



January 26, 1970.

Dear Hugh:

Here is a brief statement of some of the factors which I think ought to be considered when the System makes a decision with respect to the portfolio policy it ought to follow for the annuity accumulation account.

As you see, I think that the bulk of the committee's work should be concerned with whether or not it would pay to purchase annuities for existing retirees and for those for whom annuities would be required in the future.

Cordially,

(Signed) Sherm

Sherman J. Maisel.

Enclosure

Mr. Hugh D. Galusha, Jr., Chairman,
Board of Trustees of the Retirement System
of the Federal Reserve Banks,
Federal Reserve Bank of Minneapolis,
Minneapolis, Minnesota. 55440

cc: Dr. McGill
Mr. Sherman
Mr. Bergin

SJM:cbd

FILE COPY

FOR FILES
Sherman J. Maisel

JAN 28 1970

January 26, 1970

INVESTMENT POLICIES

One of the approaches of the committee examining possible investment procedures for the retirement system should be to analyze this question as one of portfolio choices and decisions by the Federal Reserve System--a unique public body with unique powers and responsibilities.

I would differentiate between the present retirement reserve account and the pension accumulation account.

Funds are transferred to the retirement reserve account when the System incurs a specific obligation to pay a given benefit. I see no great advantage to the System in running an insurance business. There may well be cost-benefits that make it worthwhile remaining in this business, but they ought to be carefully explored.

The problem of the pension accumulation fund is completely different. While there may be certain problems with our current trustee agreement, conceptually this fund is simply a segregation of one part of the System's assets to make it possible to vest certain obligations, which the System has incurred, if it were decided to end the retirement system. Any earnings on this fund are like any other earnings on System assets available to be used to meet the System's current expenses. At most times these earnings are earmarked for retirement purposes and the Banks add additional funds, but it seems clear that at the moment more assets and earnings are available than are required.

There are no exact relationships between the amount and income of this fund and the System's obligations to purchase each year certain benefits for retiring employees or their beneficiaries. Crude actuarial estimates are made of future costs of existing promises. However, such future costs are altered periodically by the System. Amounts required in the future if benefits remain unchanged are also calculated. The amount the System might have to pay in the future from current income, given certain arbitrary assumptions of salaries, earnings on assets, hiring and firing procedures, is also calculated.

The basic fact, however, is that future payments which will change from current estimates must come from the System's future income including the income from any segregated assets. A simple model may be used to emphasize the fact that basically the Banks are responsible both to determine how large non-accrued benefits will be in the future and also to make necessary payments either at the time future liabilities accrue or at the time actual payments are required.

Assume that instead of channeling additional segregated funds into the pension accumulation account for vesting purposes the Banks simply freeze the amount of the existing fund and accept all income from it. At the same time, each year they would purchase from current income all benefits arising during the year such as annuities at retirement, death, or added benefits agreed to for past service. I would guess that except for a difference in how sums were entered in the accounting records, not much difference from present procedure would be noted in net charges to

bank income. In addition the amounts in the pension accumulation fund would still remain much closer to the sum required to vest all accrued service than is true for the great majority of pension funds.

Such a model is not necessary for the examination of a logical portfolio policy. A portfolio policy should, however, start from the uniqueness of the Federal Reserve System. It was created to administer certain of the sovereign powers of the Government with respect to the issuance of currency; certain fiscal activities; and the control of bank assets and liabilities through the creation and requirement of bank reserves. The System holds a vast percentage of its assets in government issues. It shares with the Treasury responsibility for the marketing of and markets for these securities. It shifts its assets primarily to achieve public policy objectives. In attempting to achieve these national goals in the field of money, credit, and government bonds, it determines a particular portfolio policy irrespective of the impact of such investment activities on the System's income. Its entire income arises from the governmental powers delegated to it and as a result the Treasury is the residual claimant for all Federal Reserve earnings.

Given this background, one can ask whether it makes much sense for the System to attempt to earn a higher yield on a small part of its total assets. Total System assets amount to over \$84 billion, whereas the assets it has earmarked for pension accumulation amount to only \$200 million. Even if the System were to follow a yield maximizing policy on this \$200 million, the earnings received would not add anything to the

vested benefits of potential retirees. They would simply add a little to over-all System earnings and thus to the residual income remaining after deduction of expenditures, including those needed to cover obligations under the retirement system. In effect, this would result in a somewhat larger amount of residual earnings transmitted to the Treasury.

If a yield maximizing policy were adopted for the small volume of earmarked assets, a logical next question would be, why not differentiate some part of the large remaining System portfolio in order to obtain larger residual earnings for the Treasury on that part too? The basic question at issue in making such a decision would be, should the System be satisfied with a risk-free return on government issues, or should it be willing to take greater risks on at least some part of its portfolio as a means of augmenting earnings? If the decision were made to accept some greater risks, what then would be the logical limit to which such a policy should be pushed?

Assume that an institution operates a portfolio with perfect knowledge. It recognizes that it can invest in a risk-free portfolio or can increase its returns by accepting payments for risks it is willing to take. With perfect knowledge, the difference in earnings should be exactly proportional to the extra risks taken.

In the current circumstances, the amount of risk the Federal Reserve can take given its \$84 billion of assets is virtually unlimited. If it were to decide to increase its earnings by accepting additional risks, there is no obvious limit to the amount of risks it should take.

A logical portfolio policy would probably be to instruct its portfolio manager to make all investments with a maximum expected value irrespective of the variance of risks. Such a portfolio would consist only of issues with the largest risks since this would maximize the System's expected return.

It can be argued that no one has perfect knowledge or that our legal structure or the action of the System cause basic imperfections in the capital markets. These enable a sharp money manager to increase his earnings beyond the equilibrium rates of the sum of the risk-free rate plus payment for risks. Such imperfections may exist. I am not convinced, however, that it is a proper role for the Federal Reserve to attempt to profit from such situations. Such a role seems to me to be in obvious conflict of interest with the System's basic duty of attempting to reduce such imperfections to zero.

The System has never adopted a risk-taking portfolio management approach, and I believe for good reasons. The principle of profit maximizing is simply not consistent with the broader national objectives the Federal Reserve has in mind when it undertakes security operations. If this is the case for the bulk of the System portfolio, I see no special advantage in adopting a different approach for the small part of the portfolio that is segregated for pension fund accumulation purposes. Retirees gain nothing from the added earnings on the earmarked assets, and there is always a danger that in taking a profit maximizing approach even on this

small part of the portfolio, the System's purpose will be confused and, to that extent, the broader national goals of over-all System policy partly compromised.