



CRC Memorandum

STATE BALLOT ISSUES ON THE AUGUST PRIMARY BALLOT

PROPOSAL 02-01: COMPENSATION OF CERTAIN ELECTED STATE OFFICIALS

PROPOSAL 02-02: CHANGING LIMITS IN NATURAL RESOURCES TRUST FUND AND STATE PARKS ENDOWMENT FUND; INVESTING TRUST AND ENDOWMENT FUNDS IN STOCKS

Proposal 02-01

The Michigan Constitution defines the way compensation for most top elected officials is determined. Proposal 02-01 would amend the Constitution (Article IV, Section 12) and change that process in several ways. The State Officers Compensation Commission (SOCC), whose duties are defined in the current constitutional language, would be retained, but the Michigan Legislature would have to act affirmatively in order for salaries and expense allowances to change.

Background

The people of Michigan have maintained influence or control over state officers' salaries in a variety of ways since Michigan's first Constitution. From the Constitution of 1835 to the Constitution of 1963 and a subsequent amendment, many changes occurred in the officials covered and the amounts of compensation and manner in which compensation changes were made.¹

The current language replaced Article IV, Section 12 in the 1963 Michigan Constitution as originally approved. Under that language, salary and expense determinations were made by law. The legislature passed salaries and expense allowances subject to the governor's review and approval or veto.

The Current SOCC Process. Proposal 2 of 1968 amended Article IV, Section 12 of the Michigan Constitution. It creates the SOCC to determine compensation and expenses for members of the legislature, the governor and lieutenant governor, and Justices of the Supreme Court. SOCC determinations take effect unless rejected by a two-thirds vote

¹ The website version of this report summarizes the features of the four Constitutions as they relate to state officers' compensation.

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Proposal 02-02

Proposal 02-02 was placed on the August 6, 2002, state-wide ballot by the Michigan Legislature (Senate Joint Resolution T) and would amend Article IX of the 1963 Michigan Constitution to make three principal changes with respect to natural resource and state park funding:

1. Amend Section 35 to increase the overall cap on assets in the Natural Resources Trust Fund from \$400 million to \$500 million.
2. Amend Section 35 to permit 1/3 of revenues to the trust fund to be appropriated until the fund reaches \$500 million in assets. When that amount is reached, only interest earnings may be appropriated. (The present limit is \$200 million.)
3. Amend (and renumber) Section 36(1) to permit interest and earnings plus 50 percent of the annual revenues from the MNRTF to be appropriated from the Genevieve Gillette State Parks Endowment Fund. (The present limit is \$5.0 million, adjusted for inflation.)

Proposal 02-02 would also amend Sections 19, 35, 36(1), and 37 of Article IX to remove the prohibition against ownership of stock by state permanent and endowment funds, specifically including the Natural Resources Trust Fund, the State Parks Endowment Fund, and the Veterans' Trust Fund.

Background

The Kammer Trust Fund. Public Act 204 of 1976 created the Recreational Land Acquisition ("Kammer") Trust Fund with revenues consisting of rents and royalties from private oil, gas, and mineral exploration on state-owned

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of both houses of the legislature.

The determination of compensation for the affected officials has operated under the 1968 language for more than three decades, but not without controversy from time to time. The 1968 amendment was apparently aimed at eliminating the conflict of interest associated with legislators determining their own compensation.

Practices in Other States. More than 20 states use compensation commissions to evaluate legislative salary levels. Roughly half play purely an advisory role and legislators actually determine their pay. Six states including Michigan have commissions making advisory determinations that take effect unless the legislature rejects them. Five states have commissions with complete control over legislative compensation.²

² Source: *Compensation of Michigan*

History of SOCC Determinations.

Section 12 requires two-thirds of the members elected to and serving in each house to disapprove a SOCC determination in order for it not to take effect. This has happened once in the 34-year history of the process. Both houses rejected the SOCC determinations for 1991 and 1992, presumably because of the state's financial difficulties and relatively large increases in compensation received for the previous two years. In every year following a SOCC determination, at least one concurrent resolution disapproving the SOCC action, usually for all affected state officers, has been introduced. In only five of those years have resolutions reached the floor of the house originating the resolution. In 2001 the House of Representatives

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voted to reject the determinations and the Senate did not vote. In the other four cases they were defeated in the house originating the resolution.

Examining the salary histories of the affected state officers is instructive in understanding how the process has worked over its 34 years of existence. In order to summarize the history of SOCC salary determinations, the annual percentage rate of increase in salaries was computed for 1968 through 2002. For comparative purposes, several broad measures were compiled for the same time period. These computations are displayed in **Table 1**.

Comparing the SOCC outcomes with general economic indicators yields some interesting findings:

- None of the SOCC-determined salaries has grown as fast as per capita

Table 1
Annual Increases in SOCC-determined Salaries
Comparisons with Other Michigan Salary and Economic Measures
1968-2002

Officials Subject to SOCC	
Legislator	5.1%
Governor	3.7%
Lieutenant Governor	4.6%
Supreme Court Justice	4.0%
Other State Salaries	
Attorney General and Secretary of State	3.4%
Classified State Employees*	4.8%
Other Michigan Economic Indicators	
Consumer Price Index (Detroit)	4.0%
Michigan Per Capita Personal Income	5.8%
Average Hourly Earnings—Manufacturing	5.2%
Average Hourly Earnings—Transportation Equipment	5.2%

Sources: Michigan Department of Civil Service; 2000 Report of the State Officers Compensation Commission; U.S. Department of Labor, Bureau of Labor Statistics; U.S. Department of Commerce, Bureau of Economic Analysis; Senate Fiscal Agency

* Computed from data on general pay raises provided by the Michigan Department of Civil Service

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personal income, generally the most widely used measure of the economic well being of a state.

- The annual increases for the governor have lagged behind the rate of inflation for the period.
- None of the SOCC categories has increased as fast as hourly wages in manufacturing and transportation equipment.

Comparing the SOCC outcomes with other data on state government salaries shows:

- Only the legislature exceeded the general pay raises for classified state employees.
- The salaries of the attorney general and secretary of state grew more slowly than the SOCC-covered officials and all of the other indicators.

The data included in this analysis support the conclusion the SOCC-determined salaries have not exceeded general measures of compensation gains in Michigan.

The Genesis of Proposal 02-01.

Since 1968, the announcement of pay raise recommendations by the SOCC has encountered occasional public outcry when the size of the increases exceeded the public perception of what a reasonable and fair increase would be at that point in time. The increases cover the next two years and are usually described as making up for past gaps in appropriate compensation levels and/or to allow for cost of living increases. Therefore, the increases often seem large in the context of the general public's perception of annual

rates of inflation or publicized annual compensation increases awarded to large groups of employees, such as members of large union bargaining units.

The most recent example of public objection to a SOCC action occurred when the commission issued its determination for 2001 and 2002. This event occurred in December 2000 and many view Proposal 02-01 as a result. That SOCC determination called for the increases summarized in **Table 2**.

Largely in reaction to public objection to the size of their salary increase, the legislature, by joint resolution, approved placing Proposal 02-01 on the August 2002 statewide ballot. Both chambers approved the language without a dissenting vote.

Table 2
State Officers Salaries for 2001 and 2002
Determinations of the State Officers Compensation Commission
December 2000

	<u>2000</u>	<u>2001</u>	<u>2002</u>	<u>Percent Change</u> <u>2000 - 2002</u>
Legislators	56,981	77,400	79,650	39.8
Governor	151,245	172,000	177,000	17.0
Lieutenant Governor	100,671	120,400	123,900	23.1
Supreme Court Justices	140,816	159,960	164,610	16.9

Source: 2000 Report of the State Officers Compensation Commission

Description of Proposed Changes

Table 3 compares the current and proposed processes. If the proposal is approved, it becomes effective September 20, 2002, and the following changes will occur:

- The attorney general and secretary of state will be added to the SOCC determination process.
- The legislature by majority vote will

have to approve the SOCC determinations in order for the increases to occur.

- The legislature may amend SOCC determinations by proportionate reductions, but without reducing salaries or expenses below the pre-SOCC determination level.
- The SOCC determinations or amended determinations, if approved,

are effective for the legislative session after the next general election. Therefore, no legislature would be voting to determine its pay increase or the increase for other state officers serving at the time of legislative action.

- The legislature may establish by law qualifications for members of SOCC.

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Table 3 Principal Features of Current and Proposed SOCC Process		
	<u>Current Process</u>	<u>Proposed New Process</u>
Officials Covered	Legislators, governor, lieutenant governor, Supreme Court Justices	Adds attorney general and secretary of state
SOCC Members	Seven members appointed by governor—no qualifications for membership	Seven members still appointed by governor, but legislature may specify qualifications
SOCC Determination	SOCC recommends new salaries and expense allowances	Same as current process
Legislative Action	SOCC determination takes effect unless rejected by 2/3 vote of both houses	Both houses must approve determination by majority for it to take effect
Modification in SOCC Determination	Legislature can only reject specific determinations for specific officials or the entire determination	Legislature can reduce SOCC determination by same percentage for each official
Timing of Increases	January following SOCC determination unless rejected before February 1st	Beginning of legislative session following next general election after legislative approval

Potential Problems with the Proposal

Defining “Determination”. The definition of “determination” is open to possible interpretation and could affect the action the legislature could take to “reduce the salary and expense determinations by the same proportion”. Two alternative definitions might be chosen by the legislature:

- The determinations are the new recommended salaries and expense allowances
- The determinations are the recommended increases in the existing salaries and expense allowances

The definition of determination would presumably be included in statutory language implementing the proposal. Current statute (Act 357 of 1968) defines determination as the salaries and expense allowances rather than the recommended increases. If the definition of determination is the new recommended salaries and expense allowances and the SOCC determination produces different percent changes in salaries or expenses for

the various officials, the reduction by the same proportion produces a different final result than by applying the same proportion to the increase.

The mechanism to reduce a determination does not permit the legislature to discriminate among the officers, so an effort to reduce one determination would not be permitted. Since the 2000 SOCC determination for legislators generated most of the public outcry, it is ironic that the proposal would not allow the legislature to target reductions on one official or group of officials as out of line with others.

Timing Issues. Approval of the proposal would present some timing issues potentially requiring speedy legislative action. Current law (Act 357 of 1968, as amended) requires, in Section 6, that the SOCC file its determination after December 1 and before December 31 of each even-numbered year. The proposal makes a determination that has been approved by the legislature effective for the leg-

islative session following the next general election. This means if a pay increase is to occur for the affected officers in January 2003 or January 2004 the following will need to happen:

Public Act 357 of 1968 would have to be amended to move the filing date for SOCC determinations to a date considerably before the general election of November 5, 2002.

- The SOCC will have to meet, make a determination, and file that determination in time for the legislature to:
- Approve or reduce the SOCC determination before the general election.

These events imply that current legislators running for office for the next legislative term would be faced with approving a raise that might directly benefit them, just before the election. If the timing of SOCC filing is left unchanged, the earliest time at which increases could take effect is after the general election of 2004 (in January 2005).

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The Proposed Changes—Pros and Cons

Arguments for the Proposal

- An affirmative vote by the legislature would be required for an increase to take effect in contrast to the current process that permits the legislature to ignore the issue of state officer pay. By the legislature having a direct responsibility in the pay determination process, the public can oversee the action and express its opinion.
- Since reductions in the determinations are possible, the legislature is not faced with an all or nothing vote.
- Pay and expense allowances could not be reduced below current levels by legislative action. This would protect all officers from extraordinary actions by the legislature.
- Legislation would be permitted to establish qualifications for members

of SOCC. This might lead to requirement that members possess expertise in field such as compensation and finance.

- Increases take effect after the next general election so legislators would technically be voting on pay changes for future legislators and other state officers.
- The secretary of state and attorney general are added to the process that already determines pay for the governor and lieutenant governor.

Arguments against the Proposal

- Requiring an affirmative vote removes the legislature from the political insulation provided by an independent commission
- Requiring a legislative vote makes the compensation of other state officers

subject to the same factors that might influence the legislative pay decision, even if the circumstances for the other officers are different.

- If the validity of the independent SOCC process is in doubt, elimination of SOCC and having the legislature set the pay is a more direct approach.
- If the objective and independent SOCC process generates appropriate results, elimination of the legislature from any vote on its pay would preserve an effective process and eliminate the legislature's (potential) role in its compensation.
- The current process has not produced compensation levels for affected officials that are out of line with economic indicators.

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lands, together with bonuses resulting from bids for access to such lands. The purpose of the fund was to acquire land for hunting, fishing, or other recreational purposes, and for the payment of any local taxes owed by the state on the land. The basic concept was that of using revenues from non-renewable resources to purchase land for the benefit of future generations.

P. A. 204 structured the fund in a manner intended to make it self-perpetuating. However, diversions from the fund were made in 1979, 1980, 1981, and 1983, preventing the fund from achieving its target asset level of \$150 million. Although the largest initial diversions were made to help balance the state budget during the recession of that period, the greatest

long-term diversion was to the newly-formed Michigan Economic Development Authority (MEDA). Beginning in 1982, revenues that previously went into the Kammer fund were deposited in a new Heritage Fund from which appropriations to MEDA were made. The plan was to pay out \$20 million per year from the fund to MEDA over a 50-year period, a total of \$1 billion.

Proposal B of 1984: The Natural Resources Trust Fund. In November 1984, voters approved Proposal B, which added a Section 35 to Article IX of the Michigan Constitution. The new section established the Michigan Natural Resources Trust Fund (MNRTF) and restricted the uses to which the revenues of the fund could be put, thereby creating a constitu-

tional successor to both the Kammer Fund and the Heritage Fund. Statutory provisions for the fund were adopted in Public Act 101 of 1985.

Under provisions of the amendment, the interest and earnings accruing to the trust fund were available to be expended in the following year. In addition, the Legislature was permitted to appropriate up to 1/3 of the oil and gas lease revenue received by the trust fund each year until the fund reached its principal cap of \$200 million. Once the cap was reached, only interest earnings were to be available for appropriation. Those appropriations were limited to the purchase of land or rights in land for recreational uses because of "its environmental importance or its scenic beauty," the development of public recreation fa-

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cilities, and the administration of the fund, including payment in lieu of taxes on state-owned land purchased through the fund.

The amendment also permitted the Legislature to authorize the diversion of a portion of the trust fund revenues each fiscal year to the Michigan Strategic Fund, which replaced MEDA and which was designed to leverage private sector investment with public funds and to protect the rights of MEDA bondholders who had purchased bonds backed by the Heritage Trust. Although P. A. 101 would have terminated the Strategic Fund diversion in 1994, after the debt had been retired, the Legislature could have voted to continue the transfers.

(CRC analysis of Proposal B can be found in *Council Comments No. 950*, October 1984.)

Proposal P of 1994: Termination of the Strategic Fund Diversion; Creation of the State Parks Endowment Fund. By 1993, the principal balance in the MNRTF had reached only \$70.3 million, far short of the principal cap of \$200 million estab-

lished by Proposal B of 1984. As long as funds were permitted to be appropriated to the Strategic Fund, reaching the cap would take a very long time, so in November 1994, the Legislature submitted Proposal P to the voters. Proposal P, which was approved, did three things: 1) amended Article IX, Section 35, to eliminate the diversion of revenue from the MNRTF to the Strategic Fund; 2) amended Section 35 to increase the principal balance limit of the MNRTF from \$200 million to \$400 million, thereby providing more interest income with which to purchase land; and 3) added a Section 36 (actually, a second Section 36¹) to establish, fund,

¹ In March 1994, voters approved Proposal A, which made major changes in constitutional provisions regarding Michigan education funding and taxation. Proposal A had added a Section 36 to Article IX, providing a dedication of 6 percent of tobacco tax proceeds to health care. Through an oversight, the Legislature submitted Proposal P to the voters with its own Section 36 in November 1994 and, since it received voter approval, the Legislature could not subsequently renumber the section on its own.

and provide for the use of the Genevieve Gillette State Parks Endowment Fund (SPEF), created by Public Act 79 of 1994.

The SPEF was created to address the volatile funding and gradual deterioration of the state park system. Although supported by general fund appropriations for much of their history, beginning in 1980, state parks became more and more dependent on user fees for funding. Under Proposal P, the SPEF was to receive up to \$10 million annually from the MNRTF. In addition, if the State Accident Fund were to be sold (it subsequently was), \$40 million would be appropriated to the SPEF as seed money. When the MNRTF reached its principal cap of \$400 million, all revenues otherwise dedicated to it would be deposited in the SPEF. When the SPEF reached a principal balance of \$800 million, all MNRTF revenues, exclusive of interest, would be distributed as provided by law.

Finally, Proposal P provided that until the SPEF reached \$800 million, the Legislature could make annual appropriations of \$5 million, adjusted annually for inflation, from the fund to the state park system. Once the SPEF reached its cap, only the interest in excess of the amount required to maintain the fund at its principal limit would be available for appropriation.

(CRC analysis of Proposal P can be found in *Council Comments No. 1030*, September 1994.)

Fund Finances Since 1994. The MNRTF principal balance (currently capped at \$400 million) doubled from 1995 to 2001 as shown in **Table 1**.

Table 1

**Principal Balance, Michigan Natural Resources Trust Fund
Fiscal Years 1995-2001
(dollars in millions)**

Fiscal Year	Deposit to Principal	Principal Balance (as of Sept. 30)
1994-95		\$ 90.5
1995-96	13.7	104.1
1996-97	16.1	120.3
1997-98	12.7	132.9
1998-99	8.2	141.2
1999-00	16.0	157.2
2000-01	24.8	182.0

Source: Michigan Department of Natural Resources

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Proposal 02-02 of 2002

Provisions. Proposal 02-02 would amend Article IX to do three things regarding the MNRTF and SPEF:

1. *Increase the principal cap in the Michigan Natural Resources Trust Fund from \$400 million to \$500 million.* Under current provisions, when the MNRTF accumulated principal reaches \$400 million, all fund revenues (which come from rentals and royalties derived from mineral, coal, oil, and gas interests on state-owned land) will be deposited in the State Parks Endowment Fund. Section 35 would be amended to increase this cap to \$500 million, permitting the fund to earn somewhat greater amounts than under the existing cap.

2. *Permit annual appropriation of 1/3 of royalty earnings (plus interest) until MNRTF accumulated principal reaches the overall cap of \$500 million.* Currently, when MNTRF accumulated principal reaches \$200 million, the Legislature will no longer be able to appropriate 1/3 of the royalties each year to fund grants to local units of government as well as state agencies to acquire or develop public recreation areas. Only interest earnings of the

fund would then be available for appropriation. Proposal 02-02 would amend Section 35 to increase the cap to \$500 million.

3. *Permit annual appropriation from the State Parks Endowment Fund of interest and earnings plus 50 percent of the annual revenues from the MNRTF.* Current provisions limit annual appropriations from the SPEF to \$5.0 million, adjusted annually for inflation. Proposal 02-02 would amend Section 36(1) by increasing this cap to interest and earnings plus 50 percent of the annual revenues from the MNRTF. In FY2001, expenditures of \$7.0 million were made from the SPEF. (Proposal 02-02 would also renumber Section 36(1) as Section 35a, thereby remedying an oversight in Proposal P of 1994. See footnote on page 6)

Statutory Nature. Sections 35 and 36(1) are among the longest and most complicated sections in the Michigan Constitution, principally because Proposal B of 1984 was essentially an importation of a state statute, P. A. 204 of 1976, into the Constitution. This approach was taken in large part

to insulate the Kammer fund from the diversions that were preventing it from reaching its asset goal. In 1994, the same constitutional protection was accorded the SPEF and in 1996, the Michigan Veterans' Trust Fund, created by statute in 1946, was given constitutional status to circumscribe the uses to which it could be put.

Although these funds are now largely protected from being used for other than their original purposes, that protection entailed the placement of detailed material in the Constitution that would normally be found only in statute. Among the reasons for calling the Michigan Constitutional Convention of 1961-62 were the length to which the 1908 Constitution had grown, largely through adding amendments that might have been accomplished through statute, and the constitutional dedication, or "ear-marking" of state revenues. Proposal B of 1984 did both and Proposal 02-02, with the exception of the repeal of the prohibition against stock ownership, asks the voters to approve amendments to the law that, before 1984, could have been made by the Legislature.

Investing Public Funds in Stocks

The Internal Improvements Debacle. The success of the Erie Canal in New York in the 1820s led a number of states to the conclusion that economic development would come only through massive subsidization of "internal improvements," principally canals and railroads. In the 1830s and 1840s, these projects were enthusiastically undertaken, but, in state after state, whether by corruption, poor planning, or excessively optimistic economic assessments, they failed, re-

sulting in the creation of state debt that in many cases persisted into the late 19th century, with little to show for it. Illinois, Indiana, and Michigan were among the hardest hit of the states that were caught up in the internal improvement debacles.

Some of the failed projects were privately financed, but many involved public participation in private railroad and canal companies, such as the Michigan Central and Michigan

Southern railroads and the Clinton-Kalamazoo Canal. The reaction to this ill-starred participation was to adopt constitutional prohibitions against public ownership of stock. Article XIV, Section 8, of the Michigan Constitution of 1850 provided that

The state shall not subscribe to, or be interested in the stock of any company, association or corporation.

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This provision was retained virtually unaltered in the Constitution of 1908, but the Constitution of 1963 significantly eased the prohibition by exempting public employee pension funds and endowment funds created for educational or charitable purposes.

Provisions of Proposal 02-02. Proposal 02-02 would amend Article IX, Section 19, to extend the exemption from the prohibition against stock ownership to other permanent or endowment funds. The proposal would amend Sections 35, 36(1), and 37 to specifically permit the State Treasurer to invest the assets of the Michigan Natural Resources Trust Fund, the State Parks Endowment Fund and the Michigan Veterans' Trust Fund in the same manner as the investment of the Public Employees Retirement Fund.²

² Legislation signed in 2002 would implement the exemption from the stock-own-

Current law permits up to 70 percent of retirement fund assets to be invested in stocks. No more than 5 percent of stock ownership may be in one company and the fund may not own more than 5 percent of any company.

Most of the assets of these funds currently consist of bonds. Stocks are riskier than bonds in the sense that the deviation of the rate of return in any one year from the long-term average annual rate of return is greater for stocks. Numerous studies have

er ship prohibition for six funds: the Michigan Natural Resources Trust Fund (Act 52); the Veterans Trust Fund (Act 53); the Michigan State Parks Endowment Fund (Act 54); Nongame Fish and Wildlife Fund (Act 55); Game and Fish Protection Fund (Act 56); Michigan Civilian Conservation Corps Endowment Fund (Act 57). These acts will go into effect if Proposal 02-02 is adopted by the voters.

shown, however, that, over the long term, stocks outperform virtually all other investments and more rapid growth in the assets of these funds may be expected if they are permitted to hold stocks. A 2002 study by Wilshire Associates, for example, shows that over the 75-year period 1926-2001 the annual average rate of return for stocks exceeded that of bonds by 5.0 percentage points (10.7 percent vs. 5.7 percent). Clearly, funding public employee retirement benefits in Michigan would have been much costlier to taxpayers if the assets of the retirement funds could not have been invested in stocks.

Moreover, the current prohibition prevents these funds from fully diversifying their investment portfolios. By diversifying and creating the opportunity for offsetting losses and gains, it is actually possible to reduce the risk for the entire portfolio by adding a riskier investment class, such as stocks.