

Chapter 2

AMERICA'S FIRST FUNDED PENSION PLAN

“The door was still tight; however, the same, cold cheerless air prevailed...I hastened to inquire its name and purpose, and then my surprise vanished. It was the tomb of many fortunes; the Great Catacomb of investment; the memorable [Second Bank of the] United States.”¹

—CHARLES DICKENS (1842)

Alexander Hamilton's financial programs had restored the nation's credit by the turn of the nineteenth century, and the U.S. economy was picking up speed. Yet the country remained relatively poor in comparison to the leading industrial nations of Europe, leaving little wealth accumulation for Americans citizens to invest, much less institutions. Most surplus capital from commercial activities was reinvested in farms or small businesses. More than 125 years passed before institutional investors, such as endowments, foundations, and pension funds emerged in significant numbers—and much longer still before these institutions dominated securities markets. Even if such institutions had existed, there were few investment opportunities available besides government securities. Several decades passed before the concept of a limited liability company took hold in the U.S., and stock exchanges largely consisted of informal auctions on the streets of Philadelphia, New York, and Boston.

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At the turn of the nineteenth century, there were virtually no institutional investors in the United States. The U.S. Navy became a rare exception when it established the first *funded* pension plan in 1799. Prior to the Revolutionary War, several colonies had offered pensions but they operated on a *pay-as-you-go* basis. This is roughly equivalent to living paycheck to paycheck in the sense that failure to raise sufficient funds immediately resulted in payment delays or even default. In fact, defaults by colonial pension plans were quite common. But the Navy pension was different in that its annual distributions were supported by an investment portfolio. In addition to using principal to pay distributions, the investment portfolio generated a return in the form of income and capital appreciation. If invested prudently, investment returns could reduce required contributions in the future.

The U.S. Navy's funding model was structurally similar to those employed by most public pensions today. Even more interestingly, and despite the passage of 200 years, the challenges experienced by the trustees were much like those experienced by public pension plan trustees today. The remainder of this chapter reveals these challenges by recounting the plan's forty-one year history.

A Pirate's Pension Plan

The American victory in the Revolutionary War was an unlikely outcome considering the inferior strength of the Continental Army. The Continental Navy was even less formidable, which forced colonists to rely almost entirely on the French Navy to neutralize the British fleet. Two decades after the War, the U.S. had strengthened its navy, but it still paled in comparison to the fleets of major European powers. To compensate, the U.S. relied heavily on privateering to weaken enemies at sea. For those unfamiliar with privateering, it is a euphemism for state-sponsored piracy. The U.S. provided civilian ships with legal authority to attack merchant and military vessels operating under the flags of enemy nations. Privateers shared in the captured prizes. Considering the difficulty of overseeing a naval fleet at the time, privateering was a brilliant tactic. It provided civilians with a powerful incentive to serve the nation's military interests at no financial cost to the federal government. In fact, privateering was so effective, that the right of Congress to authorize it was literally written in the U.S. Constitution under Article I, Section 8, which granted Congress the power, "to declare war, grant letters of marque and reprisal, and make rules concerning captures on land and water."²

Privateering had its benefits, but it was also risky. The most glaring risk was that in the absence of similar incentives for a standing navy, few Americans would enlist. This could place the fledgling federal government in the precarious position of depending on a proxy military force, which could overthrow the Republic if left unchecked. Having experienced several insurrections in the late 1700s, such as Shay's Rebellion and the Whiskey Rebellion, a potential attack from a rogue confederation of privateers was not far-fetched. To mitigate this risk, the government authorized a prize system for the U.S. Navy to entice citizens to enlist rather than join a privateering operation.

Soon after establishing the prize system, the U.S. Navy experienced a financial windfall. In addition to conflicts with the British, tensions with France escalated after the French Revolution took an ugly turn in the 1790s. The inflow of prize money not only provided naval seamen with supplemental income, but it also generated excess funds, which were used as the primary funding source for the U.S. Navy's pension. In other words, the first funded pension system in the U.S. was quite literally funded by state-sponsored piracy.³

The Conservative Years (1800-1809)

Soon after funding the plan in 1800, Congress established an oversight committee, which included the secretary of war, secretary of the navy, and secretary of the treasury. The fundamental challenges faced by the committee were not unlike those encountered by public pension investment committees today. For example, trustees had variable levels of investment experience and little time to dedicate to their responsibilities. There were also few governance standards. The plan's only legal obligation was that funds were to be used solely for the benefit of U.S. Navy personnel and their families.⁴

The investment strategy employed by the trustees was simple at first, as Congress only permitted investments in U.S. government bonds, which were regarded as safe investments thanks to Alexander Hamilton's financial reforms. After receiving the first installment of prize money in 1800, the Plan invested in U.S. government bonds yielding approximately 7 percent per year. Over the next eight years, the Trustees purchased more U.S. government bonds, and interest income alone covered benefit payments. By 1808, the portfolio totaled nearly \$200,000.⁵

POINT OF INTEREST

The Origin of Fiduciary Standards

The term “fiduciary” was coined by the Romans nearly two thousand years ago, but U.S. fiduciary standards were primarily derived from 18th century English laws enacted after the bursting of the South Sea Bubble in 1720.

To understand the cause the South Sea Bubble, it is necessary to first understand the explosive economic growth in France from 1717 to 1720. The driver was a bold but reckless experiment orchestrated by John Law, an Englishman who fled the country to avoid a death sentence for killing a man in a duel. Despite his vices, Law had a remarkable understanding of the mutually reinforcing relationship between the money supply and economic growth. After shopping his ideas throughout Europe for nearly two decades, Law finally found a receptive audience in France. The Regent of King Louis XV believed that Law’s proposal could rid the crown of the unsustainable debt amassed by the king's father, Louis XIV.

John Law's experiment was breathtaking in scope. First, he obtained control of the *Banque Royale* (the French central bank), which enabled him to freely print *livres* (French currency). Next, he launched a company, which was later named the Mississippi Company, and obtained a monopoly on trading rights in the vast Louisiana territory. Interlinking his control of the *Banque Royale* and the Mississippi Company, Law then sold company stock to the public, while freely printing *livres* and encouraging citizens to swap government bonds for Mississippi Company shares. The closest analogy would be if a single individual controlled the Federal Reserve and the largest company in the U.S.—which also happened to be the only company in the country. Then, this individual printed and distributed U.S. dollars to citizens while encouraging them to exchange dollars, as well as any holdings of U.S. Treasuries, for shares in the company—which happened to have no revenue or profits.

The combination of undisciplined money printing and manic demand for Mississippi Company shares produced the greatest asset bubble in history. As is always the case, the immediate economic impact was stimulative, and from across the English Channel, it appeared that France’s economic revival threatened British competitiveness. In a classic case of fear of missing out, the British replicated John Law’s tactics, using the South Sea Company as the funding vehicle. The bubble in South Sea Company shares soon mirrored the one in France.

The Mississippi and South Sea Bubbles ended catastrophically. When demand for securities waned and confidence in the underlying businesses eroded, the bubbles burst. The French economy was ruined for generations, and the British

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economy was hobbled. Once the dust settled, the British parliament and courts enacted reforms to prevent future asset bubbles. First, parliament passed the Bubble Act, which restricted company formation. Second, British courts required trustees to limit investments to government debt and high-quality mortgages. These “approved lists” of securities became the basis of early fiduciary standards and were used in the U.S. prior to the introduction of the Prudent Man Rule in the 1830s.⁶

The Adolescent Years (1810-1829)

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Kp" eqo dkpcvqp." vj gug" hcevtu" o cf g" gs wkv{ " ugewtkkgu" o vej " tkunq" kp" vj g" gctn{ " 3: 22u" vj cp" vj g{ " ctg" vqf c{ 0' P gxgt vj gnuu." vj g" ttwvngu" eqpenf gf " vj cv' vj g" r qvqvkn' tgy ctf u" y gtg" y qtj " vj g" tkumu." cpf" vj g{ " crr r tqxgf " vj g" hktuv" gs wkv{ " kpxguvo gpv"kp"3: 2; 0' Vj g" hktuv' r vtej cug" y cu' uvqen{ kp" Eqnw dkc" Dcpn0' kpxguvo gpw" kp" Wplqp" Dcpn{ cpf " Y cuj kpi vqp" Dcpn{ hmqy gf " kp" 3: 33" cpf " 3: 340' " D{ " 3: 35." vj g" vj tgg" dcpn{ uvqemu" co qwpvgf " vq" crr r tqzko cvgn{ "62' "qh' vj g' r qt vkrkq0

Purchasing equities was not the only way in which the trustees increased risk. Soon after purchasing bank stocks, the War of 1812 commenced, yielding yet another flood of prize money. Over the next six years, the value of the plan more than tripled to approximately \$700,000. Congress’s response to the windfall

would send chills down the spines of public pension plan trustees today—they began increasing benefits. The first benefit expansion occurred in 1813, extending eligibility to widows and orphans (if no surviving widow existed). Benefits were expanded again in 1816 and 1817 to provide higher payments for more severe claims, as well as widows and orphans.⁸

The benefit expansions substantially increased distributions, but portfolio income and continuous inflows of prize money enabled the fund to maintain its value. In the early 1820s, however, perhaps sensing that increased benefit payments were unsustainable, Congress repealed the benefit expansions passed in 1816 and 1817. The repeals coincided with the bankruptcy of Columbia Bank in early 1823, which constituted approximately 11% of the portfolio value at the time. This suggests that the loss may have factored into the repeal decision.⁹

POINT OF INTEREST

The Fatal Errors of the U.S. Navy Pension Plan

The U.S. Navy Pension Plan trustees committed two errors that are still common today. On the liability side, Congress allowed unsustainable benefit expansion; on the investment side, the trustees took on too much risk by stretching for return. Each of these mistakes is described below.

- **Undisciplined Benefit Expansion**—Most twenty-first century public pension plan trustees know that investment decisions can hurt a pension plan, but undisciplined benefit expansion will kill it. This risk is amplified when benefit policy and investment strategy are managed by different entities, which was precisely the case for the U.S. Navy pension. Congress retained authority to alter eligibility and benefit levels, while trustees managed the investment portfolio. Despite objections from the trustees, Congress expanded benefits in 1837. This resulted in massive cash outflows, forcing the plan to liquidate its entire portfolio within four years. While undisciplined benefit expansions of this magnitude are less likely in the twenty-first century, this case is a cautionary tale for governments that focus excessively on pension plan investment performance at the expense of liability management.
- **Stretching for Return**—Investors often succumb to the temptation to stretch for return as they gain confidence in their abilities and/or enter times marked by low return expectations. Such opportunities usually entail greater risk, which is

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especially pronounced when investments are made in unfamiliar markets. When the U.S. Navy pension trustees purchased bank stocks, they almost certainly failed to calibrate the corresponding risks. Although markets in the 2020s are more mature than those in the early 1800s, investors make similar mistakes when entering unfamiliar markets today. One example is the case of structured products backed by subprime mortgages, which were ground zero for the Global Financial Crisis.

As of the publication of this book, many U.S. public pensions were underfunded. This position could deteriorate further if trustees and state legislatures bend too easily to pressure to chase higher returns in riskier investments and/or increase benefits. The Navy pension trustees and Congress succumbed to both pressures in the 1830s. As today's trustees confront similar challenges, it is important to consider the potential consequences.

The Sinking of the Navy Pension Plan (1830 - 1841)

Despite the benefit expansions, the U.S. Navy pension grew steadily in the 1830s and plateaued at a level just shy of \$1.2 million. At the time, the U.S. was experiencing a real estate bubble fueled by reckless credit expansion. On March 3, 1837, Congress passed the *Act for the More Equitable Administration of the Navy Pension Fund*, which required that the payment of benefits “commence from the time of [beneficiaries] being so disabled,” as opposed to the date of filing the claim. In other words, if beneficiaries filed for benefits several years after the occurrence of a qualifying event, they were owed payment for the time between the event and the effective filing date.¹⁰

The timing of the benefit expansion could not have been worse. During that very same month, the real estate bubble began to collapse, and a wave of bank failures swept the nation. The U.S. plunged into a deep depression that lasted until the mid-1840s. The depression led to the failure of the Bank of the United States, which constituted a large portion of the U.S. Navy Pension's portfolio, as well as the failure of Union Bank and Washington Bank. Simultaneously, enormous distribution requirements forced the Trustees to sell the remaining assets in the portfolio. By 1841, the Plan was completely liquidated, and the Navy shifted to a pay-as-you-go model. Figure 2.1 tracks the growth and eventual liquidation of the portfolio. Figure 2.2 tracks the approximate annual rate of distributions from the portfolio.¹¹

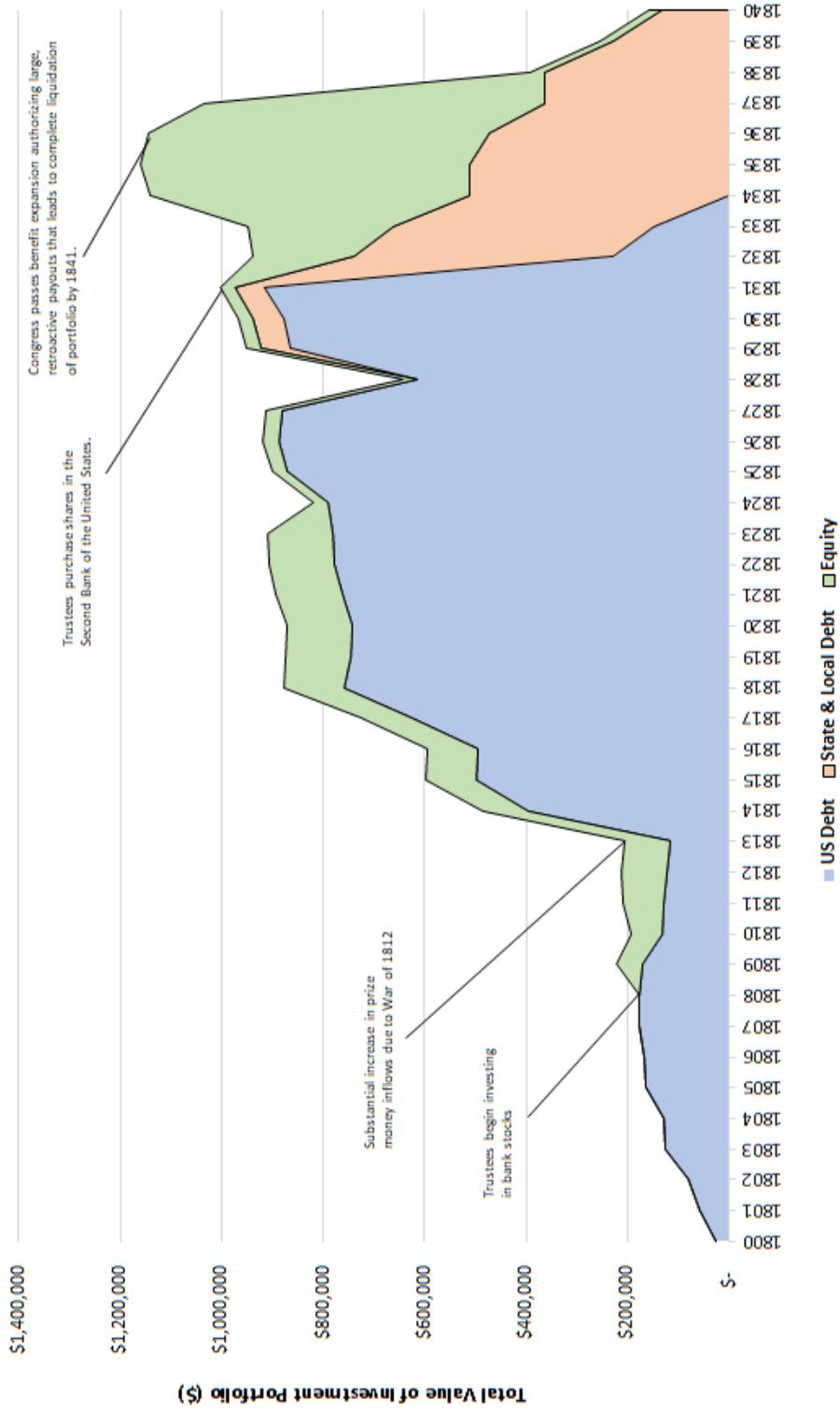


Figure 2.1: Market Value of U.S. Navy Pension Plan (\$) (1800-1840)¹²



Figure 2.2.: U.S. Navy Pension Plan Estimated Distribution Rate (%) (1801-1840)¹³

Lessons from the Sinking of the Navy Pension Plan

A series of flawed decisions led to the demise of the U.S. Navy pension plan. On the investment side, trustees chose poor investments in state-chartered bank stocks, all of which eventually failed. On the liability side, massive benefit expansions enacted by Congress in March 1837 produced unsustainable distributions just as the economy reached a cyclical peak. The timing of the benefit expansions and investments in the stock of the Bank of the United States could not have been worse. During that very same month, a massive real estate bubble began to collapse, triggering a wave of bank failures. Shortly thereafter, the U.S. entered a deep depression that lasted until the mid-1840s. The combination of portfolio losses and higher distributions left trustees with no option but to liquidate the portfolio and transition to a pay-as-you-go funding model.

Despite the passage of nearly 200 years, many lessons from the failure of the nation's first funded pension plan remain just as applicable today. A few of the more notable lessons are:

- **The Danger of Political Interference**—The performance of the U.S. Navy pension almost certainly suffered from political influence. Perhaps the most damaging was pressure from Presidents Thomas Jefferson and James Madison. In 1809, it was no secret that the strongest bank in the United States was the First Bank of the United States. However, the First Bank also happened to be the creation of the nation's first Treasury Secretary, Alexander Hamilton. Not only did Presidents Thomas Jefferson and James Madison despise Hamilton on a personal level, but they also feared that a central bank would increase the power of Wall Street's financial elites to an intolerable level. Despite offering an attractive yield and strong balance sheet, the trustees of the U.S. Navy pension never invested in the First Bank. Further, they only invested in the Second Bank of the United States after being forced by Congress in 1832, which was well past the bank's prime.

Political pressure may not be as avert in the 2020s as it was in the early 1800s, but it is still present. Politicians may target trustees of public pension plans, and wealthy donors may target trustees of foundations and endowments. In such situations, trustees must not forget that their fiduciary duties only apply to the beneficiaries of their plans.

- **Underestimating the Long-Term Impact of Benefit Expansions**—In the aftermath of the COVID-19 pandemic, millions of pension plan beneficiaries experienced the financial pressures of high inflation for the first time since the early 1980s. Those who did not receive commensurate cost of living adjustments (COLAs), suffered a meaningful reduction of purchasing power from their distributions. Trustees and/or state legislatures may feel pressure to address this by adding (or increasing) automatic COLAs for their plans. The problem with this solution is that it risks creating long-term financial costs that address what is likely to be a temporary challenge. History suggests that Post-COVID-19 inflation is likely to last for a few years but is unlikely to be permanent. In fact, current inflationary pressures resemble those that occurred in the aftermath of World War I and the Great Influenza (see chapter 14). Not only did the post-war inflation prove to be temporary (i.e., roughly two years), but it was followed by a brief period of deflation. The key principle is that financial challenges often have expiration dates, and it is important to design solutions with matching expiration dates. For plans that can afford it, granting a one-time COLA increase to compensate beneficiaries for the recent loss of purchasing power may make sense. However, increasing COLAs permanently could be problematic. Congress's failure to consider the long-term effects of benefit expansions was by far the costliest error for the U.S. Navy pension plan in the early 1800s.
- **Increasing Skepticism When Venturing into Unfamiliar Terrain**—An alternative to settling for potentially lower returns in the foreseeable future is to seek higher returning opportunities. Such opportunities entail greater risk, which is significantly amplified when investments reside in unfamiliar markets. When the U.S. Navy pension plan trustees began purchasing bank equities, they almost certainly failed to consider the corresponding risks. Although markets in the 2020s are considerably more mature than those in the early 1800s, the risk of making costly mistakes still increases substantially when investors exit their comfort zone. A recent example is private credit, which seemed to be all the rage in the 2020s. Some investment opportunities in private credit are legitimately attractive, but there are also significant risks that are often discounted. These risks have increased over the past several years as

hordes of followers have allocated massive amounts of capital. Private credit fund managers—like all alternative asset class managers—charge relatively high fees. Further, identifying top quartile managers requires an exceptional level of skill and highly stable governance. Few institutional investment plans possess these capabilities, and even fewer are aware of their deficiencies.

Chapter 2

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