



Harry Markham's Loyalty Dilemma (A)

John Minahan, Cate Reavis

In early 2012, as he prepared to enter a meeting with the board of trustees of a state pension fund, Harry Markham,¹ CFA, couldn't help but feel professionally conflicted. Since earning his Master of Finance in 2004 at one of the top business schools in the United States, Markham had worked for Investment Consulting Associates (ICA), a firm that gave investment advice to pension funds. Since joining the firm, Markham had grown increasingly concerned over how public sector pension fund liabilities were being valued. If he valued the liabilities using the valuation and financial analysis principles he learned in his Master of Finance and CFA programs, he would get numbers almost twice as high as those reported by the funds. This wouldn't be such a problem if he were allowed to make adjustments to the official numbers, but neither his clients nor his firm were interested in questioning them. The board didn't want to hear that the fund's liabilities were much larger than the number being captured by the Government Accounting Standards Board (GASB) rules and his firm wanted to keep the board of trustees happy. How, Markham wondered, was he supposed to give sound investment advice to state treasurers and boards of trustees working from financials that he knew were grossly misleading?

Markham's dilemma came down to conflicting loyalties: loyalty to his firm, loyalty to the boards of trustees and others who made investment decisions for public pensions and who, by turn, hired his firm to provide investment expertise, and loyalty to the pensioners themselves, as Markham believed was called for by the CFA Code of Ethics and Standards of Professional Conduct.

¹ This case is based on actual events; however, the protagonist, the firm, and some of the narrative is fictional.

This case was prepared by Cate Reavis, Associate Director, Curriculum Development, under the supervision of Senior Lecturer John Minahan.

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Public Pensions

Like their private sector counterparts, public sector pensions provided retirement income and benefits for public sector employees. While the goal was the same, the way in which the two sectors reached that goal was often quite different. The private sector increasingly relied on defined contribution plans (e.g., 401Ks) whereby the employee decided where and how much money to invest in a retirement account. In a defined contribution plan, the employee bore all responsibility. (See **Figure 1**.)

In contrast, nearly 80% of state and local government workers had defined benefit pension plans.² In a defined benefit plan, an employer commits to paying its employee a specific benefit for life upon their retirement. The amount of the predetermined benefit was usually based on factors such as age, earnings, and years of service. Actuaries determined the contributions by using statistical analysis to calculate the costs of future risks.³ Under a defined benefit plan, employers bore the financial risk. When payouts fell short, say, for example, if funds' return on investments failed to meet expectations as they did during the financial crisis of 2008, governments would be forced to dip into other areas of the budget and/or raise taxes to fill the gap.

Figure 1 Traditional Defined Benefit Plan and Traditional Defined Contribution Plan

Strategic Considerations	Defined Benefit Plan	Defined Contribution Plan
Employee retention	Attracts longer tenured/older employees	Attracts shorter tenured/younger employees
Financial liabilities	Placed on the corporate sponsor	Placed on the participant
Responsibility placed on employee	Very little	Significant--voluntary contributions, necessary investment decisions
Responsibility placed on employer	Significant--investment decisions, financial liability	Less significant
Employer fiduciary responsibility	Significant	Significant
Investment results	Average returns are higher/narrower distribution of returns	Average returns are lower/broader distribution of returns

² <http://www.bls.gov/ncs/ebs/benefits/2010/ownership/govt/table03a.htm>

³ "What is a defined benefit pension plan?" *New York Life*, November 16, 2010.

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Economic savings	Significantly increases savings rate and the available pool of national savings	Less significantly increases savings rate and the available pool of national savings
Personal retirement savings	Maximizes savings for retirement	Allows withdrawals and loans before retirement, depleting retirement savings
Fees	Lower overall fees	Higher overall fees
Administrative complexity	Generally high	Generally high
Portability	Not typical	Yes

Source: Stephen P. McCourt, "Defined Benefit and Defined Contribution Plans: A History, Market Overview and Comparative Analysis," *Benefits & Compensation Digest*, February 2006.

Diverging Views on Liabilities

In their 2009 article, "The Liabilities and Risks of State-Sponsored Pension Plans," Joshua Rauh of Northwestern's Kellogg School of Management and Robert Novy-Marx of the University of Chicago, had some sobering words for the future of public pensions. While it was well known that public pension funds were facing a funding crisis, Rauh and Novy-Marx believed the problem was much worse than what was being reported in government financial statements. It was their view that state pension funds were underfunded not by \$1.04 trillion, the official figure, but rather \$3.23 trillion (**Exhibit 1**).⁴

What accounted for the discrepancy? In valuing the liabilities of pensions, actuaries followed the rules set forth by the Government Accounting Standards Board (GASB), which called for discounting the cash flow of pension liabilities at the expected return on assets that had been set aside to fund the liabilities. With support from GASB, actuaries argued that, due to the long-term horizon of public pension funds, a discount rate of about 8% was appropriate, and that this rate was supported by investment return history.⁵ However, economists argued that it was inappropriate to discount liabilities at the expected return on assets — 8% was too high a discount rate not only because it reflected possibly over-optimistic expectations about future returns, but more importantly, because it was inappropriate to discount liabilities at the expected return on assets in the first place.⁶ The use of an 8% discount rate resulted in "nonsense valuations," economists argued, valuations that were nonetheless taken seriously by actuaries and plan sponsors.

⁴ Robert Novy-Marx and Joshua D. Rauh, "The Liabilities and Risks of State-Sponsored Pension Plans," *Journal of Economic Perspectives*, Fall 2009, p. 191-210.

⁵ Mark Miller, "How Big Is the Public Pension Funding Gap?" *Reuters Money*, March 16, 2011.

⁶ Lawrence N. Bader and Jeremy Gold, "Reinventing Pension Actuarial Science," *The Pension Forum*, Society of Actuaries, 2003.

In contrast, economists and financial analysts, like Rauh, Novy-Marx, and Harry Markham, did not take accounting at face value. According to Markham, “Some actuaries and plan sponsors act and speak as if accounting measures are unambiguous, unbiased measures of reality, or perhaps are reality itself. Economists and financial analysts have a term for this: accounting illusion.” Like Rauh and Novy Marx, Markham believed the discount rate should reflect the fact that public pensions were secure promises. In his view, a 3% to 4% rate was more appropriate. He explained:

If you knew for sure you were going to earn 8%, then it would be appropriate to discount the liabilities at 8%. But the highest rate you can earn with any degree of certainty is about 3% in the current environment, so this is the appropriate discount rate for a promise, which is intended to be low-risk. The plan sponsor may decide to invest in assets more risky than the liabilities in the hope of earning 8%, but so long as the pensions remain secure, employing a risky investment strategy to juice expected returns doesn't change the value of the pensions, or the appropriateness of a low-risk discount rate.

But Markham was well aware that this wasn't the mindset of a majority of those responsible for managing state pension funds or, for that matter, Investment Consulting Associates.

Markham's Dilemma

In his role as investment advisor, the differing views on how to value pension liabilities challenged Markham on both a practical and an ethical level. “My role is not to decide the value of liabilities,” he explained.

That's the actuary's job. My role is to give investment advice. But as an investment adviser, the first thing you want to understand is the client's circumstances. That's a basic ethical precept. The CFA professional standards say you should never give advice without knowing what your client's circumstances are. And so what happens is that we have these funds that are grossly short of money, but the accounting doesn't show them as being grossly short of money. I make the case within my firm that we need to know where we're starting before we give advice. And perhaps our advice would be different if the client knew they were starting from a multi-billion dollar hole that they're seemingly not aware of.

In addition to the fact that Markham was constrained by not having what he believed were accurate accounting figures to work with, he was also well aware that his clients didn't like bad news. He feared that if he was to raise the liability issue, he and his firm could very well be fired:

Most plan sponsors want to minimize near-term contributions to their pension fund, and this makes them predisposed to points of view that justify higher discount rates. Furthermore, investment committees and staffs consider their mandate to be to earn, at least, the discount rate assumed by actuaries. The social pressure to embrace overly optimistic return expectations can be

enormous. As one plan sponsor told me, 'It wouldn't be in plan members' interest to lower the discount rate because the increase in liabilities would so shock the taxpayers and the state legislature that it would undermine political support for the plan.' Given this context, plan sponsors don't want to hear the news that they are less well funded than the numbers show and may blame the messenger. And if it's an elected official you're dealing with, they don't want a crisis on their watch.

But an investment advisor has a professional responsibility to help plan sponsors make good investment decisions, and understanding one's financial condition is a necessary precursor to making sound investment decisions. This may require telling plan sponsors things they don't want to hear. If investment advisors don't do this, they become enablers of their clients' denial and of the poor decisions that result from that denial.

As a CFA charterholder, Markham annually attested to his compliance with the Code of Ethics and Standards of Professional Conduct (**Exhibit 2**). Specifically, CFAs must not knowingly make any misrepresentations in investment analysis recommendations. "So if you have an investment recommendation that's based on bad numbers," Markham began, "numbers that are legal and comply with the rules, but you know they're bad, are you violating this ethical rule?"

Risks and Loyalties

As Markham was summoned into the conference room to begin his presentation to the board of the state pension fund, he was wrestling with whether or not to raise the liability issue. He knew there were risks either way. There was the risk that his client would choose to take their business elsewhere if he told them what he believed to be the fund's financial reality. Furthermore, such a move would not only result in lost business, but would likely be interpreted as disloyalty towards his firm.

But then he thought about what didn't happen during the 2008 financial crisis, and this reality gnawed at him:

When the subprime crisis played out everybody was asking why, even though there were all these people that had a role in making it happen, no one spoke up? And so does somebody who is playing a bit part in creating a reprise of the last crisis have a responsibility to speak up on behalf of the pensioners themselves even though this is contrary to the wishes of their employer and the board of trustees who has hired their employer to provide investment advice?

Exhibit 1 State Pension Underfunding (as of 2008)

State Name (# of plans)	Pension Assets (in \$ billions)	Liabilities	
		As stated (in \$ billions)	Economist Estimates (in \$ billions)
Ohio (5)	115.6	190.9	332.5
Colorado (1)	29.3	55.6	105.4
Rhode Island (1)	6.0	12.4	27.1
Illinois (4)	65.7	151.1	284.8
Alabama (3)	22.3	41.0	78.8
Wisconsin (1)	62.2	82.9	153.3
South Dakota (1)	6.0	7.1	13.6
Missouri (3)	27.0	51.3	88.6
Mississippi (3)	15.1	29.3	51.8
Oregon (1)	46.1	56.6	90.4
New Mexico (2)	16.2	26.7	45.0
South Carolina (2)	21.8	39.7	68.4
Kentucky (3)	21.6	43.6	74.5
Oklahoma (4)	12.0	32.3	54.7
New Jersey (4)	60.5	123.4	204.8
Arizona (3)	25.0	40.6	85.1
Connecticut (3)	20.4	42.8	80.7
Texas (4)	125.3	179.0	313.5
Georgia (2)	53.7	75.2	137.3
New Hampshire (1)	4.4	7.8	14.2
Maine (1)	8.3	13.7	24.0
Nevada (1)	17.8	24.0	44.0
Minnesota (4)	36.2	57.9	109.9
California (3)	330.0	484.2	805.7
Montana (2)	5.9	8.6	15.4
Arkansas (3)	8.1	20.8	38.3
Louisiana (2)	17.7	35.7	61.4
Maryland (1)	27.8	50.2	88.2
Hawaii (1)	8.3	16.6	28.1
Pennsylvania (2)	70.9	104.1	190.5
Iowa (1)	18.1	24.5	42.3
Kansas (1)	10.3	20.1	36.0
Wyoming (4)	4.8	7.0	12.3
Alaska (2)	11.7	14.5	24.3
Idaho (1)	8.1	11.9	21.0
Utah (3)	18.6	20.4	38.5

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Indiana (2)	15.5	36.4	62.4
Florida (1)	97.2	124.1	213.7
Washington (7)	44.3	58.9	101.1
Virginia (1)	41.3	61.6	100.1
Michigan (4)	43.4	69.9	118.4
Massachusetts (2)	37.8	55.4	96.7
Tennessee (1)	25.8	34.7	58.1
West Virginia (2)	6.6	12.3	19.1
New York (3)	189.8	227.0	356.2
North Carolina (2)	59.1	68.7	117.0
Nebraska (2)	5.4	7.9	14.1
North Dakota (2)	2.9	3.6	6.7
Delaware (1)	6.2	6.9	12.0
Vermont (3)	2.4	3.8	6.7
Total (116)	1936.7	2975.1	5167.1

Source: Robert Novy-Marx and Joshua D. Rauh, "The Liabilities and Risks of State-Sponsored Pension Plans," *Journal of Economic Perspectives*, Fall 2009, p. 191-210.

Exhibit 2 CFA Code of Ethics and Standards of Professional Conduct

PREAMBLE

The CFA Institute Code of Ethics and Standards of Professional Conduct are fundamental to the values of CFA Institute and essential to achieving its mission to lead the investment profession globally by setting high standards of education, integrity, and professional excellence. High ethical standards are critical to maintaining the public's trust in financial markets and in the investment profession. Since their creation in the 1960s, the Code and Standards have promoted the integrity of CFA Institute members and served as a model for measuring the ethics of investment professionals globally, regardless of job function, cultural differences, or local laws and regulations. All CFA Institute members (including holders of the Chartered Financial Analyst® [CFA®] designation) and CFA candidates must abide by the Code and Standards and are encouraged to notify their employer of this responsibility. Violations may result in disciplinary sanctions by CFA Institute. Sanctions can include revocation of membership, revocation of candidacy in the CFA Program, and revocation of the right to use the CFA designation.

THE CODE OF ETHICS

Members of CFA Institute (including CFA charterholders) and candidates for the CFA designation ("Members and Candidates) must:

- Act with integrity, competence, diligence, respect, and in an ethical manner with the public, clients, prospective clients, employers, employees, colleagues in the investment profession and other participants in the global capital markets.
- Place the integrity of the investment profession and the interests of clients above their own personal interests.
- Use reasonable care and exercise independent professional judgment when conducting investment analysis, making investment recommendations, taking investment actions, and engaging in other professional activities.
- Practice and encourage others to practice in a professional and ethical manner that will reflect credit on themselves and the profession.
- Promote the integrity of and uphold the rules governing capital markets.
- Maintain and improve their professional competence and strive to maintain and improve the competence of other investment professionals.

STANDARDS OF PROFESSIONAL CONDUCT

I. PROFESSIONALISM

A. Knowledge of the Law. Members and Candidates must understand and comply with all applicable laws, rules, and regulations (including the CFA Institute Code of Ethics and Standards of Professional Conduct) of any government, regulatory organization, licensing agency, or professional association governing their professional activities. In the event of conflict, Members and Candidates must comply with the more strict law, rule, or regulation. Members and Candidates must not knowingly participate or assist in and must dissociate from any violation of such laws, rules, or regulations.

B. Independence and Objectivity. Members and Candidates must use reasonable care and judgment to achieve and maintain independence and objectivity in their professional activities. Members and Candidates must not offer, solicit, or accept any gift, benefit, compensation, or consideration that reasonably could be expected to compromise their own or another's independence and objectivity.

C. Misrepresentation. Members and Candidates must not knowingly make any misrepresentations relating to investment analysis, recommendations, actions, or other professional activities.

D. Misconduct. Members and Candidates must not engage in any professional conduct involving dishonesty, fraud, or deceit or commit any act that reflects adversely on their professional reputation, integrity, or competence.

II. INTEGRITY OF CAPITAL MARKETS

A. Material Nonpublic Information. Members and Candidates who possess material nonpublic information that could affect the value of an investment must not act or cause others to act on the information.

B. Market Manipulation. Members and Candidates must not engage in practices that distort prices or artificially inflate trading volume with the intent to mislead market participants.

III. DUTIES TO CLIENTS

A. Loyalty, Prudence, and Care. Members and Candidates have a duty of loyalty to their clients and must act with reasonable care and exercise prudent judgment. Members and Candidates must act for the benefit of their clients and place their clients' interests before their employer's or their own interests.

B. Fair Dealing. Members and Candidates must deal fairly and objectively with all clients when providing investment analysis, making investment recommendations, taking investment action, or engaging in other professional activities.

C. Suitability.

1. When Members and Candidates are in an advisory relationship with a client, they must:
 - a. Make a reasonable inquiry into a client's or prospective client's investment experience, risk and return objectives, and financial constraints prior to making any investment recommendation or taking investment action and must reassess and update this information regularly.
 - b. Determine that an investment is suitable to the client's financial situation and consistent with the client's written objectives, mandates, and constraints before making an investment recommendation or taking investment action.
 - c. Judge the suitability of investments in the context of the client's total portfolio.
2. When Members and Candidates are responsible for managing a portfolio to a specific mandate, strategy, or style, they must make only investment recommendations or take only investment actions that are consistent with the stated objectives and constraints of the portfolio.

D. Performance Presentation. When communicating investment performance information, Members and Candidates must make reasonable efforts to ensure that it is fair, accurate, and complete.

E. Preservation of Confidentiality. Members and Candidates must keep information about current, former, and prospective clients confidential unless:

1. The information concerns illegal activities on the part of the client or prospective client,
2. Disclosure is required by law, or
3. The client or prospective client permits disclosure of the information.

IV. DUTIES TO EMPLOYERS

A. Loyalty. In matters related to their employment, Members and Candidates must act for the benefit of their employer and not deprive their employer of the advantage of their skills and abilities, divulge confidential information, or otherwise cause harm to their employer.

B. Additional Compensation Arrangements. Members and Candidates must not accept gifts, benefits, compensation, or consideration that competes with or might reasonably be expected to create a conflict of interest with their employer's interest unless they obtain written consent from all parties involved.

C. Responsibilities of Supervisors. Members and Candidates must make reasonable efforts to detect and prevent violations of applicable laws, rules, regulations, and the Code and Standards by anyone subject to their supervision or authority.

V. INVESTMENT ANALYSIS, RECOMMENDATIONS, AND ACTIONS

A. Diligence and Reasonable Basis. Members and Candidates must:

1. Exercise diligence, independence, and thoroughness in analyzing investments, making investment recommendations, and taking investment actions.
2. Have a reasonable and adequate basis, supported by appropriate research and investigation, for any investment analysis, recommendation, or action.

B. Communication with Clients and Prospective Clients.

Members and Candidates must:

1. Disclose to clients and prospective clients the basic format and general principles of the investment processes they use to analyze investments, select securities, and construct portfolios and must promptly disclose any changes that might materially affect those processes.
2. Use reasonable judgment in identifying which factors are important to their investment analyses, recommendations, or actions and include those factors in communications with clients and prospective clients.
3. Distinguish between fact and opinion in the presentation of investment analysis and recommendations.

C. Record Retention. Members and Candidates must develop and maintain appropriate records to support their investment analyses, recommendations, actions, and other investment related communications with clients and prospective clients.

VI. CONFLICTS OF INTEREST

A. Disclosure of Conflicts. Members and Candidates must make full and fair disclosure of all matters that could reasonably be expected to impair their independence and objectivity or interfere with respective duties to their clients, prospective clients, and employer. Members and Candidates must ensure that such disclosures are prominent, are delivered in plain language, and communicate the relevant information effectively.

B. Priority of Transactions. Investment transactions for clients and employers must have priority over investment transactions in which a Member or Candidate is the beneficial owner.

C. Referral Fees. Members and Candidates must disclose to their employer, clients, and prospective clients, as appropriate, any compensation, consideration, or benefit received from or paid to others for the recommendation of products or services.

VII. RESPONSIBILITIES AS A CFA INSTITUTE MEMBER OR CFA CANDIDATE

A. Conduct as Members and Candidates in the CFA Program.

Members and Candidates must not engage in any conduct that compromises the reputation or integrity of CFA Institute or the CFA designation or the integrity, validity, or security of the CFA examinations.

B. Reference to CFA Institute, the CFA Designation, and the CFA Program.

When referring to CFA Institute, CFA Institute membership, the CFA designation, or candidacy in the CFA Program, Members and Candidates must not misrepresent or exaggerate the meaning or implications of membership in CFA Institute, holding the CFA designation, or candidacy in the CFA program.

Source: <http://www.cfainstitute.org/ethics/codes/ethics>.