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Office of Program Policy Analysis
& Government Accountability

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Economically Targeted Investment Program Under Development

at a glance

In 2008, the Legislature determined that using Florida pension funds to make financially prudent technology and growth investments had the potential to generate high-growth and high-wage jobs that would economically benefit the state. These types of investments are called "economically targeted investments." Federal law requires that such investments maximize returns to pension funds before their economic benefits are considered. Currently, 21 states make economically targeted investments using pension funds.

The State Board of Administration is developing Florida's program, which may invest up to 1.5% of the net assets of the state retirement system trust fund, or approximately $1.9 billion as of June 30, 2008, in technology and high-growth investments. Board officials are currently negotiating with investment firms to make targeted investments on behalf of the board. SBA officials report that they plan to follow best practice guidelines developed from other states' experiences with similar programs. OPPAGA will issue a report in January 2010 on the board's progress in making these investments.

Scope

As directed by the Legislature, OPPAGA reviewed the State Board of Administration's (SBA) investments in technology and high-growth industries targeted to benefit the state's economy. [1] This report examines the SBA's efforts to implement Ch. 2008-31, *Laws of Florida*, and answers five questions. [2]

1. What are economically targeted investment programs?
2. What are the key provisions of Florida's technology and high-growth investment legislation?
3. How will the SBA implement the new program?
4. What policies are other states using to protect against economically targeted investment failures?
5. How will OPPAGA evaluate the SBA's economically targeted investment program?

Background

The State Board of Administration is composed of the Governor, the state's Chief Financial Officer, and the Attorney General. The board derives its powers to oversee state funds from Article XII, Section 9, of the Florida Constitution. It has oversight of the Florida Retirement System's Pension Plan, which represents approximately $127 billion as of June 30, 2008, or 82% of the $155 billion in assets managed by board fund managers.

[1] Chapter 2008-31, *Laws of Florida*.

[2] OPPAGA is directed to annually report on SBA's economically targeted investment program. Our next report, to be issued in January 2010, will further assess the State Board of Administration's progress in implementing the legislation. Pursuant to statutory requirements, we will work with the Department of Revenue, the Office of Economic and Demographic Research, and other entities as necessary to evaluate the direct and indirect economic benefits to the state resulting from these investments.

Although the board makes some of its investments directly, it generally hires and oversees external fund managers to research, invest, and manage monies in the Florida Retirement System Pension Plan portfolio.

Questions and Answers —

What are economically targeted investment programs?

Economically targeted investments are those that produce competitive rates of return, while also providing collateral benefits. In the case of state pension funds, these collateral benefits aid targeted geographic areas, groups of people, or sectors of the state economy. Collateral benefits may include affordable housing, job creation or retention, sales and tax revenue generation, and payroll growth. Rather than making traditional investments in national stock and bond markets, a pension plan with an economically targeted investment policy may establish venture capital funds that target some portion of their assets to in-state companies. The intent of these investments is to make equity financing available to viable in-state companies that may not come to the attention of venture capital partnerships. [3]

Proponents of economically targeted investments contend that targeted investments in venture capital, small business loans, and affordable housing improve the state economy and tax base. The investments also support both the employment and pension security of public employee participants and beneficiaries.

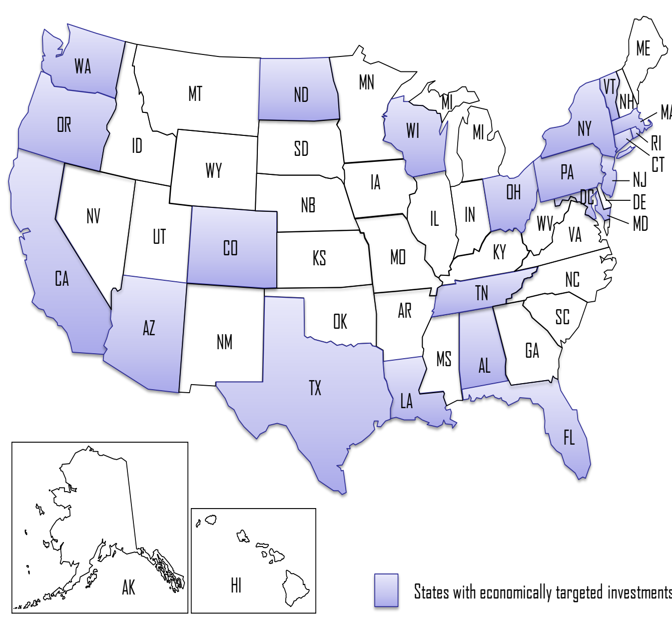
Florida's economically targeted investments, like traditional investments in state pension funds, are subject to requirements of Florida law and the U.S. Employee Retirement Income Security Act. [4] These laws require pension fund managers to (1) act as fiduciaries and (2) follow the prudence rule. These two requirements charge the State Board of Administration, its trustees, and its fund managers with

- acting prudently in evaluating the suitability of investment vehicles for the pension fund;
- seeking expert opinions on these investments and ensuring this information is complete and up-to-date;
- selecting investments that do not result in lower rates of return than would alternative investments with commensurate degrees of risk; and
- purchasing these investments with the exclusive goal of benefiting the pension participants and beneficiaries.

In sum, these requirements essentially charge public pension fund managers with maximizing investment returns to the retirement system first, and maximizing economic benefits second.

Currently, 21 state pension plans have economically targeted investment programs (see Exhibit 1). These states include several with similar populations and demographics as Florida, such as California, Texas, and New York. These states typically use the investments to provide resources for urban development, housing, small business loans, company start-up capital, and capital for business expansion to those firms identified as benefiting the state.

Exhibit 1
Twenty-One States Use Pension Funds to Make Economically Targeted Investments



Source: OPPAGA analysis.

[3] *Public Pension Plans: Evaluation of Economically Targeted Investment Programs*, U.S. Government Accountability Office (formerly General Accounting Office) Report No. GAO/PEMD-95-13, March 1995.

[4] Section 215.47(10), *F.S., and* Title 29, Chapter 18, *United States Code*.

What are the key provisions of Florida's technology and high-growth investment legislation?

The 2008 Legislature determined that using Florida pension funds to make financially prudent technology and growth investments has the potential to generate high-growth and high-wage jobs that would economically benefit the state. Such job creation would in turn improve the state's tax base that supports state employment and the pension security of state employees.

To achieve these goals, Ch. 2008-31, *Laws of Florida*, authorizes the State Board of Administration to invest up to 1.5% of the net assets of the state retirement system trust fund, or approximately $1.9 billion as of June 30, 2008, in technology and high-growth investments. Such investments include space technology, aerospace and aviation engineering, computer technology, renewable energy, medical science and drug development, medical implants and devices, bio-related diagnostic products, bio-agriculture technologies, bio-security, bio-fuels, and bio-related applications.

The legislation also requires OPPAGA to review these investments and submit its findings to the SBA and the Legislature by January 15 each year. The annual review must include

- the dollar amount of technology and growth investments in the state made by the board during the previous year ending June 30 and the investments' percentage share of the system trust fund's net assets;
- a list of investments in the state identified by the board as technology and growth investments within each asset class; and
- an analysis of the direct and indirect economic benefits to the state resulting from the technology and growth investments.

Prior to passage of this legislation, the SBA invested pension funds in Florida-centered technology and high-growth industries as part of its overall investment portfolio. Although potentially benefiting Florida, these investments were not economically targeted, but were made as part of the SBA's asset allocation process to diversify risk and maximize portfolio returns. Exhibit 2 shows that, as of June 30, 2008, the board had more than $566 million in these types of investments.

Exhibit 2
The State's Pension Portfolio Currently Includes Florida-Based Technology and High-Growth Investments

Type	Amount Invested (in Millions)[1]
Aerospace and Aviation Engineering	$ 15.5
Computer Technology	90.6
Medical and Life Sciences	19.7
Other Technology Investments	440.6
Total	**$566.4**

[1] Includes investments as of June 30, 2008.

Source: Florida State Board of Administration.

How will the SBA implement the new program?

To implement the new legislation, the State Board of Administration has issued an Invitation to Negotiate, which invites bids from investment firms interested in contracting with the board to invest in technology and high-growth businesses that are domiciled in Florida or with a principal address in the state.[5] The investment firms must have five years of experience managing high-growth or technology investments and have managed or raised $100 million in assets. The firms must also have three years of returns on any investments the board deems are relevant to the new legislation.

[5] Bids were due on October 6, 2008.

The SBA will authorize the selected firms to invest in Florida-based high growth and technology businesses using any combination of the following approaches.

- **Venture Capital** – funds invested in start-up companies or early development firms
- **Growth Capital** – funds used for the expansion of existing businesses that are not yet profitable or generating sufficient cash flow to fund future growth
- **Infrastructure Sector Funds** – funds used for infrastructure projects, such as ethanol, wind, or solar energy sources
- **Co-investments** – investing with other corporations or business organizations in joint ventures
- **Merchant Banking** – funding through private investments made by financial institutions in unregistered securities (e.g., stocks and bonds) of either privately or publicly held companies

The investment firms that the SBA chooses to contract with will be required to make prudent investments and, along with the board, serve as fiduciaries for the retirement fund's participants and beneficiaries. The board anticipates hiring investment firms by early 2009 and for these firms to begin making these investments mid- to late-2009. These investments are not to be regarded as subsidies for economic development programs.

Over time, the board expects these high-growth and technology investments to provide rates of return commensurate with other comparable investments with similar risk already in the Florida Retirement System Pension Plan portfolio. However, consistent with the literature on these investments, the SBA does not expect to earn competitive rates of return for at least 8 to 10 years because these investments typically involve relatively young or start-up companies. The SBA further estimates that the available Florida market for these investments is approximately $400 million. Board officials state they will invest in a portion of this market following fiduciary and prudence guidelines.

What policies are other states using to protect against economically targeted investment failures?

While 21 other states are pursuing economically targeted investments, some have experienced failures that have lead to the development of guidelines to help ensure that pension managers focus on the fiduciary aspects of these investments before considering their collateral benefits. Three states have been cited as examples of problems that can arise when states fail to ensure that economically targeted investments maximize portfolio returns before any collateral benefits—Kansas, Connecticut, and Pennsylvania. [6]

- In Kansas, administrators for the Public Employees Retirement System lost $73 million by investing nearly $8 million in a steel mill and $65 million in a Kansas Savings and Loan, both of which subsequently failed. [7]
- The Connecticut Retirement and Trust Funds lost $20 million after acquiring 47% of the Colt firearm manufacturing company, which filed for bankruptcy three years after the acquisition.
- Pennsylvania's state and teacher fund lost $40 million after investing in an in-state automobile plant that failed.

Exhibit 3 shows policies that researchers, investment consulting firms, and public pension managers developed to help prevent these types of failures. SBA officials report that they will use these guidelines when implementing Florida's economically targeted investment program.

California, Vermont, and New York City provide positive examples of using these guidelines to fulfill fiduciary duties while making investments that benefit the local economy. Since 2001, the California Public Employees Retirement System has committed $975 million to companies that had limited access to capital; employed workers that resided in economically disadvantaged areas;

[6] *Economically Targeted Investments (ETIs)*, Joint Economic Committee Briefing, Congress of the United States, June 7, 1995.

[7] Kansas Public Employees Retirement System no longer considers geographic or economic development factors when evaluating investment alternatives. In 1991, after several Kansas-based economically targeted investment failures, the state repealed its economically targeted investment requirement.

or had female and/or minority management. California's policies require that these investments meet portfolio objectives before collateral benefits are taken into account, considers these investments as part of the retirement fund's overall asset allocation, and requires these investments to follow fiduciary and prudence guidelines while also conforming to all applicable California laws.

Similarly, in 2007, Vermont's state pension system funded a real estate project that met commensurate financial returns of the state's non-targeted real estate investments, but also had the collateral benefit of enhancing the state's land conservation policies. The state requires investments like these to be overseen by managers with proven success in managing applicable asset classes. The Vermont legislature rejected a proposal for the pension system to purchase Vermont Housing Finance Agency bonds. Although the bonds would have facilitated community development, they did not provide financial returns consistent with the state's fiduciary responsibility to pension plan participants.

Since 2002, the New York City Employees' Retirement System promoted economic development within the city by investing funds for rehabilitating distressed multi-family buildings in low- and moderate-income neighborhoods. These projects are benchmarked against the Lehman U.S. Aggregate Bond Index. System managers report that these investments have consistently exceeded the benchmark while also bringing rehabilitated properties back onto the city tax rolls, creating affordable housing, and providing construction and other small business employment within the city.

Exhibit 3
Industry-Accepted Guidelines Help Ensure That Economically Targeted Investments Meet Primary Fiduciary Standards

Policy

- **Legal compliance** – Economically targeted investments should conform to all laws, policies, and procedures governing the retirement system.
- **Fiduciary responsibility** – Selection of economically targeted investments should rest solely with the retirement system fiduciary and be the result of a prudent process.
- **Expected returns** – An investment should be evaluated solely on the basis of its financial strength and expected return; potential state economic benefits are secondary to the evaluation.
- **Due diligence** – Economically targeted investments should undergo the same level of due diligence required of all investments, including the verification of all related material facts and identification of potential conflicts of interest.
- **Asset allocation** – Economically targeted investments should be part of the fund's overall asset allocation and should not alter the fund's overall risk or return profile.
- **Fund management expertise** – Managers of economically targeted investments should have a strong and sufficiently long-term performance record of results for managing such investments.
- **Performance milestones** – Managers should develop milestones to periodically assess an investment's progress in reaching its expected rate of return, which can commonly take 8 to 10 years.
- **Performance benchmarks** – Economically targeted investments should be subject to applicable performance benchmarks consistent with industry practices for similar asset classes including
  - bond purchases should be compared against similarly rated bonds with like maturity and sector characteristics;
  - fixed-rate small business association purchases should be compared against treasury securities of like maturity;
  - variable-rate loan purchases should be compared against three-month treasury bills;
  - private placements should be compared against similarly rated bonds with like maturity and sector characteristics;
  - certificate of deposit (CD) programs should be compared against three- to six-month secondary market CD rates or three-year treasury securities; and
  - venture capital should be analyzed against other venture capital invested during comparable periods (called vintage year analysis).
- **Routine periodic evaluation** – Routine investment performance evaluations of the economically targeted investment program should occur.

Source: OPPAGA literature review and compilation of other state investment practices.

How will OPPAGA evaluate the SBA's economically targeted investment program?

OPPAGA is required to annually report on SBA's economically targeted investment program. Subsequent reports will, in consultation with the Office of Economic and Demographic Research, measure the direct and indirect economic impact of economically targeted investments using an input-output model. These models measure the direct and indirect economic effects of a specific investment or expenditure. [8] Direct impacts are a result of the initial investment, which in turn create indirect impacts that can be measured in a number of ways including expenditures in related industries or the well-being of state or regional economies. In the case of economically targeted investments, the direct impact would be the funds invested in technology sectors, and the indirect impacts would include increases in expenditures in related industries, tax revenues, jobs, and salaries.

OPPAGA also will report on whether these investments are projected to provide competitive rates of return to the Florida Retirement System Pension Plan before any collateral economic benefits are considered.

Agency Response

In accordance with the provisions of s. 11.51(5), *Florida Statutes*, a draft of our report was submitted to the executive director of the State Board of Administration for review and response. The executive director's written response is included in Appendix A.

[8] Our ability to report investment performance and direct and indirect economic benefit will be highly dependent upon implementation status and the number of technology and high-growth investments that the SBA makes in Fiscal Year 2008-09.

Appendix A

STATE BOARD OF ADMINISTRATION OF FLORIDA

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ASH WILLIAMS
EXECUTIVE DIRECTOR & CIO

December 30, 2008

Mr. Gary R. VanLandingham
Director
OPPAGA
Claude Pepper Building, Room 312
111 West Madison Street
Tallahassee, FL 32399

Dear Mr. VanLandingham:

We reviewed OPPAGA's preliminary report entitled, *Economically Targeted Investment Program Under Development.* We have no objection or questions in regard to the information presented in the report.

We welcome OPPAGA's efforts and, as always, we appreciate your diligence and professionalism.

Sincerely,

Kevin SigRist for ACW

Ash Williams
Executive Director & CIO

AW/db

The Florida Legislature

Office of Program Policy Analysis and Government Accountability

OPPAGA provides performance and accountability information about Florida government in several ways.

- OPPAGA reviews deliver program evaluation, policy analysis, and Sunset reviews of state programs to assist the Legislature in overseeing government operations, developing policy choices, and making Florida government better, faster, and cheaper.
- Florida Government Accountability Report (FGAR), an Internet encyclopedia, www.oppaga.state.fl.us/government, provides descriptive, evaluative, and performance information on more than 200 Florida state government programs.
- Florida Monitor Weekly, an electronic newsletter, delivers brief announcements of research reports, conferences, and other resources of interest for Florida's policy research and program evaluation community.
- Visit OPPAGA's website, the Florida Monitor, at www.oppaga.state.fl.us

OPPAGA supports the Florida Legislature by providing evaluative research and objective analyses to promote government accountability and the efficient and effective use of public resources. This project was conducted in accordance with applicable evaluation standards. Copies of this report in print or alternate accessible format may be obtained by telephone (850/488-0021), by FAX (850/487-3804), in person, or by mail (OPPAGA Report Production, Claude Pepper Building, Room 312, 111 W. Madison St., Tallahassee, FL 32399-1475). Cover photo by Mark Foley.

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Gary R. VanLandingham, Ph.D., OPPAGA Director