Public Pension Management and Asset Investment Review Commission
Public Hearing - September 20, 2018

Opening Remarks
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Thank you Chairman Tobash, Vice Chairman Torsella and the Commissioners of this Public Pension Management and Asset Investment Review Commission for giving me this opportunity to present to you today.

As you know, this commission has been created by the legislature to study the two Pennsylvania plans and develop recommendations to reduce pension-related expenditures. Specifically, the mandate of this Commission is to focus on fee and cost transparency with a view to generating actuarial savings of $1.5bn, per plan, over 30 years.

That's why we are here. But the reason why *I am* here is easy: I've been focused on fees and costs for over a decade. I believe they are an entry point to broader discussions of governance, organizational design, management and even strategy. I think it's an incredibly important topic, albeit at times uncomfortable for many parties.

For the last two decades, I've been focused on helping the world of pensions and other beneficial long-term investors. Yesterday, I was in Des Moines working on a project with their State pension. Last week, I was in Mongolia helping that country think with their resource revenues. Today, I'm in Harrisburg. These are wildly different places with different contexts, but I've gone to these places with a similar objective: To help the governments design or improve the investment organizations that are required to meet their specific and often idiosyncratic social obligations.

I've dedicated so much of my life to this topic because our societies increasingly rely on these investment organizations to pay for pensions, to fund education, to fund medical research, to create inter-generational equity, and so on. Pension Funds. Sovereign Funds. Endowments. Foundations. Our social welfare literally relies on these funds and their ability to execute at a high level. And so, they have to be the best they can be.

If we can help these plans operate more effectively, and generate higher returns, we can literally keep the cost of our social programs down. It's simple math: Higher returns means lower contributions and / or higher benefits. So, higher returns mean cheaper pensions.

As such, we – in America and around the world - have asked these organizations to generate higher returns. The Boards of pensions, and their consultants and actuaries, pushed staff into riskier investment strategies – and often more expensive asset manager relationships – in the pursuit of *cheaper* pensions.

This was, and is, not problematic on its own, as the returns for some funds have been remarkably strong. The problem was, and is, that most Americans did not fully understand this decision and the new approach to taking more risk via external managers in complex strategies. And most people surely did not grasp the sheer scale of compensation our pensions would pay – and today are paying - to external asset managers. Nor did they appreciate the additional consequences of taking this approach for the plans own operations.

In sum, the pension funds took this approach without explaining all aspects of it <u>clearly</u> to their stakeholders. And, in my view, this lack of understanding was a recipe for stakeholder conflict and loss of trust. I'll come back to this. But before I get into the heart of this presentation, I'd like to make two key points: One, I want to talk about <u>why</u> there is a lack of understanding of the fees and costs among stakeholders. And, two, I want to offer some sense for the secondary and tertiary consequences of this lack of understanding.

<u>1) Why:</u> There is a lack of understanding among stakeholders about the external costs because much of the compensation data has been buried in fund footnotes, hidden in net asset value calculations, waived away as profit sharing or ignored by pensions under the false protection of an MFN provision. (I'll come back to the problems with MFNs later.) And the information was thus not reported. Not measured. Not tracked. And not managed.

It was hidden away because the staff in many plans across the country were afraid that the public – armed with true fee and cost information – would prevent them from investing in the complex and high cost asset classes that the plans thought they needed to generate higher returns. As staff at these organizations saw it, these strategies were strengthening the pension promise by reducing the cost of the benefits. "So what", they thought, "If the cost of the investment is astronomical… the pensions are more secure!"

So, a deal was struck: pension funds would protect managers from scrutiny so long as the returns kept coming, which is why there's so much hiding of fee data today.

<u>2) Consequences:</u> I don't think the pensions understood the secondary and tertiary consequences of the deal they made. Because those high, hidden fees created new advantages for the managers – economies of scale – which they in turn wielded back against the pension plans at the negotiating table. The gap in skills, capabilities and resources between public pension funds and private managers grew, without much understanding as to the reasons since the fees weren't being tracked! This reinforced the asymmetries of information, skill and ultimately power in favor of the managers. And the managers could thus demand more and more of those hidden fees… and they did.

Today, asset managers often set the terms for pension participation in their funds, with endowments and pension plans literally pleading and thanking their GPs for granting them – the people with all the money – a chance at an allocation in their funds. The agents are disciplining the principals, which is a perversion of the principal agent theory that is so fundamental to capitalism functioning correctly. Principals, we know, must discipline the agents. The opposite is now increasingly common in the investment business, due to a lack of fee and cost transparency right from the beginning.

As you might be starting to understand, I think the major consequence of hiding fees and costs was pension fund under-resourcing. Please recall, the responsibility of a pension fund Board and senior management team is often as much about building professional and effective investment organizations as it is actually picking things to invest in. It's the Board that should help ensure their plans remain the principals in this complex chain of principal agent relationships.

But in order to properly resource an investment organization for success, to remain the principal, one has to first assess the true cost of producing a target return – whether those returns are produced internally or externally is not the issue. The issue is how much it costs to generate a certain amount of return per unit of risk.

By minimizing the importance of fees and costs and keeping them a secret from the public, we've allowed our pension organizations to go under-resourced. And we've allowed the for-profit asset management industry to enjoy an incredible advantage at the expense of this critical social welfare institution: the American public pension plan.

I think it ironic that in trying to bolster the solvency of our most important social institutions, we have unwittingly created more billionaires on Wall Street than in any other industry in America. Today, you are twice as likely to become a billionaire by setting up an investment business and managing pension fund capital than you are starting a technology company.

In short, hiding the fees may have allowed the pensions to pursue riskier and higher returning strategies, but it also prevented the Boards from properly resourcing and thus overseeing and holding accountable their pension organizations and the associated strategies. The principals have found themselves increasingly subservient to their own agents.

And while this all might have seemed – at least in the short run – a way to optimize a portfolio given the obvious governance constraints – yes. I've heard that story many times; 'we did this in spite of the Board not because of them' – what this has actually done is weaken the plans operating capabilities and created an incredibly precarious position with stakeholders.

Here's the good news: Pennsylvania has, with this Commission, joined other courageous States to tackle this issue head on. There are new reporting regimes in places like California. We've seen funds such as CalPERS own up to past failures on fees, in terms of monitoring, and work to remedy their processes. The SEC has investigated fees and costs of alternative managers, and they uncovered a startling amount of over-charging. Newspapers around the world are now putting fee and cost numbers on their front pages.

Transparency is now on a path to inevitability. And I think that's healthy and will hopefully lead to a realignment between our pension funds and Wall Street.

But this change will probably be painful. It may require some change for how the plans are managed. Boards. Staff. Managers. Consultants. Service providers of all kinds. All of these players may see roles change after the true cost of managing a plan is revealed.

I've seen this around the world: the process of achieving fee and cost transparency is one of the most powerful catalysts I've seen for Boards to become re-invigorated and re-empowered to consider, from first principles, how they should design their own organization to achieve their investment objectives. And, for some, that's why this Commission and its work are so scary.

But, in my view, to bring our public pension funds into the modern era of finance – and level the playing field with external managers – we really do need fee and cost transparency. We need to spark change in the way we manage these plans, for the benefit of these plans.

I'd personally rather see a few less billion in the hands of investment professionals on wall street and few more billion in pension fund coffers. But we don't get there by ignoring this issue and pretending status quo is working.

Now, to be clear, I'm not arguing that any fund should seek to minimize costs at the expense of all else. I'm simply saying that funds should aggressively minimize fees *in order to maximize returns*. I don't mind if you pay a manager high fees, so long as they've actually earned it. But the problem is, they often haven't.

And so that's why I'm here today. To help your plans get a better deal. Make more money. Take home more of the money that their managers make. And we have been commissioned to write a report that will document some ideas to help these plans, and help the state save 3 billion over the years.

Over the next 25 minutes or so that remain in my presentation, I'll offer some of our preliminary findings from our work. I will seek to get into some objective data and local context. I have been asked here today to give you a sense of two specific things: the relative investment performance of PSERS and SERS; and the fee and cost performance of the funds. But before I get into these sections, let me note two caveats of importance about my analysis:

1) Performance is very challenging to measure, particularly for comparisons. The context of the performance is often so important in understanding whether a fund is generating strong risk-adjusted returns. To be honest, this is partly why I have tried to spend so much of my time focusing on the fees and costs of the funds, as it's easier to compare processes and mandate-specific terms to judge how a plan is performing than to look at performance. If you have the data, you can measure exactly what a fund has been paid and compare that directly to other funds with the exact same strategy and sometimes manager. Performance, on the other hand, can be manipulated, but the fees and costs – which you can think of as the exhaust coming out of the tailpipe of running these pension machines at high speed. This exhaust tends to offer a very useful way of assessing whether plans are running well.

2) I am genuinely sorry to say that we have not been given sufficient data to do the fee and cost analysis correctly… no private equity data. SERS failed to provide public equity contracts; the data we needed was often redacted, hidden away once again from public scrutiny. To be fair, this is a common position among some investors, such as US endowments, but, even still, the lack of data here struck me as… abnormal. This data was requested by a Commission set up by the State Legislature for oversight. The fact that it was not shared seems noteworthy. And so, I'm noting it on the record.

Notwithstanding these two constraints, we persevered and went about conducting the two key areas of analysis on the two plans to the best of our ability. The first analysis was to compare the asset allocation and performance of the two funds with a peer set of funds. The second was to examine the fees and costs of the two funds with regards to their external managers.

For the peer analysis on performance, data was obtained from the Public Plans Database of Boston College. The data from this database was audited against individual fund annual reports to ensure data accuracy. Furthermore, it is our understanding that both SERS and PSERS have validated the data from the PPD database, but I'm sure JP Aubry who is here from BC's CRR will elaborate on this in his presentation later on today.

For the analysis on fees and costs, data was obtained from the two pension plans themselves but as stated, was significantly withheld. The reason given was that the data was confidential and contained trade secrets. We will elaborate on why this reasoning is problematic in the analysis, but this is exactly the type of reasoning that has resulted in the situation I have highlighted already – it serves the interests of asset managers and weakens the pensions and systems they support over time. Notwithstanding, the fees and costs analysis presented here thus focuses predominantly on the public equity mandates where we could obtain reliable data.

[Refer to PowerPoint slides from here forward]