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Public pension funds fret over high-flying U.S. equities

Two-thirds of investment managers believe that U.S. equities are overvalued, and some pension funds are considering cutting back on allocations

Dietrich Knauth | 11 Aug 2017

With U.S. stock prices regularly hitting new records in 2017, pension plans are enjoying high returns from their public equity investments. But many institutional investors are beginning to get nervous, wondering when the good times will inevitably come to an end.

A recent **Northern Trust Asset Management** survey found that 65% of investment managers believe U.S. equities are overvalued, compared to just 30% in the first quarter of 2016.

Some pension funds are reacting with cuts to public equity allocations, others are standing pat, and some are second-guessing their recent shifts to non-U.S. equities.

“There are fewer and fewer managers that think U.S. equities are fairly valued or undervalued,” said **Mark Meisel**, senior vice president at Northern Trust. “Some people are beginning to reallocate toward

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European equities and emerging markets. You are seeing some assets flowing that way."

But despite growing nerves around valuations, institutional investors tend to have faith in the overall U.S economic outlook, benefiting from a long-term investment horizon as a shield from the pressure.

Scott Evans, CIO for the $160bn **New York City Retirement Systems**, attributed recent positive returns to "ebullient" markets, calling the funds' situation "dicey" and "fraught with risk" at a June 21 quarterly meeting.

"This is as good as it gets, so we should not be complacent," Evans said. "We should be sure to rebalance frequently to keep our portfolio taut, because we're going to get hit by a wave sooner or later. We can't predict when it will come."

The $323bn **California Public Employees' Retirement System** (CalPERS), which is amid of a long-term asset allocation study, has shown some anxiety about having missed out on some of the recent good times. Although the fund reported an 11.2% net return for the 12-month period ended June 2017, board member **Priya Mathur** asked the investment staff at the system's June meeting whether CalPERS' commitment to "a truly global portfolio" had hurt it, and whether the system should move to a more U.S.-centric equity portfolio.

A portfolio weighted more toward U.S. holdings would diminish the expected equities portfolio growth, since the 5-year equities run creates a higher starting point and offers less opportunity for future growth, CalPERS staff replied.

"It is the case that international stocks, and specifically emerging market stocks, are much cheaper from a valuation standpoint now, and it's because of the run that U.S. domestic markets have had. That has hurt us for the past several years," said **Dan Bienvenue**, CalPERS' managing investment director for global equity. "We think those things tend to be mean-reverting, and this would be the worst time for us to change that, candidly."

Iain Douglas, senior vice president for business strategy at **Dalton Investments**, said high-flying U.S. equities complicate efforts to persuade institutional investors to ditch home country bias and other bad habits of a bull market.

"It just so happens that the bias in U.S. portfolios would have been very beneficial in recent years, so that certainly would have been a headwind if you'd moved to a global structure earlier," Douglas said. "It can be a challenge to move assets out of a portfolio that has performed strongly."

The $5.05bn **City of Milwaukee Employees' Retirement System** (CMERS) is considering reducing its equity exposure as part of a long-term strategic asset allocation study.

CMERS has 56% of its assets in global public equity, with U.S. equities accounting for just under half that amount. At a July meeting, CMERS' investment consultant, **Callan Associates**, proposed six asset allocation options, each of which proposed slashing public equity to anywhere from 26% to 52%.

"Their projections for equities are definitely lower than they've been historically, so they are taking into account that we're starting at the high end of the range," CMERS senior pension investment analyst Erich Sauer said. "They presented some mixes that reduce out allocation to public equity, raise our exposure to private equity, and also allocate more to real return. We haven't made any decisions yet, but that's the way the review is heading."

The **New Jersey State Investment Council**, on the other hand, is getting strong stay-put signals from its consultants at **Goldman Sachs Investment Management Division**. The council manages $75bn in assets, with targets for 30% U.S. equities, 11.5% non-U.S. developed market equities and 6.5% emerging markets equity.

A Goldman Sachs presentation at the July 27 council meeting warned that selling equities based solely on expensive valuations has traditionally been a losing strategy. Markets can continue to provide unexpected upside, and valuations don't seem to be stretched relative to their macroeconomic

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fundamentals, as they were in the late 1990s before the tech bubble burst, according to the presentation. The last years of a bull market can be among the strongest, raising the opportunity cost of a premature exit, the consultants said.

Goldman Sachs also noted a “paucity of good alternatives to U.S. equities,” adding that European valuations are similarly high, and that they tend to decline quickly when S&P 500 returns are negative. Emerging market equities, while offering upside, also carry more risk of cratering due to downside earnings surprises and geopolitical events, according to the presentation.

Still, European and emerging markets are increasingly viewed as attractively priced options, according to the Northern Trust survey. While 65% of managers believe U.S. equities are overvalued, more than 85% of respondents believe European and emerging market equities are either undervalued or fairly valued.

“Managers view emerging market equity valuations favorably and are most bullish on that asset class,” Meisel said.

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