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WALL STREET FEES AND INVESTMENT RETURNS FOR 33 STATE PENSION FUNDS

Fiscal Years Ending June 30, 2014

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SUMMARY

This study outlines fees and investment returns for state pension funds with fiscal years ending June 30, 2014. The study concludes that pension funds with the highest fees, as a percent of assets, recorded inferior investment returns, on average, versus those in states with the lowest fees. This conclusion contradicts the assumption that Wall Street advice helps clients achieve superior returns.

The study also shows that a passive index that mimics the investment allocation of the typical state pension fund outperformed the peer group median by 1.62 percent per year over a five-year period. On an initial $50 billion pension fund, this difference over five years is equivalent to $6.8 billion in foregone income.

In this report, the Maryland Public Policy Institute updates calculations completed two years ago for the fiscal year ending June 30, 2012. The conclusions then are identical to those today—more fees equal lower returns. Neither state pension fund trustees, pension fund executives, nor investment management industry executives contested the findings of the earlier study, which were reasonably publicized.

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HIGHER FEES MEAN LOWER INVESTMENT RETURNS

The top 10 states in terms of Wall Street fees had lower pension fund investment performance over the last five fiscal years than the bottom 10 states. See Table 1. Note that returns are expressed as "net of fees."

INDEXING COULD SAVE PENSION FUNDS TENS OF BILLIONS

Instead of using the approach of active management, state pension funds should consider indexing. Indexing fees cost a state pension fund about three basis points yearly on invested capital versus 66 basis points for active management fees (or 1/30th the cost). For the five years ending June 30, 2014, we selected public security indexes that were good proxies for state pension fund asset allocations, just as we did two years ago. Indexing provided a much higher investment return. See Table 2, which shows a 1.62 percent annual premium for indexing, after deducting three basis points for fees.

If a fund had invested $50 billion in the replicating index on June 30, 2009, by June 30, 2014, five years later, it would have had $98.2 billion, assuming reinvestment of dividends. The same $50 billion investment in the median state fund portfolio would have been worth $91.4 billion, indicating a $6.8 billion shortfall.

By indexing most of their portfolios, we conclude the 33 state funds surveyed could save $5 billion in fees annually, while obtaining similar (or better) returns to those of active managers. Enacting this policy potentially reduces unfunded pension liabilities by $70 billion within two years.

Indexing is easy for states to implement, as index firms respond to state requests for proposals just like active managers. A state can liquidate most of its active manager portfolios within a few months, and provide the cash to index firms, which can then invest the money in the underlying securities of an index within a few weeks. Many large corporate pension funds and individuals already use indexing for equity portfolios, and equity indexing has perhaps a 15 percent market share of equity mutual funds for retail investors. To our knowledge, only one state, Nevada, is fully indexed.

STUDY PROCESS

The authors reviewed Wall Street money management fees of 33 states that disclosed appropriate public data and had a June 30 year-end. We compiled the states' five-year annualized investment returns. The information was provided in the state pension funds' Comprehensive Annual Financial Reports (CAFR). CAFRs are usually released five to six months after the fiscal year ends, so June 30 data are usually available the following January. Pension investment consultants, such as Wilshire Associates and Callan Associates, compile return data, but access to the individual state comparisons is limited to paying clients. The Wall Street fee data prepared by the authors is not commonly calculated in a comparative way.

In this report, money management fees are expressed as a percentage of the fiscal year's ending assets. For comparing five-year annualized investment returns, this analysis only used those pension funds with a fiscal year-end of June 30, 2014 (in order to facilitate an 'apples to apples' comparison). When states have different year-ends, it is not appropriate to make annualized investment return comparisons. The 'start' and 'end' dates are different for different portfolios. For those states that separate 'state employee' and 'state teacher' pension funds, we used the larger of the funds for comparison purposes.

Based on our work, we conclude that a number of states are not reporting fees properly. Misreporting may be a particular problem with private equity and hedge fund investments, where managers often deduct fees before sending cash returns. California's Public Employees' Retirement System admitted as much in June 2015, when it said tracking such fees was complex.

ACTIVE MANAGEMENT DESCRIBED

The 33-state sample collectively spent $6 billion on such fees over their latest fiscal year. The vast majority of the state public pension systems contract with Wall Street firms to select publicly traded stocks and bonds, which comprise the bulk of the systems' investment portfolios. Wall Street firms typically pitch their ability to outperform a given section of the stock or bond market, and declare that the system should pay them for a fee for their prowess in choosing a stock (or bond). To varying degrees, pension

TABLE 1 HIGHER FEES MEAN LOWER RETURNS

	MEDIAN WALL STREET FEE RATIO	MEDIAN ANNUALIZED FIVE-YEAR RETURN
TOP 10 WALL STREET FEE RATIO STATES	0.66%	12.44%
BOTTOM 10 WALL STREET FEE RATIO STATES	0.26%	12.70%
DIFFERENCE	0.40%	(0.26%)

When a state had separately managed pension funds, we selected the largest fund for inclusion.

TABLE 2 PASSIVE INDEX RETURNS SIGNIFICANTLY EXCEED STATE PENSION FUND RETURNS

	ANNUALIZED FIVE-YEAR RETURN
INDEX PORTFOLIO	14.45%
MEDIAN STATE PENSION FUND	12.83%
DIFFERENCE	1.62%

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TABLE 3	MEDIAN HEDGE FUND PERFORMANCE OF STATE PENSION FUNDS, NET OF FEES, FIVE YEARS ENDING JUNE 30, 2014
MEDIAN HEDGE FUND [1]	7.30%
VANGUARD BALANCED U.S. FUND (60% BOND/40% STOCK)	13.65%
HEDGE FUND SHORTFALL	(6.35%)

[1] *Five states reporting*

TABLE 4	MEDIAN PRIVATE EQUITY FUND PERFORMANCE OF STATE PENSION FUNDS NET OF FEES, FIVE YEARS ENDING JUNE 30, 2014
MEDIAN PE FUND [1]	16.72%
S&P 500 PLUS 3% [2]	21.83%
PE SHORTFALL	(5.11)%

[1] *17 states reporting*
[2] *PE funds (mostly leveraged buyouts) comprise low-tech, consistent earnings, non-finance operating companies. S&P 500 plus 3 percent is a popular LBO (leveraged buyout) benchmark annual return target, although underlying investments have perhaps a 40 percent overlap.*

funds employees monitor the Wall Street firms, usually with assistance from other Wall Street-type companies (investment consultants).

Public Money Managers: Poor investment performances versus indices. Evidence suggests that managers who select publicly-traded securities (on behalf of clients) cannot beat benchmark indices. According to the S&P Dow Jones Indices/SPIVA Scorecard Year-Ended 2014, over the five years ending December 31, 2014, 84 percent of domestic equity funds *failed* to beat the S&P benchmark. On the fixed income side, 73 percent of managed fixed income funds *failed* to beat related indices. Such underperformance has been a consistent problem over time for active managers.

If public pension fund assets were indexed to relevant markets rather than actively managed, public pensions across the United States would save an enormous amount of money on fees, without undue harm to investment performance. In fact, many Wall Street managers 'shadow' their target public market indexes with 70 to 80 percent of their investments in the same stocks (or bonds) as those in the target index. The pension funds are thus buying the same stocks (or bonds) in the index, but are paying sizeable fees for the privilege and bearing substantial transaction costs.

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Alternative Investments: No proof they beat the market. To try and compensate for the fact that beating the market is difficult with traditional publicly-traded securities, most public pension funds have increased their exposure to alternative investment managers, who claim to possess a secret formula that allows them to beat the public markets consistently. However, there is no scientific evidence to support such a notion, and our review shows the opposite. Despite this information, on the median, alternative investments represent an astounding 24 percent of state pension fund assets.

Hedge Funds. Hedge fund managers mostly buy and sell publicly-traded securities, and the hedge fund managers (of states that report hedge fund fees separately) have failed to beat a 60 equity–40 bond (U.S. only) split by a wide margin. See Table 3.

Private Equity. Furthermore, the private equity industry has yet to offer proof that private equity (PE) consistently beats the relevant public equity market index, after fees. Recent experience suggests the reverse. See Table 4 for the returns of the PE portfolios of reporting state pension funds.

If a fund invested $10 billion in the S&P 500 on June 30, 2009, by June 30, 2014 the fund would have had $23.7 billion, assuming all dividends were reinvested (18.83 percent compound annualized return). The same $10 billion investment in a typical private equity fund would have been worth $21.7 billion, indicating a $2.0 billion shortfall.

When questioned about the unproven history of alternative assets, public pension funds officials and investment consultants typically respond that while performance may be mediocre, alternatives allow diversification out of public equity and public fixed-income markets. This statement shows a lack of understanding about alternatives.

Hedge funds principally invest in publicly-traded securities or example, Pershing Square hedge fund, run by Bill Ackman, has sizeable positions in Canadian Pacific (long), Herbalife (short), and Burger King (long). Private equity funds acquire mainly securities in privately owned corporations. However, the underlying issuers of such private securities have economic attributes that resemble their publicly-traded counterparts in many ways. That is hardly diversification.

No Positive Correlation between High Fees and Performance. *For the five years ending June 30, 2014, we*

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TABLE 5 STATES WITH THE HIGHEST WALL STREET FEE RATIOS

RANK	STATE	WALL STREET FEE RATIO
1	MISSOURI	1.70%
2	SOUTH CAROLINA	1.56%
3	NEW JERSEY	0.76%
4	MARYLAND	0.73%
5	OREGON	0.68%

were unable to find a positive correlation between high fees and high returns. In fact, we found a negative correlation. This is not a glowing endorsement for Wall Street advice, reminding one of author Fred Schwed Jr.'s critique of Wall Street, when he asked, "Where are the customer's yachts?"

PENSION SYSTEMS' PERFORMANCE VERSUS INDEX FUNDS THAT MIMIC ACTIVE MANAGERS

We asked a wealth management firm to calculate the returns a pension fund would realize by investing in relevant indexes and allocations. The indexes and allocations mimic the state pension fund composites. Indeed, consultants often benchmark an asset allocation's performance by comparing it to an index. See Table 6.

Over the five years ending June 30, 2014, the index portfolio had an annualized return of 14.48 percent, or

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14.45 percent, net of assumed fees of .03 percent annually. The index portfolio was rebalanced every 12 months. The median return for the 33 state pension funds with the same five years was 12.83 percent net of fees. The states earned 1.62 percent less annually than the composite index, as noted in Table 2.

Certain states index a portion of their portfolios to public stock and bond market indexes. Assuming the performance differential set forth in Table 2 holds true over varying historical time periods, states may want to extend this indexing practice to 80 or 90 percent of their portfolios. This policy would provide annual savings approximating $5 billion. Applying this annual savings at a 7 percent liability discount rate reduces unfunded pension liability by $70 billion.

TABLE 6 STATE PENSION FUND COMPOSITE ASSET ALLOCATIONS AND INDEXES THAT MIMIC/BENCHMARK THE ASSETS

TYPICAL STATE PENSION FUND ASSET ALLOCATION CATEGORY	PUBLIC SECURITY INDEX THAT 'MIMICS' THE ASSET CATEGORY	TYPICAL STATE PENSION FUND ASSET ALLOCATION
U.S. STOCKS	RUSSELL 1000	30%
NON U.S. STOCKS	ACWI EX-U.S.	20
PRIVATE EQUITY	U.S. MICRO CAP [1]	10
U.S. FIXED INCOME	BAR CAP USAAG	20
NON U.S. FIXED INCOME	CITIGROUP WCBI EX-U.S.	10
REAL ESTATE	MSCI U.S. REIT [2]	10
		100%

[1] *Proxy for private equity*
[2] *Proxy for actual holding of real estate*

WHY PENSION FUNDS LIKE ACTIVE MANAGEMENT

Many legislators and investment industry participants have asked us why state pension fund trustees and their senior investment staffers insist on following active management when the investment results are inferior to indexing. Our research has produced three explanations:

"Hope springs eternal." Even though contrary evidence is conclusive, it is human nature to believe that your own fund can do better by active management.

"Agency problem." Pension fund investment executives do not want to (i) index themselves out of a job, or (ii) endanger their career prospects of crossing over to Wall Street where compensation is higher. To preserve their own career goals, executives do not share the facts with fund trustees or fund legislative overseers.

"Stockholm Syndrome." Pension fund executives deal with so many Wall Streeters and hear so many active management pitches that they become industry captives. The executives fail to acknowledge opposing lines of inquiry like those presented in this paper. For example, the National Association of State Retirement Administrators has an advisory committee full of active managers, like Goldman Sachs and UBS, but no indexers.

CONCLUSION

State pension systems represent the retirement security of public employees across the nation. Confidence in the

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strength of that safety net is eroding. The administrators of the states' pension systems would be wise to consider indexing the systems' portfolios[(i)] to ensure average investment returns and[(ii)] to cut unnecessary fees. This would be a safer, more responsible use of system resources than paying Wall Street management firms billions of dollars each year to deliver sub-par results on public securities and alternative investments. Taxpayers and public sector employees suffer the results of subpar performance.

Implementing an indexing policy should be moderately problematic for state governments, relative to other money-saving measures. Wall Street fee reduction from indexing is not a hot button issue like local school funding. Also, the fee cuts will impact principally the incomes of public stock and bond money managers, hedge fund managers, and private equity fund managers, who are concentrated in just a few states. Encouraging more indexing for public pension funds should thus be an easy vote for most legislators. Nevertheless, the indexing education process for state legislators will be formidable, and may consider pension fund fees to be 'inside baseball' that is unworthy of political capital.

Getting pension funds administrators to support the policy and educate legislators about indexing will be an uphill battle. By agreeing to the policy, administrators essentially admit they made mistakes by betting heavily on active managers. Who wants to admit an error? Investment consultants and Wall Street money managers will vigorously oppose such a policy because it deprives them of fee income.

EXHIBITS: (i) Excel exhibits with state-by-state data and (ii) index calculations are available at mdpolicy.org

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