{http://www.osc.state.ny.us/pension/snapshot.htm} Although the state is contributing enough to the NYSCRF to prevent a rise in unfunded liability with its stated expected return, when using a market-based, risk neutral return, the state comes up short in its contributions.\footnote{https://www.hoover.org/sites/default/files/research/docs/rauh_hiddendebt2017_final_webreadypdf1.pdf} In the midst of this pension crisis, some public officials in the state of New York have considered divesting the state’s pension funds from certain assets due to political pressures.

During his 2018 State of the State Address, Governor Andrew Cuomo unveiled his plan for divesting the state’s pension fund from energy stocks. As of 2017, the New York pension fund listed holdings in more than 50 oil and gas companies. Cuomo has asserted that divesting from fossil fuels will encourage the state to reduce its carbon footprint and that renewable energy will be a less risky investment due to its projected growth.\footnote{https://www.governor.ny.gov/news/governor-cuomo-unveils-9th-proposal-2018-state-state-calling-nys-common-fund-cease-all-new}
There has also been a push for divestment within the New York Legislature. A bill currently in committee in the New York State Senate (Senate Bill S4596) would:

- Require funds from the NYSCRF be divested from coal companies within 1 year and from all other fossil fuel companies by the start of 2020.
- Prohibit the State Comptroller from investing NYSCRF funds in any of the top 200 companies which hold the largest fossil fuel reserves.  

While state senators in Albany have been using very strong language when it comes to divestment, State Comptroller Tom DiNapoli has pushed for a more restrained approach. DiNapoli has often urged for “engagement” over divestment. This type of strategy would involve using NYSCRF funds as leverage to encourage energy companies to address climate change. Other proponents of a more fiduciary responsible approach include various union leaders in the state. At a New York State Public Employee Conference this past February, union leaders cited California as a reason to be wary of divesting from companies for political reasons. California has recently divested its public pension fund from tobacco companies which was estimated to have cost the state anywhere from $2 billion to $3 billion.

A situation similar to New York state’s is occurring at the city-level within the nation’s largest municipality. The New York City Pension Fund is made up of five separate funds, each of which is independently run by its own board of trustees. As of the end of 2017, the total of these five funds was valued at almost $195 billion with the city’s stated unfunded liability totaling $61.5 billion. However, if using the market-based estimate, its unfunded liability is closer to $145 billion. Further, using market-based rates, the city falls short in its contributions to prevent a rise in unfunded liability, suggesting that the crisis is only going to worsen in the coming years.

Reminiscent of what is occurring at the state-level, Mayor Bill De Blasio and City Comptroller Scott Stringer have announced their intention to divest the city’s pension fund from companies engaging in fossil fuel-related activities. Of the almost $200 billion in the fund, $5 billion is currently invested in fossil fuels. This comes even after the decision to divest three of the five major pension funds from firearms manufacturer’s stocks in the wake of the Florida shootings. The New Yorker offered criticism of the move to divest of the firearms stocks. They stated that firearms manufacturers would not lose money from this divestment, but instead pensions would be selling the stocks on the secondary market for pennies on the dollar. Clearly, divestment will not solve New York’s pension problems and is more likely to only make it worse.

Illinois

As a state that has become notorious for the mismanagement of its budget, Illinois is in the midst of an economic crisis. The state’s bond status is near-junk, its population is falling, and it is consistently running a deficit every year. According to the Governor’s Office of Management and Budget, the state had a $1.7 billion general funds deficit during 2017. With this poor financial management as a backdrop, it should be no surprise that Illinois’ pension fund is in one of the worst positions in the union. Current estimates of the total debt for state and local retirement benefits in Illinois total over $203 billion. Further, if calculating using state’s own expected rate of return, it is not even close to contributing enough to the pension fund to keep its unfunded liability from rising even more.

23 https://www.nysenate.gov/legislation/bills/2017/s4596/amendment/original
27 https://www.hoover.org/sites/default/files/research/docs/rauh_hiddendebt2017_final_webreadypdf.pdf
28 https://www.newyorker.com/business/currency/does-divestment-work
Much of the growth in unfunded liability within the pension fund has been traced to a rise in pension benefits, and not to funding shortfalls. A report conducted by Wirepoints, using data from the Illinois Department of Insurance and Pew Charitable Trusts, found that promised pensions have grown by over 1000% in just three decades while the state’s median household income has only grown by a little over 100%. There are important political reasons as to why this exponential growth in benefits has occurred. For one, there is a clause in the Illinois Constitution stating that pension benefits cannot be diminished or impaired. In addition to this constitutional restriction, public sector unions wield a great deal of influence in Springfield, particularly during election years.

At the city-level, Chicago is facing a similar pension crisis. In 2015, the city’s stated unfunded liability topped $45 billion while the market-based estimate was closer to $90 billion. Just like with the rest of the state, this situation with the pension is only worsening the city’s economic condition. By the end of 2016, while the city had managed to increase its cash holdings by over $60 million due to increases in tax revenues, the city’s pension funds continued to be in worsening shape. During his State of the City address, Mayor Rahm Emanuel touted the city’s improving economic condition. However, the financial services company Standard & Poor’s (S&P) took issue with some of Emanuel’s claims. S&P agreed that Chicago is taking steps towards a sustainable fiscal situation, but that it is still not doing enough to meet the expected rise in pension costs.

In the midst of this pension trouble, Chicago’s City Treasurer, Kurt Summers is pushing the city to engage in a new politically driven investment strategy. Summers, who manages Chicago’s pension funds, has stated his desire to use environmental, social, and governance (ESG) factors to guide the city’s investment portfolio. Among other things, such a move would have the city creating a carbon-neutral portfolio by 2020. In order to codify Summers’ goals, Alderman John Arena has introduced an ordinance to the Chicago City Council empowering Summers to undertake ESG-focused investing. Emanuel has yet to take a position on Summers’ proposal, though in the past he has been hesitant to push for divestment. With the state’s finances in such dismal shape and the pension following along, it’s time to get the politics out of the management of Illinois’ pensions and instead focus on gaining the best returns possible.

"With the state’s finances in such dismal shape and the pension following along, it’s time to get the politics out of the management of Illinois’ pensions and instead focus on gaining the best returns possible."

33 http://www.ilga.gov/commission/lrb/conf3.htm
34 https://www.hoover.org/sites/default/files/research/docs/rauh_hiddendebt2017_final_webreadypdf.pdf
PUBLIC PENSION DIVESTMENT - A POLITICAL PROBLEM

As visible in some of the worst performing pension states, politically driven divestment is a growing movement across the country. Much of the push is for public pensions to divest from industries with negative externalities, including being damaging to the environment; being unhealthy; and otherwise being perceived as a social “bad.” While this is not a novel concept, current movements focus on groups pushing for divestment from fossil fuel companies given their perceived negative impact on the climate and environment. Other examples include divesting from tobacco companies, soda companies, gun manufacturers, and the military and nuclear industrial complex.

In some cases involving energy companies, divesting is only from coal companies or specific gas companies. In others, it’s a complete divestment including from pooled funds or index funds that include some portion invested in fossil fuels. As mentioned above, both New York City and New York State are planning to divest significant portions of their pension funds from fossil fuel investments. Other cities, including Seattle, San Francisco, Chicago and Ann Arbor (MI) have faced pressure to divest from fossil fuels; but in most cases the city’s pension fund boards have rejected these pressures and have opposed divestment. Often this pressure comes from climate change advocates, such as 350.org and other groups often backed by progressive political entities. The argument is that pensions should divest from fossil fuels and instead invest in sustainable investments. This is a respectable undertaking, however, one report estimated that the New York Common Retirement Fund would lose between $188 million to $302 million over five years if forced to divest from fossil fuels. The same report estimated that fossil fuel investments on average earn an 8% annual return, compared to the 3-5% annual return of environmentally cleaner investments. This clear financial loss of divesting from fossil fuels has driven other municipalities and organizations to not divest.

Seattle, known for its progressive politics and climate-centric policies, did not divest its city employee pension fund from fossil fuels after a strong push to do so. The lawyer for the pension board, Michael Monaco, emphasized the board’s fiduciary responsibility that prohibits it from compromising the financial return of the fund to pursue environmental, social, or governance goals. Numerous universities that have been subject to sit-ins and other protests from students and faculty on this same topic have also refused to divest. A report from 2015 showed that Harvard, Yale, MIT, Columbia and New York University would collectively lose more than $195 million if they divested of their equities in fossil fuels.

Beyond the financial windfall of divestment, fossil fuel companies represent some of the best performing and most reliable stocks available. Six major energy companies were listed in the top 18 retirement stocks to purchase by Kiplinger, noted for extended rates of return and reliable dividends over decades of investment.

Energy companies even produce strong returns in a down economy, proving their reliability. As municipalities across the state and other industry investment leaders have shown, divestment is not responsible investment strategy and any public pension manager that pushes for that is not executing their fiduciary responsibility appropriately.

38 https://350.org/
42 https://www.kiplinger.com/article/investing/T052-C000-S015-7-energy-stocks-you-can-trust-in-retirement.html
Politically driven divestment is not just focused on the energy industry. It is a growing political movement, which urges investors to avoid gun and weapons related companies as well. Particularly targeted are companies like Northrop Grumman and Boeing who support the American military industrial complex, and therefore nuclear weapons. More than $525 billion of private funds are invested in nuclear weapons manufacturers\(^43\) and about 27 private companies are involved in nuclear weapons production, which is about 2% of the S&P 500.\(^44\) These numbers have not been calculated for public pensions, but it can be assumed that given the diverse companies included as nuclear weapon manufacturers, that at least some public pension funds are invested in this economic sector.

As the call for divestment from companies supporting the nuclear triad gets stronger, the push will carry over to public pensions divesting. However, what those who are calling for this divestment fail to calculate is the growth these companies (e.g. Northrop Grumman, Boeing, Lockheed Martin, Honeywell, etc.) are experiencing in today’s market. In the last five years, Northrop Grumman’s stock has grown 489%.\(^45\) Boeing has a similar gain, growing 379% in the last five years\(^46\). Lockheed Martin similarly has grown 352% in the last five years\(^47\). This trend is not changing. Given the current political climate, divesting from these companies would be disastrous for the already underfunded public pensions.

**CONCLUSION**

As demonstrated throughout this paper, the primary responsibility of any public pension fund manager is to manage the investment in way that guarantees the best return possible for beneficiaries. Even though many are managed by politically appointed or elected managers, those individuals must be able to separate politics from the money. Pension funds are to be handled responsibly, free of politics and personal gain. This country is facing a huge unfunded pension liability as detailed above, and without active management and possible policy changes to improve the pension debt, pensioners will see their benefits decrease and future generations will be left with huge bills they can’t pay. Enough is enough, and the first step to solving the problem is to get and keep politics out of pensions.

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\(^{47}\) [https://www.google.com/finance?q=NYSE:LMT](https://www.google.com/finance?q=NYSE:LMT)