

California State Archives
State Government Oral History Program

Oral History Interview

with

GRETA MARSHALL

Chief Investment Officer at
California's Public Employees Retirement System, 1985-1988

April 6, 1990
San Francisco, California

By Carole Hicke
Regional Oral History Office
University of California, Berkeley

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None.

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PREFACE

On September 25, 1985, Governor George Deukmejian signed into law A.B. 2104 (Chapter 965 of the Statutes of 1985). This legislation established, under the administration of the California State Archives, a State Government Oral History Program "to provide through the use of oral history a continuing documentation of state policy development as reflected in California's legislative and executive history."

The following interview is one of a series of oral histories undertaken for inclusion in the state program. These interviews offer insights into the actual workings of both the legislative and executive processes and policy mechanisms. They also offer an increased understanding of the men and women who create legislation and implement state policy. Further, they provide an overview of issue development in California state government and of how both the legislative and executive branches of government deal with issues and problems facing the state.

Interviewees are chosen primarily on the basis of their contributions to and influence on the policy process of the state of California. They include members of the legislative and executive branches of the state government as well as legislative staff, advocates, members of the media, and other people who played significant roles in specific issue areas of major and continuing importance to California.

By authorizing the California State Archives to work cooperatively with oral history units at California colleges and universities to conduct interviews, this program is structured to take advantage of the resources and expertise in oral history available through California's several institutionally based programs.

Participating as cooperating institutions in the State Government Oral History Program are:

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California State University, Fullerton

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California State University, Sacramento

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Regional Oral History Office
The Bancroft Library
University of California, Berkeley

Oral History Program
University of California, Los Angeles

The establishment of the California State Archives State Government Oral History Program marks one of the most significant commitments made by any state toward the preservation and documentation of its governmental history. It supplements the often fragmentary historical written record by adding an organized primary source, enriching the historical information available on given topics and allowing for more thorough historical analysis. As such, the program, through the preservation and publication of interviews such as the one which follows, will be of lasting value to current and future generations of scholars, citizens, and leaders.

John F. Burns
State Archivist

July 27, 1988

This interview is printed on acid-free paper.

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INTERVIEW HISTORY

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Interview Time and Place:

April 6, 1990; session of one and a half hours
San Francisco, California

Editing:

Hicke checked the verbatim manuscript of the interview against the original tape recordings, edited for punctuation, paragraphing, and spelling, and verified proper names. Insertions by the editor are bracketed. The interviewer also prepared the introductory materials.

Papers:

No papers were available to the interviewer.

Tapes and Interview Records:

The original tape recordings of the interviews are in The Bancroft Library at the University of California at Berkeley along with the records relating to the interview. Master tapes are preserved at the California State Archives in Sacramento.

BIOGRAPHICAL SUMMARY

Greta Marshall grew up in Louisville, Kentucky where she attended grade school and high school. She graduated from the University of Louisville with both a Bachelor of Arts and a Master of Business Administration degree. She has spent considerable time in the investment business, went to The New York Institute of Finance, and worked for General Electric Company. She also worked in the trust departments of several banks in both Louisville and Cincinnati, Ohio. In 1974 Ms. Marshall joined John Deere and Company to head up its investment program. In 1984 she was president of Bay Banks Investment Management in Boston, Massachusetts, and she was chief investment officer for the California Public Employees Retirement System from 1985-1988.

[Session 1, April 6, 1990]

[Begin Tape 1, Side A]

HICKE: I think that I'd like to just start with a little bit of your background: where you grew up and were educated and how you got interested in your present work.

MARSHALL: I grew up in the Midwest, in Louisville, Kentucky. I also attended the University of Louisville, from which I have both a B.A. [Bachelor of Arts] and an M.B.A. [Master of Business Administration]. I worked, as I was mentioning to you earlier, in France for one summer during my college, between my sophomore and junior years in college.

HICKE: And that was for a company?

MARSHALL: That was for a company called Sucrarese Dutramere. It was an exchange program run by the University of Louisville where we as students got jobs for French students in Louisville and we got sent to Paris, which I thought was a much better trade on our part. [Laughter]

HICKE: Oh, yes.

MARSHALL: And the French students got sent to Louisville. But nevertheless, it was a great program.

HICKE: Good experience.

MARSHALL: Yes, and I met some wonderful French people that way and students. Then in 1960, between my B.A. and M.B.A., I went to New York and found a job in the brokerage industry. And since 1960, with one exception, when for a few years I worked for General Electric [Company] in market research, I've worked in pretty much every aspect of the investment business. I've worked

for brokerage firms, both in their research departments and I've actually sat on trading desks; I've worked for banks; I've worked for firms that provide advisory letters and stuff; I've worked for private corporations. Maybe I should back up and start here and give you the last sort of ten years update.

HICKE: Let me just interrupt first. How did you get interested in getting an M.B.A. and going into the financial industry?

MARSHALL: Well, my undergraduate degree was in English and languages with a minor in history, so I really had no interest then, and I got into it simply by having started on my M.A. and my pure master's degree in which I was pursuing linguistics. And not being able to find some courses I wanted, I went to Washington to try to find a job in Europe.

I couldn't find anything in Europe, so I went to New York one weekend and decided I liked New York and wanted to stay there for a while and just happened to luck into people who were looking for someone to work in their research department. They wanted someone who would be able to write a market letter, in fact a brokerage market letter, and my background in English was very helpful. So I got started in that business and became fascinated by the market and all aspects of it, then went to the New York Institute of Finance and learned about brokerage house procedure and all sorts of other things while I was in New York.

Then when I came back to Louisville, during the period of time when I was working in market research at General Electric, I started on my master's, my M.B.A., because at that point it was clear to me I was going to stay in the business world, and so I thought an M.B.A. would be a nice thing to have, and General Electric was one of the companies that fully paid for your M.B.A. So that's how I happened to go on and get the M.B.A., although I think I would have had to have gotten it sooner or later anyway.

So, the most recent history, after working in the trust departments of several banks in both Louisville and Cincinnati [Ohio], in 1974 I went to [John] Deere and Company to head up their investment program. That's John Deere, the tractor manufacturer in Moline, [Illinois]. I was there for the next ten years, from '74 to '84, and was during that time responsible ultimately for managing most of the pension fund, hiring the external managers for the pension fund, running the portfolios for the wholly owned insurance subsidiaries of Deere and Company and some of the foundation funds.

After Deere, I went to Boston and was president of something called Bay Banks Investment Management, and what I was doing there was setting up in effect the investment management subsidiary of this Boston-based bank.

After a year I was approached to go to California and run the investment funds for California. During my tenure at Deere and Company, I had served on the board of the Illinois State Board of Investments, so I knew something about the public sector pension plans. And the opportunity of running one of the largest pools of money in the country was just too interesting to pass up, and so I left Bay Banks and accepted the position at California. I was at California from June of '85 until July of '88, at which point I left--since that was the end of my contract--I left to set up my own firm, which is what I'm doing now: an investment management firm.

HICKE: All right. Well, we need to back up here just a little bit. [Laughter] We went by a lot of that experience fast, but maybe you'll refer to it as it's appropriate as we go along. I know that the California PERS [Public Employees Retirement System] instituted a search for someone, and I'm sure that they had quite a few applicants.

MARSHALL: They used a search firm to screen the applicants.

HICKE: That was Pathfinders, [Inc.]?

- MARSHALL: Right. And I don't know exactly how many applicants there were. That's something you'd have to ask Basil [Schwan], but I do think there were five finalists of which I was one, and the other finalists were typically at that point chief investment officers at other public funds.
- HICKE: And do you have a sense of what they were looking for and why you were selected?
- MARSHALL: They had been looking for some time. It was a difficult search, because they had decided that they couldn't pay what they thought they would have to pay to get the kind of talent that they wanted in that position under the civil service system. So first they had to get approval to hire an independent contractor into this position, and it was the first independent contractor they had had, and it was just very difficult.
- HICKE: You were the first.
- MARSHALL: I was the first. It was a very difficult search to go through, and I believe there had been nobody in the position of chief investment officer or investment manager for the system for about a year and a half prior to June of '85 when I joined them.
- HICKE: OK.
- MARSHALL: I thought there were at least three areas in which I could make some comments that I thought would be of interest and significance, and one of them was related to the growth of the funds, the size of these funds, and some aspects of what that means and why that's important. And then talk more generally about the changes that were made while I was in office: number one, the automation and computerization of the investment program and the new custodial arrangements for the system, which was a departure from what had happened in the past. And then, finally, I can make some comments about what I saw as the increasing and high level of political attention to these funds--for many reasons, but mainly because of their size--the impact of the pensions on the state budget, and what I call the access to the

fringe benefits associated with these investment positions; that is, the fact that the people who want to sell services to the system are the same kinds of people that can make very large campaign contributions and that, for many of the people who are affiliated with this system in one capacity or another, there's a great deal of both visibility and travel and entertainment.

HICKE: So you're going to elaborate on that.

MARSHALL: I'm going to elaborate on all of those things.

HICKE: Let me just ask you to begin with, what kind of shape was it in? Tell me a little bit about what it was like when you arrived.

MARSHALL: I think the fund was in good shape when I came there. The fund at that point was about \$27 billion. It was about 25 percent or less invested in equities at that point, and that was as a result of legislation in the past that had limited the funds to 25 percent of the funds being in equities.

HICKE: Where was the rest of it?

MARSHALL: In fixed income, short-term governments or corporate issues, some real estate, other assets, but predominantly in fixed income securities, bonds and notes.

HICKE: I think [Assemblyman Louis] Lou Papan told me that they were getting a return of about 4 percent.

MARSHALL: The returns were low at that point because since the fund had invested primarily over its entire history in long-term, fixed income securities. . . . You may remember that fixed income securities pay a coupon that is somewhat above the rate of inflation. And so as we had gone through a long period of low inflation in the fifties and sixties when many of these thirty-year bonds were bought, they were purchased at coupon rates or rates of return on those bonds of something like 3 and 4 percent. So as interest rates rose, more and more of the bonds were being rolled over into higher yielding securities, but that's a very long process if you've had a policy of buying long-term bonds. That was, as I say, partly a function of legislation that mandated or

required that the funds predominantly be invested in fixed income securities.

I said the funds were in good shape in the sense that there was a good staff there; they had done, I think, the best they could with limited resources and sort of neglect over the period of time, and they were dealing with what were some fairly severe legislative constraints in terms of what kinds of investments they could make.

Now one of the major things I guess that I should have mentioned--it didn't really happen on my watch--but a year or so prior to my coming to the state--and I think a lot was due to the efforts of Lou Papan and his consultant, Marcy Avrin--a constitutional amendment was passed in California that eliminated what is typically called legal list or legislative restrictions on investment and substituted something called a prudent man or a prudent expert rule of investing. And this is the common rule and common law, in fact, that applies to most trusteed assets and enables prudent investors or expert investors, professional investors, to make judgments as to what other prudent investors would do and invest their assets accordingly, without regard to legislative or, as we say, legal list restrictions.

HICKE: Is this A.B. 671?¹ He made several tries for that prudent person, I think, and that's the one that became the constitutional amendment.

MARSHALL: Right. And I think that was highly beneficial in really two ways: number one, in, as I say, freeing up the constraints on the system in terms of what it could invest in; and number two, in making the system subject to the ERISA [Employee Retirement Income Security Act]² language that says that the funds have to be invested for the sole interests of the beneficiaries and for the

1. A.B. 671, 1983 Reg. Sess., Cal. Stat., ch. 462.

2. Employee Retirement Income Security Act, 29 U.S.C. Sec. 1001

exclusive purpose of providing benefits and deferring necessary expenses. So it in effect put into a constitutional amendment some very strong protections for the funds and for the ways in which they would have to be invested. And it also put in a standard of conduct, in terms of the people who were managing the fund; it made them fiduciaries, which carries with it some severe penalties if you breach your fiduciary responsibilities with respect to how you manage the money. So it makes people more careful about how they invest people's money.

- HICKE: That was in this statute also?
- MARSHALL: Yes, that's right. In that constitutional amendment.
- HICKE: Well, since we're on this subject, maybe you could tell me a little bit about Lou Papan's role and how he managed to get this legislation through.
- MARSHALL: I'm really not the best person to tell you that, because, as I say, it happened before I came, and while I met and know Lou Papan and appreciated very much what he did in that regard, and I think in other ways he was very helpful in his role as the acting chair of the pension . . .
- HICKE: It was the Joint Committee on . . .
- MARSHALL: Joint Committee on Pensions. I was really not at all involved in that, and it was Lou and Marcy Avrin, whom I'm sure you would be able to access in terms of this oral history. . . . She was the one who actually was campaigning around the state. There was also another person who would be able to tell you quite a bit about this would be [Sidney] Sid McCausland and/or Basil Schwan, because they were both involved. There was a fund set up and contributions were solicited in order to publicize this constitutional amendment and to try to get it implemented. Unfortunately, as I say, I was not involved at that stage of the game, and so I really can't say so much about that.
- HICKE: But Lou and that committee had an ongoing role, right?
- MARSHALL: Yes. Absolutely.

- HICKE:** Throughout your tenure, so if that comes up. . . . I don't want to skip too far ahead of your schedule, but at some point maybe you could tell me a little bit more about this legislation that he continued to carry. I have lists of it all here. So let's do what you wanted to do first, and then maybe I can go back to that.
- MARSHALL:** You may have to remind me on that, because as I say, there were a few pieces of legislation that affected us directly during the time I was there, and I'm pretty familiar with those, but other than that, I'm not very familiar with the legislation that was carried before I came.
- HICKE:** Yes, well, those would be the best ones for me to ask you about, sure.
- MARSHALL:** I started out talking about the size of the funds and their growth, and as I said, I think they were in pretty good shape given the constraints they had operated under at the time I came. At that point they were, as I said, \$27 billion. They subsequently grew over the next three years to \$45 billion or \$50 billion, where they are now.
- HICKE:** And they grew as a result of . . .
- MARSHALL:** They grew as a result mostly of market action. This was a period in which both the equity markets and the fixed income markets were appreciating at something like 15 percent a year, so a lot of that growth in the funds came from market action.
- HICKE:** From your investments?
- MARSHALL:** Yes, but, you know, if you had just bought the whole market, you would have gotten a lot of that. I think I can say that we actually did better than the market, and to that extent we added something above and beyond what we would have gotten just from being in the market. So, yes, the management of it did add something, but a lot of it you would have gotten just because you had money to invest and you invested it.
- HICKE:** But it's also possible to fall behind, I mean, if you in fact didn't invest wisely.

MARSHALL: It's possible to fall behind, right. But you only get ahead or fall behind probably on a compound basis something like 1 or 2 percent a year typically, and particularly with a large, diversified fund. So, if the market's going up 15 percent, mostly you're getting the market, and you're only adding a little bit.

HICKE: Well, every little bit helps. [Laughter]

MARSHALL: Yes, it does.

HICKE: Especially with that amount.

MARSHALL: Well, 1 percent of \$50 billion is a half billion dollars, and if you get that every year, some people say, "It adds up to real money!" [Laughter]

Another part of that growth in the size of the fund comes from the annual contributions that are made, and these are contributions that are made by the state and other entities that participate in the Public Employees Retirement System fund and from the members themselves, because it's a contributory plan, and they contribute like 6 or 7 percent of their salaries into the fund also for their retirement. So, unless you want to ask me some other things about the growth in the size of the fund, I think that covers pretty succinctly what happened there.

I believe that I was hired because, as Sid McCausland said, the board was really offered two good choices. If they had selected one of the other candidates, they would have gotten a more traditional investment manager. If they selected me, and as a part of the interview process I outlined this, they were going into the newer investment technologies, what I call state of the art, the quantitative system; it's a systematic approach--the automated trading, those sorts of things. So by virtue of selecting me as their candidate, the board in effect made that decision.

HICKE: Oh, that's interesting.

MARSHALL: While I was in office, that's really basically what I proceeded to do. One of the minor things that I think I did, and one of the first things that I did, was simply to look at the costs that we were

currently paying. One of the major costs was commission costs. This is the money that we pay to the brokers for transacting our business. When I came to California it was somewhere between ten and twelve cents a share. At Deere and Company, on a much smaller fund, we had been paying substantially less than that, an average of three cents a share. And so one of the first things I did when I first came here--it was not very popular with the California brokers, or brokers in general--was to say that one thing we could do immediately was to reduce the commission costs that we were paying.

HICKE: Why hadn't somebody done that before?

MARSHALL: Well, you know, first of all there was nobody in charge. I mean, the funds were being run; there were people there. But you have to stand up to some people whom you've been doing business with for years and say, "No, I'm not going to pay you what I've been paying you anymore. The funds are now much larger and commission costs have come down, and it just isn't going to be this way anymore." If you're sitting there without a chief investment officer, most of the people underneath you are not going to make that decision on their own. So I think in some ways, one of the reasons that you have someone in charge of something is you have someone that is supposed to be looking at all these things and saying, "Let's do this. Let's make these decisions." So when you had nobody that was specifically designated as being in charge of the whole plan, you just don't have the motivations or the incentives to do that.

HICKE: Sure, OK.

MARSHALL: I don't know about Mr. Papan, but I know that Mr. [Treasurer Jesse] Unruh at that time was publicly noticed as getting heavy contributions from the brokerage industry. So I suppose there was always the issue of that relationship. Mr. Unruh was only one of the, I think at that point, thirteen board members, but obviously a very important one. And the way I handled that was

I drafted my letter that I was going to send to the brokers, this famous broker letter, and went over and requested a meeting with Mr. Unruh and told him what I was going to do, and he said, "Fine."

HICKE: Is that right? Oh, that's very interesting. He was treasurer at that time?

MARSHALL: Yes, he was treasurer at the time. An interesting follow-on to that: I was back over in his office talking about something else at one point, and he said, "You know, the brokers have been calling me." And I said, "Now, Mr. Unruh, remember we had this conversation about why, and the conversation was fair." And he said, "No, no, no, I'm not complaining. I just wanted you to know they were calling me." [Laughter] So, as a sort of sidelight into Mr. Unruh, he was a delightful person to deal with. I mean, he could be very difficult sometimes, as I've been told I can be also, but he was always very polite and great fun to deal with, as was Mr. Papan.

Back to what I thought were the other changes I made. As I say, this was the first change; it was a relatively minor change. The major change that I felt was required was that I thought we should bring a substantial portion of the money in-house and manage it internally. It's just so much cheaper. You pay external managers ten, twenty, thirty basis points, a fraction of a percent, but you can do that, you can manage the money in most cases internally just as well for probably on a fund this size one to three basis points. A basis point is a hundredth of 1 percent. So that means that it's ten times cheaper to manage money internally as it is to manage it externally.

HICKE: Were they using outside managers at the time?

MARSHALL: Yes. And once again on very large scale. Those managers were actually acting in an advisory capacity and were not paid a huge sum, and there were only a couple of them. But I felt that we really needed access to the best investment managers out there,

and in order to keep the total costs of managing the funds low, when we were going to have to pay them more, we should manage the significant portion of it, both the index portion and a portion of active management, internally. As I say, once again, it was a cost reduction measure. That required, in my opinion, significant automation and computerization of the system if we were going to do that efficiently and do that well. In my opinion, it also required that we have an independent custodian for the system's assets, so that we could efficiently receive and deliver securities.

- HICKE:** Could you elaborate on that concept a little bit and tell me who was the custodian before? I think it was the treasurer?
- MARSHALL:** Right, the custodian of the funds was historically the treasurer. And in fact, one of the bills that you're talking about that passed while I was there was a bill that permitted the systems to go out and hire their own custodians.
- HICKE:** Could you just take a minute and look through this and see if you can point it out?
[Interruption]
- HICKE:** You said this was '86 or '87?
- MARSHALL:** Yes.
- HICKE:** That wasn't on the tape, so that's why I repeated.
- MARSHALL:** Oh, have you started the tape again?
- HICKE:** Now we're back on, yes.
- MARSHALL:** And I might be able to find that, or certainly Basil can give you the . . .
- HICKE:** Well, yes. Oh, OK. We can probably find it in our . . .
- MARSHALL:** At that point, as I said, the treasurer was the custodian. Securities were held at various different custodians around the country. The assets of the state teachers and the public employees [funds] were frequently held by the same custodian, and there was increasingly errors resulting from wrong securities

getting delivered from wrong funds. This went back to the time when both funds were managed as a single investment pool.

HICKE: PERS and STRS [State Teachers Retirement System]?

MARSHALL: Right. And that is, in that legislation, that is one of the bills carried by Lou Papan that split those two systems.

HICKE: Yes, I have that. That's A.B. 3163.¹

MARSHALL: So we asked for, for a couple of reasons. . . . I thought that there was no way that the state of California could or should spend the kind of money that would be required to build a state-of-the-art custodial system, which most of the larger banks spend millions of dollars on each year updating their systems that are able to keep track of all securities and credit dividends.

HICKE: The computer-based systems that would track the . . .

MARSHALL: Yes, right. And secondly, I felt that Mr. Unruh, as a fiduciary to the fund, was in a difficult position, where he was in a dual role as a fiduciary to the fund and also providing services to the fund. So, as a result of that, we asked for and got legislation, unopposed, that enabled us to hire an external custodian.

HICKE: And this was '87. Is that about right?

MARSHALL: Yes. Can we turn this off for a moment?

HICKE: Yes.

[Interruption]

MARSHALL: At the time, the real thing that precipitated this request for the legislation to hire an outside custodian was the fact that the system had started to trade its securities more actively, and increasingly we were unable with the different custodians and with operating through the treasurer's staff to get prompt and accurate delivery of securities.

At one point there was an enormous fail, and because on fixed income securities when you fail you lose interest, the fund was actually losing money. So I wrote a memo and requested a meeting with the staff of the treasurer to try to figure out what

1. A.B. 3163, 1982 Reg. Sess., Cal. Stat., ch. 1434.

we should do about this. So Basil Schwan, myself, and Marcy Avrin, who was the consultant to Lou Papan, went to a meeting at the treasurer's office, and Mr. Unruh at that point said that he understood that I was upset about this, and that while they might have made some mistakes, he felt there were mistakes made on both sides, and they wanted to put their side on the table. And I said, "Fine."

The way I recall this meeting going, the staff started out and said, "Well, after we failed this trade, your staff was unable to recalculate the interest," because on these Ginnie Mae [Government National Mortgage Association] securities you have to recalculate the interest. It's a very complicated process, because the Ginnie Mae's are Government National Mortgage Association securities, and they're pay-down securities, so the principal is always changing and therefore the interest is always changing on a monthly basis, and it is extremely difficult once you've done a trade to then go back and recalculate, not knowing exactly when you're going to be able to deliver them on top of everything else.

And so the treasurer's staff went on and explained their side of it, and after they finished I finally said, "Well, the only problem with that is that once you said, 'After we failed the trade, it was your problem.'" And at that point I said, "If we had had an outside custodian"--what I called a real custodian--"they would have been responsible for paying the interest to the fund." At that point, I think Mr. Unruh became frustrated, [Laughter] obviously angry with me, and said to me, "Ms. Marshall, you might have been a dictator when you were at Deere and Company, but this is California." [Laughter] So we sort of took our lickings that day and dragged ourselves out with our tails between our legs, and we thought we had lost this whole battle.

But a few weeks later I was talking to one of Mr. Unruh's associates, a wonderful lady in L.A. [Los Angeles]--Madale

MARSHALL: Watson--and Madale said she understood I had been speaking to the treasurer. She had a meeting with the treasurer. And I said, "Yes, and he called me a dictator." I said, "Can you think of a worse case of the pot calling the kettle black?" [Laughter] And she said, "Well, young woman, I also understand that he told you that he may have been partially at fault." And she said, "I want you to know that I've known Mr. Unruh for forty years and he doesn't normally say that. That was a real compliment." [Laughter]

So these are sort of little anecdotal things, which at the time are traumatic and emotional but in retrospect are what made the job so charming and so much fun. Mr. Unruh, as I say, subsequently did not oppose the legislation and we did actually get our outside custodian.

HICKE: That, I might say, is another thing that seems unusual for him, because he always wanted to expand his job to the limits of the responsibilities.

MARSHALL: Mr. Unruh I think would have preferred that California be more like New York where a single person, the controller or the treasurer, is the sole trustee and fiduciary and custodian of the funds [Laughter], but that's a losing battle. People are going the opposite way from that. That was going back. And as you also may be aware, I think that the treasurer was not well for at least a part of this time during my tenure.

[End Tape 1, Side A]

[Begin Tape 1, Side B]

MARSHALL: I think we made some good arguments about the fact that he was a fiduciary to the fund and, acting both as a fiduciary and then in the role of providing services to the fund, there were potential serious conflicts of interest there. And so I don't know which was the most telling argument [Laughter], but nevertheless, it worked.

HICKE: It worked, whatever.

MARSHALL: Now, what always seems to happen in life, at least to me, is what I call the law of the unintended consequences of your actions. As a result of having this new custodian, where both systems, both STRS and PERS, went out and hired national custodians--none of the California banks were either large enough or elected to apply for the job--but after the custodian was hired. . . . Most of the securities, the equity securities, were being held during the time Mr. Unruh was custodian at the Pacific Depository. The Pacific Depository is a part of the Pacific Stock Exchange. At that point the Pacific Depository had maybe 1 to 3 percent of the depository assets in the country, and 95 percent plus were held by the New York Depository, which is the main securities depository in New York. We suggested to our new custodian that . . .

HICKE: Who was?

MARSHALL: . . . who was Boston Safe, that politically they should at least consider using the Pacific Depository for all of the securities since this was a California fund. And after much soul searching, I think Boston Safe came to the conclusion that the Pacific Depository would not be able to give them the services nor the security that the New York Depository was able to give them. We communicated that decision to the Pacific Depository, and I don't think it was a half hour later [Laughter], or thirty minutes later, when we heard from the administrative and legislative people, I think. We heard both from representatives of the administration and representatives of the legislature, getting their unhappiness with the fact that we were going to move California assets out of Pacific Depository and, as the Pacific Depository said, result in a reduction of, I don't know, a hundred, four hundred jobs. You'd have to go back and look at press clippings or something like that.

We all agreed that we were going to have a meeting. We all sat around a table and Boston Safe explained, I thought very

succinctly, why they felt the New York Depository was the way they had to go or they had to recommend as a fiduciary to the fund. The arguments were not totally persuasive and there was some comment made about the fact that it would be necessary to have a legislative hearing on this and legislation was going to be introduced mandating that we would have to keep the securities in the Pacific Depository, and they were going to call all the brokers in California to discuss why this was a good idea.

So I said, "Well, that's fine with me. I think it's appropriate that we have a hearing, but I'm going to insist that we call all the banks in California, and then I'm going to ask them to explain why all the custodian assets that they currently hold for everyone else except the state of California are in the New York Depository." End of necessity to have a hearing, [Laughter] and I don't think everyone was happy with the result. I mean, everyone went away happy, but I just say this as an illustration of how politics--I think for good reasons; I'm not complaining about this--but how politics tends to enter into the administration and management of these very large funds.

HICKE: But you're also saying that even people with a political viewpoint can understand the necessities of life when it comes to managing a fund like that. Or am I jumping to a conclusion?

MARSHALL: I would say you're jumping to a conclusion there. I would say that the politicians feel, and I think legitimately, that they represent their constituents. And they would rather have a short-term benefit--that is keeping four hundred jobs or maybe expanding the number of jobs--than an unknown and unquantifiable, in those cases, future benefit to really the taxpayers of California; because if we were right that the New York Depository was going to be more cost-effective and more secure, then the people who would really benefit would be the taxpayers who ultimately would have to pay less in taxes in order to provide the benefits to the beneficiaries of this fund.

- HICKE:** I see.
- MARSHALL:** And to a certain extent the beneficiaries who would have a larger and therefore more secure fund to pay their benefits. But, since this is a defined benefit plan, the people who are really on the hook if anything goes wrong are the taxpayers of the state of California.
- HICKE:** Why is that?
- MARSHALL:** Because a defined benefit pension plan says that based on your years of service and your final average pay, whatever the agreements are, the state is obligated to pay you X dollars of pensions for the rest of your life. So if not enough money is put aside or not enough money is earned on the monies that are put aside to pay those benefits, future taxpayers in California are going to have to come up with additional money to make that up, because it doesn't say that we'll pay you only if there's money there to pay you. It says, "We will pay you," and then it's up to the state to get the money somehow. And the only way the state can get the money is to earn it on the funds put aside or raise taxes when they fall behind what they need.
- HICKE:** In this case the state acts as employer?
- MARSHALL:** The state is the employer for about--once again, you could check with Basil on this--the state is the direct employer for about 30 percent or more of the funds. The other, in the Public Employees Retirement System, various other entities, other public agencies . . .
- HICKE:** Like the University of California, for instance?
- MARSHALL:** The University of California has its own fund for most of it, but some of the employees of the University of California are in the Public Employees Retirement System. Once again, Basil can tell you much more about who the people are, but basically in the public employees, it's the things like the workers of like CalTrans [California Department of Transportation], the CSEA--California State Employees Association--people who belong to

that are covered by the plan. So all the engineers at CalTrans or the secretaries at any of the state offices or agencies of the state, many of the janitors and bus drivers, all of the nonteaching employees of the public school systems are covered by PERS. The teachers, most of the teachers, are covered by STRS, State Teachers.

Then, in addition to that, any county that is not one of the thirty-seven Act counties which are allowed to have their own pension funds, all of the counties are part of the Public Employees Retirement System. And as I say, I think that's the rest of them: the state directly is about a third, and the others are about two-thirds, other agencies that participate in this pooled pension plan.

HICKE: And this joint committee of the legislature has oversight responsibility?

MARSHALL: That's correct. I don't know if you know how the board works. The board is the one who really runs the pension fund, the board of administration.

HICKE: The board of administration of the pension fund.

MARSHALL: Right, of the pension fund. And the members of that board are a group of them--I want to say six--elected from the participants, from the members of the plan. Some of them are elected at large by all the members. Some of them are elected only by certain categories of members; like the retired members have their own representative on the board and the. . . . What's another group? Well, in any event, as I say, I think there are six of those. Then there are seven that are either appointed by the legislature or the administration or served by virtue of the offices that they hold: the treasurer, the controller, the Department of Personnel Administration, something like that. All of those are what we call ex-officio, so whoever is in that office is a member of the board. As I say, I think there are thirteen board members now, and they are the people who technically on it control the

policy of the fund. They select the people like myself or the executive officer and have oversight and those things.

HICKE: Do you want to take a break?

MARSHALL: Yes, I'll take a break for a second.

[Interruption]

MARSHALL: Before I talk really about the people and the politics involved, I'm going to go over the corporate governance program, because that was one of the other major programs that we started when I was there. The fund was already very much involved, because Jesse Unruh and--I've forgotten the fellow's name in New York--one of the politicians in New York and some other people had founded something called the Council of Institutional Investors.

The Council of Institutional Investors was, as I understand it, founded when Jesse Unruh noticed or was informed that one of the corporations in which we held a large position had paid a substantial amount of money to what has come to be known as a greenmailer, that is, someone who buys a stake in the company and makes himself obnoxious enough to management or management wants to get rid of them so they don't take over the company or take it away from management. They [management] take, in effect, corporate assets, therefore the shareholders' assets, and pay the greenmailer a price above the market and don't make that price available to all the other shareholders at the same time. So there was some particularly egregious greenmail episode which led Jesse to found the Council of Institutional Investors.

I suppose I really started the internal corporate governance program. And I felt that many things were happening in the corporate sector and in the private sector that were of concern to shareholders, and increasingly the managements of American corporations, for some good reasons and some bad reasons, were taking steps that I thought were very detrimental to the

shareholders in trying to combat some of these things, mainly the hostile takeover movement that started.

However, my experience with corporate governance goes back to my days at Deere and Company, where in the course of managing the money internally, we had decided we were going to hire a different custodian than we had had before. Once we hired this new custodian, I assumed this new custodian would take on all the chores that the prior custodian had handled for me or for the monies that were managed internally, one of which was voting the proxies. The new custodian said, "Sorry, we don't consider that our job. That's your job." [Laughter]

This was back in the late seventies, and I thought, "Well, the last thing I want to do is sit around and read proxies and vote them; so we'll just have a policy that we'll vote with management, and if we don't like management, we'll sell the stock." It was the old theory of vote with your feet. And then, of course, I didn't even want to do that; so I told my secretary if proxies came in vote with management on everything, just to make a copy of it, put it in the file, and send it off. And I forgot about it.

Well, several years later a question came up as to how we had voted on a particular proxy issue with our pension board at Deere, and I said, "Well, I'm pretty sure we voted with management, whatever that was. But," I said, "I'll go back and check, because we keep all of our proxies." So I went in there, and I found out that we had voted for the proposal, but it was a proposal sponsored by a dissident shareholder, so management had wanted us to vote against it. So I went to my then secretary, and I said, "How are you voting the proxies?" And she said, "Well, when I took this job over from Joni [], Joni said we vote *for* everything. So, in the translation, we had just been voting yes, which is much easier than voting with management, because when you vote with management you had to at least figure out what management wanted you to do; I mean you just checked off

- MARSHALL: the box for those. [Laughter] So we'd been voting for every kooky proposal that was in there.
- HICKE: Oh, my word.
- MARSHALL: So anyway, at that point I decided well, we have to do something. We have to do something rational about this. So we developed a corporate proxy voting policy at Deere and Company, and the first thing that did was get me in trouble with the Deere management, because I decided that if I was going to have to do this, I would do it in the way in which I thought would be in the best interests of the shareholders. And as I went through the issues that normally come up, one of the issues that comes up which seems innocuous enough is the corporation asks you to vote for an increase in the number of shares outstanding of the company, and that's a legal limit, and the shareholders have to approve of it if it's going to be increased.
- HICKE: Doesn't that dilute the shares?
- MARSHALL: Well, not if they just split the stock. You just get two shares for every one share, which is interestingly enough what they want to do. I mean, they typically when they want large increases in the shares outstanding, they want to split the stock, because there used to be this theory, which I don't find any rationale for, that you wanted to keep your stock price under fifty dollars a share or something to make it accessible to individual investors. This goes back to the time when there was something called an odd-lot differential where you had to pay more if you bought less than a hundred shares than if you bought in hundred share lots. [Inaudible] well that didn't disappear.

But this practice continued, so the first thing that happened was I said, "It doesn't make any economic sense for the pension fund, because we just get two pieces of paper instead of one piece of paper, and because of the way the brokerage people want to run their business, we have to pay two commissions instead of one commission to buy the same amount of dollars."

So I said, "That's not in my interest, so I'm voting against it."
 [Laughter] Which I found out was something ultimately that the board was going to want to go to our shareholders on our board, the Deere board, and ask the shareholders to vote in favor of.

HICKE: I see.

MARSHALL: So you find that when you get involved there are always going to be conflicts, and I think Mr. Unruh found that out when he found it was easier to take on managements of companies that were outside of California than it was to take on managements of companies that were inside California.

So, once again, before you do something, you want to think a few steps ahead and figure out what it's going to get you into. In my case it seemed to me that it didn't matter, that it was clear to me that I was a fiduciary for the pension fund, and that under ERISA in the private sector as a fiduciary, the only thing that I could consider was the sole interest of the beneficiaries and the exclusive purpose of paying those pension benefits, and it didn't matter if my corporate management who hired me and paid my salary wanted me to do something else. [Laughter] Which always gets one into trouble, as it does everywhere.

HICKE: So you have conflicting responsibilities.

MARSHALL: Yes. I felt that I had a clear responsibility as a fiduciary to the fund, you know, I felt one way. Managements obviously have other responsibilities than simply the pension fund, and therefore they may feel they should vote differently. And I don't know if you remember that we talked earlier about the fact that the politicians feel that they have obligations to keep jobs in California, invest in California--which is where the whole idea of in-state investing comes from, sometimes called economic targeting--and so they are really wearing two hats, whereas it was clear to me I was only wearing one hat.

Another name that may come up, [Controller] Gray Davis and I had an interesting discussion one time. Gray's interest was

why we didn't invest more in California, because these were California assets. I mean that's a reasonable question to ask. My answer to that was what I call my drought and rubble argument, and that is it is good policy for pension funds, particularly defined benefit kinds of funds that were going to have to pay benefits, not to invest in entities that have the same economic exposure that they do. For example, this goes back to the early days of General Motors in the fifties, when General Motors set up its pension fund. The company made a decision that it would not own General Motors [Corporation] stock in its pension fund, because it felt that its employees were already exposed enough to the automotive industry and General Motors and therefore shouldn't be exposed in their pension fund. I think that's a very good idea here.

Similarly, I said that if you look into the future, the problems in California could be drought or rubble, that is rubble is earthquake and drought is a drought, which we've got right now. And if we had either or both of those in an extreme case, the economy of the state would be hurt, and if all its pension funds were invested in the state of California, the pension funds would be drastically affected lower--we would lose money in the pension funds--at the same time that the state was least able to make contributions. And therefore, from the economic perspective of diversifying our risk, the pension fund should be invested predominantly outside of California rather than inside California.

Mr. Davis told me that that was not an argument that sold well on the [Inaudible]. [Laughter] And I believe him.

HICKE: Yes, I'm sure that's probably right. So how did you resolve that? Or did you?

MARSHALL: We haven't resolved that, and there's an interesting law here that says. . . . There's a law--I can't think of the name of it now--that says we're supposed to invest 25 percent of our cash flow in

California residential mortgages, I think. And Basil will know what that law is, because we have to answer to that law every year. The nice thing about the California constitution is that the constitution overrides any law, so that you can say, "Well, yes, that is the law, but the law specifically says, 'unless it's clearly prudent to do something else.'" And so if you can say, "But it was clearly prudent that we not invest 25 percent of our cash flow into California real estate or residential mortgages or whatever it was," then we are not obligated to follow that particular law.

And that brings up the whole issue of South Africa probably. The staff and the board of PERS, and I think STRS also, opposed the South Africa legislation on the grounds that to the extent that the fund was limited in any way from investing in recognized securities or valuable securities, the total potential return to the fund was going to be limited, and therefore the fact that the legislators were putting a restriction on the fund in terms of not owning companies that operate in South Africa, they were potentially hurting the long-term return of the fund. We lost that argument.

By the way, I think very highly of [Assemblywoman] Maxine Waters. I don't agree with her on that, but she's certainly a delightful woman and a very dynamic legislator. But I disagree with her on this point.

HICKE: And you lost on that, you said.

MARSHALL: We lost on that, and I think we lost in an interesting way. We said as fiduciaries we wouldn't be able to do it, and in the law we are in fact indemnified, so that if as a fiduciary someone--not clear who, a taxpayer or a beneficiary--wanted to sue the board or any of the fiduciaries on the staff because they invested in or they didn't invest in companies that were operating in South Africa, and those companies did much better than the companies that we did invest in, the legislation also indemnifies everyone from any legal exposure for that. Maxine's law.

HICKE: So you were protected if you didn't do it?

MARSHALL: No, we were protected if we obeyed the law, and as a result demonstrably lost money or didn't get the return that we could have gotten for the fund.

HICKE: I see.

MARSHALL: It's an interesting question, because the people who really have to pay for this fund are the taxpayers of the state of California, the personal and the corporate taxpayers. That's where this money comes from. There's no other place for it to come from. And so you can make the argument that legislators or the administration, who are elected by the taxpayers or people of California, should have the right to determine that. It's not clear to me that in the way the bills were sold or the way in which the legislation was passed that people were willing to step up front and say, "We're doing this even if it's going to cost us money, and therefore we'll have to raise taxes in order to make this statement." I also felt that it was unfortunate to single out the pension funds. That is, it didn't seem to me to make any sense to prohibit us from buying IBM [International Business Machines Corporation] securities and yet have the state buy IBM computers.

HICKE: Good point.

MARSHALL: So for all those reasons, I was on the losing side of that particular battle.

However, getting back to the corporate governance, I decided we ought to have a policy. I decided that we would gradually escalate that policy to the extent that we didn't get a response. So in the first year we simply voted proxies. We looked at the proxies very carefully; we voted against anything that we thought might reduce shareholder controls: staggered boards, super majorities, poison pills, the whole list of them. The second year, having not gotten much response to that particular activity . . .

HICKE: From the corporations, you mean?

MARSHALL: From the corporations, right. From the corporations. The next year, our next step was to actually propose some proxies. So we got into the whole business of getting proxy materials onto the corporate agenda. And then finally we stepped it up to solicit on behalf of our proxy provisions that we were introducing on these in the elections, and finally we attempted in some cases to go into court to, number one, find out how certain people had voted; that is, to try to ascertain whether the count had been fair when the final vote was very close, when we lost by less than 1 percent and we thought that the votes might have been miscounted. We tried to go into court to get some what we thought were excessive fees overturned. And we tried to go into court to prevent some things, some greenmail.

We were unsuccessful in all of those in any court in this land in getting anything done, mainly because you have to go into the courts in Delaware for most of the major corporations, and the courts in Delaware are simply not sympathetic to shareholder rights.

HICKE: That's probably why the corporations are there. How about golden parachutes?

MARSHALL: Well, I have opposed golden parachutes. I think that corporate managements are paid enough, if not too much--and by the way I think investment managers are paid too much, too--but relative to the work they do compared to other work done in society. But that's my personal opinion; people get paid what they're paid.

HICKE: The marketplace.

MARSHALL: Yes. But I thought managements were paid sufficiently so that they could make a rational decision about a takeover of a company without having. . . . They argued that they needed these golden parachutes so that they could dispassionately view an offer for the company, because they would themselves be protected. Well, that's ludicrous. And then it became worse

than that; it became, after that, that they could in effect take the companies over themselves, as Ross Johnson at RJR [Nabisco] tried to do, and still pay themselves these enormous golden parachutes. So in effect, they were putting in golden parachutes and they were in effect pulling the trigger on when they wanted them to pay off, and then on top of that they stayed in place. It was ludicrous. It's incredible what went on.

We opposed all of those. The whole takeover issue was an interesting area, because we were not comfortable--and I'm still not comfortable--in a blanket sort of way supporting raiders, some of whom I think are really chop chop artists that just want to chop up the company and dismantle it with whatever. Some of them were completely incapable of running companies. And on the other hand, I'm also very uncomfortable entrenching current management to the point where you can never get rid of them. And that's, in some cases, where we've gotten to today.

So corporate governance was a very important issue and became an increasingly important one as I was there, and that program has continued if not accelerated since I've left. I would like to make the point, as I started off in the beginning of this, by saying that some people would say, "Well, you just came to this religion when you arrived at the state pension fund." In fact, I didn't. In fact, I felt the same way or I felt mostly the same way when I was at Deere and Company as I felt here, and that is that all decisions had to be made as a fiduciary on behalf of the beneficiaries and not for targeting economically in the state or any other private corporate purposes, nor for political reasons--South Africa, baby formula, or anything like that--or for any other noneconomic, non-tied to the benefits of the shareholder.

HICKE: But how do you maintain that position? There must be enormous pressure on all sides to give in here, a little there.

MARSHALL: Yes, just everybody gets mad at you. It's easy. And you just sort of reconcile yourself, and you try to. . . . What you try to do is

you try, and not always successfully, to remain unemotional about this, that is not to take sides, to just try to . . .

[End Tape 1, Side B]

[Begin Tape 2, Side A]

HICKE: You try to establish a rational. . .

MARSHALL: Yes, you try to take a rational position and a defensible position--not always easy, because many of these areas are not black and white; they're gray--but you try to take a position that you think fairly represents the fiduciaries' point of view, and then you try not to get emotionally involved in it, and you try to keep talking all the time to try to find what is the common ground that is acceptable to everyone and yet still represents a prudent position with respect to the funds. And as I say, you accept the fact that everybody's going to be mad at you some of the time.

HICKE: So communication and negotiation skills are important for this job?

MARSHALL: Yes, and I guess that's the one thing I would say about when I came here; I came here with almost my entire career spent in the private sector with very little experience--in fact no experience--dealing directly with a legislature and very little experience dealing with public boards, that is with nonprofessional boards. Number one, I would not have been able to do my job without incredible help and assistance and encouragement and everything from the staff, and in particular Sid McCausland and Basil Schwan.

And I think it takes a period of time. It takes a period of time anywhere; it doesn't matter where you are. It takes a period of time in any job that you're in to first of all figure out how things work, and you can either get a fast start on that if people are helping you or people can make it almost impossible for you to do your job if they don't help you, because this organization is too large for one person to run.

Secondly, it involves building a rapport with all the disparate groups of people that you have to deal with. The day I flew into Sacramento, which was sort of late May or early June, the headline in the paper as I landed said, "Pension War Erupts." And for the next year or two there was sort of all-out warfare between various factions both in the legislature and various factions on the board about who was going to be executive officer, very little of it having really to do with the investments. But with all this going on about who is going to be in charge, who is going to control, [Laughter] it was a wonderful experience.

But it takes a period of time, and therefore I think a person really should be in this job at least five years, because by the end of three years I had gotten to the point where I knew most of the players and where I had been consistent enough, at least with some of them, that they would say to me, "If you need help on something, give me a call."

And so there are good people in there. They want this system to work. They will help you. But on day one, if you haven't been here before, you walk in here and not to mention that everyone's got their guns out and they're blazing, but you don't know who anybody is and, you know, whatever. It's a difficult job; it's a fun job. It's a very interesting job from that point of view. And as I say, people can make it easier for you or they can make it tougher for you; and it's a tough enough job, I think. I think most things in life are tough enough without people making it tougher for you by being difficult. So communications are extraordinarily important.

That's a nice lead-in to what I really wanted to talk about: the political involvement in these funds. I don't want to just make it political in the bad sense of the word. For reasons that I don't completely understand, because I keep going around and telling everybody how hard this job is, everybody loves to be involved in investments. It's nothing to do with the public sector.

MARSHALL: At Deere and Company, we'd have an opening in the investment office, and we would get hundreds of resumes from all over the company and outside.

It's fun in the sense that you're so much caught up in everything that's going on. The investment area gets involved in everything in the political arena and the economic arena and around the world. The people who are involved with this frequently become very visible, particularly this large fund. That has both political benefits and sort of psychic benefits, I guess, if you like that kind of thing. There are enormous fringe benefits in the sense that you have all of the top economists and people from every brokerage house and bank and insurance company and everybody else wanting to do business with you, and therefore wanting to entertain you and put on seminars for you and all that other sort of thing. So there are enormous what I call fringe benefits to this.

And I suppose also there's the issue of the potentially enormous campaign or political contributions that can arise out of this kind of activity, because the financial industry has been so profitable in the last years, money just floats around here that is unbelievable; and therefore, it makes it very attractive in terms of fund raising.

All of those issues I think raise serious conflicts of interest. My preference would be to not accept any gifts, travel and entertainment, honoraria whatsoever. The reality is. . . . And in fact that's what we did at Deere and Company; when people came and visited us, we took them to lunch in the corporate dining room, and the corporation paid for it. We could have lunch with people, but we couldn't accept any gifts more than twenty-five dollars or any kind of entertainment more than twenty-five dollars' worth.

And if the legislature is now going to talk \$250, that's with inflation, that's probably a little bit high, but somewhere within

MARSHALL: that. Somewhere within that, people can take you to dinner and a show in New York for \$150 now maybe, and if you're in Tokyo, it's more. It seems to me anything more than that is asking for the potential if not the actual conflict of interest, the appearances of conflict. So I think one of the issues that the pension funds should deal with and maybe now will deal with in conjunction with the new focus on political ethics or the legislative ethics--would-be ethics--for the pension funds.

HICKE: Can the people in the fund establish that themselves or is that up to the legislature to mandate?

MARSHALL: The board could adopt a code if they wanted to. There are certain existing state codes that you have to comply with, but most of those are if you announce it, if you tell everybody about it, whatever you can get is fine. According to fair political practices, you have to fill out statements; you have to, say, fill out your ownership of securities and things.

But there are, unfortunately, political conflicts. It was well known that many of the political members of the board were accepting honoraria, two thousand, five thousand, ten thousand [dollars] for a breakfast from investment managers and brokerage firms. And then if an issue came before the board as to whether they would be hired or continued or terminated, in my opinion that was a conflict of interest, and those people should not have been voting on those issues. And I think those are issues that are going to have to be dealt with.

HICKE: Could you elaborate a little bit on the connection with the campaign financing? Who would that influence? Members of the board or persons on the staff or the legislature that has oversight?

MARSHALL: The staff really doesn't get involved in that. Typically all that happens to the staff is that they get taken out to lunch or dinner, or they get taken to a show in New York, or they go to a seminar and they get maybe a golf game or something like that. What

you would not want to see with your staff--and I think that the current regulations that we have should cover this, although monitoring it is not easy--is you don't want the staff, for example, buying securities in advance of the fund. For example, if someone knew that we were going to buy a particular stock, we should be monitoring, and probably are not in the way that most brokerage firms do, the brokerage accounts of all fiduciaries. And we should be. That's how staff would get involved.

You certainly don't want staff investing in a joint venture with one of the hired advisors for the fund. I think that's a conflict of interest. So you don't want staff getting benefits or even opportunities to invest as a result of their position that they wouldn't have otherwise, because I consider that using a public position for, number one, their own advantage, and number two, introducing a potential serious conflict of interest in dealing with that particular service provider or contractor.

The people who would tend to get the political contributions would obviously be the people who run for political office, and so there you're talking about the statewide offices or anybody else that It's even possible. . . . I don't see and didn't see what kind of contributions, for example, say Lou Papan might have gotten for his campaign as a result of any dealings that he had with the pension fund. I'm assuming there were none, but . . .

HICKE: So what we're talking about is some corporation that the pension fund has bought stocks of donating funds to a legislator's campaign fund who then has some oversight responsibilities for the pension fund?

MARSHALL: Or somebody who wants to be an investment manager for the pension fund making campaign contributions. A bank that wants to be a custodian for the fund making campaign contributions. And sometimes they don't even volunteer them. Sometimes they are asked for them. [Laughter]

- HICKE: Oh, yes.
- MARSHALL: And you know, there are all those potentials for conflicts that I'm not sure that we have adequately dealt with yet in relationship to the pension fund. And the pension fund is very large.
- HICKE: OK. Thanks for spelling that out a little bit.
- MARSHALL: I guess maybe that's about all that I have kind of thought up in my mind to say about this.
- HICKE: Does the fund as it's managed have an impact on the financial market?
- MARSHALL: Oh, good. Yes, that's one more thing I wanted to mention that you had asked me about and I didn't mention. It can have, first of all, because of its size. To illustrate that, when we were first looking at the initial South Africa legislation, we asked our custodian to take our list of securities. And what we did was we said, "There are roughly five or six thousand securities that the fund could invest in"--this is just the equity market--"if you wanted to." And then we said, "Eliminate all the ones that operate in South Africa, and eliminate all the ones that have less than \$50 million in market caps outstanding, because we can't buy enough of those to make it worthwhile. What percent of those securities would we have to own as the fund was getting larger and as we were going forward, owning parts of the fund?"
- And it was onerous. We would be owning close to 5 percent of the total value of those funds, and since many of the stocks are closely held, we would represent something like somewhere over 30 or 40 percent of the trading volume in those securities. So that's one reason why these funds need as broad a mandate as possible so they can invest as broadly as possible so they do not impact the market.
- Even a small fund like Deere and Company. One day in I think it's July we were investing our annual contribution one time, and I was horrified to find that this fund, which was probably a \$2 billion fund, on this one day--July and August are

normally light days in the market; there's a lot of people on vacation--we were over 2 percent of the total volume on the New York Stock Exchange that day, just Deere and Company with a \$2 billion fund investing a small portion of that fund. So that can give you some idea of the impact that these funds can have and do have on the markets.

And yes, they are very large, and what that generally means is you have to do things when other people are not doing them. That is, you can't want to buy stocks on the same day that everybody else wants to buy the stocks, so you have to, as we did We were selling stocks all through the early part of '87 and had raised \$3 billion by October 19. The market dropped 25 percent. There were very few people who were willing to step up and buy. We had our buy orders in there; we went in and bought on that day. So we were providing liquidity to the market. And that's the kind of thing you want to do, because that's when you can get the really attractive bargains in the marketplace.

HICKE:

That's very foresighted.

MARSHALL:

Well, yes, except I consider this a very disciplined process, and I had some rules. I said, "We want to be"--which was the policy adopted by the board, which I'll give you--we wanted to be 60 percent in equities and 40 percent in fixed income, and that was our ultimate, long-term policy. By virtue of our selling, we were still at the higher end of that bend where we wanted to be in equities on both going into the third quarter, into September. But when the market dropped 25 percent, I knew that that took us to the lower end of the bend, and I said, "We say when we're at the lower end of the bend we're going to buy."

I didn't know that the market wasn't going to go lower. I mean everybody thought the next day it was going to fall off another cliff or something. I don't know that. I don't know when markets are going to go up or down. But I know that when we're getting above where we want to be exposed we start selling, and

then once you have a significant drop in the market, you know that you're underexposed and you want to buy. Over the long term that would be of enormous benefit to the fund, and I guess sort of in ending this, I would talk about the impact that something like that can have.

What the actuaries say is that for every 1 percent that you can improve the rate of return on the fund, that is long-term expected return on the fund--I think now it's supposed to be 8 or 9 percent. If instead of 9 percent per year compounded, we actually were able to get 10 percent, that would result in a 20 to 25 percent reduction in the annual cost of pensions to the state. That 1 percent compounded every year on the total amount of the assets adds a significant impact on the contributions that the government has to make.

And those contributions are now very large. You should ask Basil for exactly what they are, but you can imagine that the budget of the state of California is what now, about the same as the pension fund, about \$50 billion, I think, is the total budget. In any kind of a service organization or a government, about 50 percent of that is in payroll cost. So about \$25 billion of that is probably something like payroll, \$20 or \$25 billion. The typical pension cost is somewhere between 10 and 20 percent of payroll, so the typical pension, the pension cost for the whole state of California, is 20 percent of whatever number I came up with, about \$25 billion. So that's maybe \$400 million or something like that. So the pension costs are very large. Anyway, Basil can give you the actual numbers of what they are. Obviously, 20 percent of \$400 million is a lot of money.

And then that's money that can be, if it doesn't have to go in the pension fund, can be spent on infrastructure, on roads or bridges, or on libraries or on salaries or whatever you want to spend it on. On the other hand, if it has to go in the pension fund and there's been a court case that the state has to put money in

- MARSHALL: the pension fund regardless of what happens to its revenues, then if they have to put more money in than they expected, that means that there's less money available for anything else in the state. Or higher taxes.
- HICKE: OK. Well, if you just have a couple more minutes, there's one thing we didn't get to, and that was you installed this high technology data base system.
- MARSHALL: Yes, I didn't go into that in great detail, because I thought it would be covered in the documents that I was going to give you.
- HICKE: OK. Well, maybe you could just tell me a little bit about getting approval for that and some of the people who . . .
- MARSHALL: Well, it was interesting. When I came out here I said that that was needed. They sent me all the documentation in the interview process; I said that was what was needed. I was told that there was five hundred thousand dollars or half a million dollars in the budget for that. When I got here, it had disappeared.
- HICKE: Oh, my.
- MARSHALL: And so what we did, which is acceptable practice and a number of other people would do, we used what are called soft dollars, that is commissions that are higher than they would absolutely have to be--say they were five or six cents instead of maybe we could get them down to three or four--that difference then brokers will buy these things for you that you need. That is the broker will say, "This is what's called a soft dollar." So we used soft dollars to buy both the hardware and the software. This system cost about a million dollars to install, hardware and software.
- HICKE: What did you get?
- MARSHALL: We got a large computer. It happens to be DEC, a Digital Equipment Computer. I can't remember the model number right now, but a large mini-computer actually, not a mainframe, not the biggest one, and custom designed software to run on that

system. In addition to the investment system, there's also office automation on there, so now all the people in the office are linked on E-Mail and calendaring and scheduling and that sort of stuff.

HICKE: Word processing.

MARSHALL: Yes, word processing.

HICKE: How long did that take to . . .

MARSHALL: Oh, you don't want to know.

HICKE: I don't want to bring up those bad things. [Laughter]

MARSHALL: Everybody told me that it was amazing that I got things done as quickly as I could, but I always thought things were taking far too much time or far longer than I expected that they would. But from the time we identified the system and got it all in place, I'm sure it was a year. It was a year of just pure hell trying to pull everything together.

HICKE: What was used before this system?

MARSHALL: Well, independent little computers in different places or in some cases 3 x 5 file cards in the vault of the treasury over there to keep records on some security.

HICKE: Well, that explains a little bit of the problem. OK, well, let me just ask you what you see for the future in the PERS?

MARSHALL: Well, obviously the funds can only get larger. And one thing that, of course, had nothing to do with my tenure there but which the funds will have to address in the future are the unfunded health benefits that have been promised to retirees. This is true also in the private sector. Those health costs, as everybody knows, have been escalating very rapidly, and they're probably of the same order as the pensions that we owe, and there's no money put aside to pay those future benefits. So I think in the future the funds can only grow as the fund approaches 100 percent funding--it's slightly underfunded now--and as I'm sure some movement will be made to address the funding of those

health benefits. So the funds will get larger; of course the markets will get larger.

The funds have expanded. One of the other things that we did that I haven't talked about here but will show up in some of the documents: we put in a program to expand international, and that's now being funded, so that the funds can now invest in other markets around the world, and so they're expanding their universe that they can invest in. While the basic structure or process for making decisions is in place, those decisions need to be revisited every year or every few years to make sure that the policy is still appropriate, that you still want the same mix of equity ownership and fixed ownership. Within equity it's not only stocks, it's equity real estate. And within fixed it's not only bonds, it's mortgages and that kind of thing.

The funds can only become more involved in the political ends of this as the funds become larger and as the claims of these funds on the state budget are already large and maybe get larger. As the issues about corporate governance heat up and the conflicting claims of both state-owned and licensed companies versus companies outside of the state and increasingly globally impact or try to impact on the decision that are made.

So I think there are going to be a lot of challenges and opportunities ahead for this fund, and it has some very good and very talented people working for them, so I'm sure they will do well.

HICKE: And you left to form your own company?

MARSHALL: I left to form my own company, yes. [Laughter] I thought that was going to be easier. I'm not sure that it isn't harder, but it's also been both a challenge and a great deal of fun.

HICKE: Well, I'd like to thank you so much for your participation in the oral history program. You've added a lot.

MARSHALL: Well, I enjoyed it.

HICKE: Thank you.

[End Tape 2, Side A]