pennsylvania
Public School Employees'
Retirement System

Public School Employees' Retirement System (PSERS)
Testimony From
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Good Morning Chairman Tobash, Vice Chairman Torsella, and members of the Public Pension Management and Asset Investment Review Commission.

I am Glen Grell, Executive Director of the Public School Employees' Retirement System (PSERS). With me today is Jim Grossman, PSERS' Chief Investment Officer.

I would like to thank those Commission members who attended PSERS August Board and Committee meetings which included our Asset Liability Study and Asset Allocation process. We hope your attendance gave you a clearer understanding of how PSERS approaches these important processes.

Also thanks to Commissioner Bloom for attending PSERS' recent October Committee and Board meetings, as well as having a one-on-one meeting with Jim Grossman.

Before we present PSERS' ongoing fee savings and efficiency recommendations, I would like to take a few brief moments to address the false narrative that has been circulated and unfortunately continues to be circulated surrounding these hearings about PSERS.

To date PSERS has taken the high road and not engaged in a negative public debate. We prefer to engage on issues in a thoughtful, professional, factual, and principled manner. Having said that, we believe the right time to address some of the most outrageous allegations is at today's hearing when we finally have an opportunity to address the entire Commission in person.

PSERS has a duty and a responsibility to address these allegations and politically-motivated hyperbole of "hiding fees" or "wasting" the System's assets. I have two specific points regarding the public commentary to date.

1. **PSERS does not waste System assets**. This is a fact and it is not up-for-debate. Saying PSERS wasted funds is irresponsible and insulting to every PSERS employee who works hard each and every day on behalf of our members with **only** the best interests of our members in mind. This false narrative also disparages our Board members who volunteer and devote a significant amount of their time and expertise to serve on PSERS Board. As those of you who have attended PSERS Committee and Board meetings know, these meetings are very long and the Board packet contains thorough and extensive due diligence write-ups on investment opportunities as well as detailed materials on the often overlooked benefits administration side of the Agency. The ensuing discussion at Board Meetings can result in questions, dialogue, and vigorous debate on potential investments and other administrative agenda items.

The specific assertion is that PSERS "wasted" $3.9 billion in fees to Wall Street managers.

The fact is that PSERS engages and compensates money managers in areas where we can't internally manage the investment and only after due diligence of the manager. We carefully track the manager and the investment to make sure we are getting value for these fees, and we report asset class and manager performance to our Board of Trustees.

While not every investment is productive—and we frequently terminate underperforming managers—the value of these external managers fully justifies the fees paid.

Over the past 20 fiscal years, PSERS has outperformed a global 60/40 portfolio by 84 basis point. In dollars, PSERS generated $10 billion in performance above a global 60/40 passive portfolio at a cost of $6.9 billion. Net investment income during the past 20 years was approximately $62 billion and would have been only $52 billion if we followed a passive, no cost global 60/40 index portfolio.

2. **<u>PSERS does not hide fees.</u>** Another charge of this Commission is that the Funds have hidden billions of dollars in fees. PSERS has long been a leader in fee transparency. While the Government Accounting Standards Board (GASB) only requires the reporting of "readily separable fees," PSERS professionals have gone above and beyond the reporting requirements of the GASB, releasing both readily separable as well as not readily separable fees. PSERS discloses them annually in our Comprehensive Annual Financial Report, our annual budget requests to the General Assembly, and in an annual presentation to the Board of Trustees. At PSERS we pay strict adherence to reporting standards and take great pride in having been recognized for 34 straight years for excellence in public financial reporting.

   With few exceptions, standard practice for public pension plans across the country has been to disclose those fees that are readily separable. PSERS additional reporting of many not readily separable fees has led to frequent criticism of PSERS since our reported fees look much higher than many peers who have chosen not to expend the resources to capture and report not readily separable fees. We regularly hear "why are your fees so high" when various lists and surveys are published. In fact, we are actually criticized because we report fees that other funds cover in footnotes or not at all.

   We take great offense to the accusations that we are "hiding" billions of dollars in fees. While this false allegation creates sensational headlines, it is incorrect and irresponsible. This accusation relates to testimony regarding the capture and reporting of "carried interest." Carried interest received by our investment general partners is not being "hidden." Carried interest is the General Partner's (GP's) ownership interest in the venture and is a share of profits distributed from a limited partnership to the general partner. It is only earned and paid if the investment is successful and exceeds a certain predetermined "hurdle" or preferred return rate, generally 8%.

Additionally, there is no industry standard as whether carried interest is even a fee. Federal tax law views it as a capital gain while base management fees are reported as ordinary income. Income distributed from limited partnerships is net of carried interest earned and is reported accordingly in our financial statements. If we were to detail it as a "fee" in our financial statements, it would only gross up income and gross up investment expenses with no impact on the bottom line. However, given the current focus of some on this subject, we have spent significant staff time over the past year and have broken out, to the best of our ability to gather historical data, the total amount of carried interest received by our GPs in calendar years 2016, 2017, as well as since inception of our investments in private equity, private real estate, and private credit. The total amount of GP carried interest distributions since inception **(from the 1980s)** through December 31, 2017 was $5.2 billion. Clearly a large number, but to put this in perspective, the System received $24.2 billion in income net of the carried interest and all other costs. This carried interest presentation is posted on our web site and has already been provided to the Commission.

The fact is however, PSERS and its members, benefit when we incur carried interest to our GPs because it means our investments have been very profitable. I'd pay $5 billion to get $24 billion for our members any time.

Before moving to the next portion of our testimony – dealing with management fees and efforts to control and reduce them – I want to offer some research and analysis we have compiled while awaiting our opportunity to address the Commission. Chairman Tobash's invitation made it clear not to dwell on our views on your prior witnesses or any explanations of how we operate and manage PSERS. However, we offer these materials for your consideration.

Moving to the subject of manager fees and efforts to reduce them, I want to take you back three years ago, shortly after I became the Executive Director of PSERS. Governor Wolf expressed an interest in the investment operations at both pension funds. We were asked to meet with Governor Wolf to review our investment policies and strategies. In an effort to be professional and thorough, PSERS prepared a slide deck of 50+ pages and provided this briefing material to the Governor's Office. We are providing the Commission with a copy of the slide deck we presented to Governor Wolf in June 2015. The point is that PSERS has been focused on monitoring, measuring, and controlling external fees every day since I have been Executive Director.

It was very clear during the presentation that Governor Wolf had personally reviewed the lengthy presentation in detail and had a complete grasp of the information provided. The Governor asked astute questions regarding why and when PSERS manages funds internally versus externally; how we select and monitor managers; and when we use active versus passive management. The Governor expressed an interest in keeping external managers and external manager fees as low as possible, but we quickly moved on to other topics, having satisfied his concerns about our approach to the use of external managers.

In the ensuing year we reduced our reliance on external managers and requested additional complement positions to further support PSERS internal investment operations. This move to expand internal management significantly lowered external manager fees even while we awaited the additional complement. The Governor issued a press statement in March 2016 noting this accomplishment. Unfortunately further reduction efforts stalled when it took PSERS approximately 18 months to receive approval for seven of the 15 additional internal investment office positions we had requested. The seven positions, once approved, were filled and we have continued to add significant talent to our investment office which now includes 13 Chartered Financial Analyst Charterholders and 16 MBAs.

Like many other large public pension funds with best in class internal investment operations, we believe a part of the solution to large external management fees is to build a strong internal investment platform with the skills and tools to engage in the kind of sophisticated pension asset management that other comparable public pension funds do. PSERS investment professionals currently manage 19 portfolios in-house with a net asset value of over $23 billion in-house saving approximately $39 million a year in external manager fees. The amount managed internally increased $6 billon from just three years ago from 30% of the Fund's asset to 36% today.

I would like to turn over the next portion of our testimony to our CIO Jim Grossman, to present PSERS Fee Savings Plan. This plan was created in response to Act 5 and to Treasurer Torsella's sponsored Board resolution challenging PSERS Investment Professionals to work with our consultants to create a Fee Savings Plan. The plan was presented and adopted by PSERS Board at the August 2018 Board meeting. This plan is a fluid and flexible plan of action that will adapt and change as necessary.

Fee Savings Plan – (Jim Grossman)

Section 8538 of Act 5 established a goal for PSERS to develop a plan to save $1.5 billion in management fees over 30 years. PSERS Retirement Board Resolution 2017-41, passed December 8, 2017, was developed by the Treasurer and our Executive Director. It directed PSERS Investment Professionals and the Board's investment consultants to come up with a fee savings plan to present to the Board. PSERS Investment Professionals presented such a plan at its August 2018 Board Meeting.

The plan focused on investment manager cost efficiency, assumed no changes to the strategic asset allocation, included those portions of the asset allocation where we expected fees to increase in the future, and was to be implemented over three years. Annual savings were converted to cumulative compounded savings over a 30-year period.

PSERS Investment Professionals took a two-pronged approach to generate fee savings.

The first was to establish a plan to renegotiate management fee arrangements to create a better alignment of interest between PSERS and each investment manager. The goal was to decrease the guaranteed fees, or base fees, in exchange for a profit-sharing arrangement on returns above a negotiated benchmark. Estimated savings from these reduced guaranteed fees amounted to over $1.5 billion compounded over 30 years.

The second was to expand internal management and bring additional assets in-house at a lower cost than external management. Net of the cost of the additional 9 investment professionals needed, we estimated savings of over $900 million compounded over 30 years.

Together, the cumulative fee savings are $2.4 billion compounded over 30 years, which represent a 9.6% annual reduction in base management fees. The detailed presentation is posted on our website and has been provided to the Commission.

The fee savings plan crafted is by no means an end to our efforts to reduce management fees and better align the interests of the investment managers with PSERS. Since the plan was prepared, we've identified over $350 million in additional cumulative base fee savings compounded over 30 years. The cumulative fee savings have now increased to $2.8 billion compounded over 30 years, a 10.4% annual reduction in base management fees.

In addition, we've aggressively negotiated management fee deals with new managers and mandates. In two cases recently, we entered into agreements with zero base management fees and the investment manager only gets a share of the profits generated, plus we are currently negotiating two other similar deals. In other cases, we have continued our longstanding practice of obtaining fee discounts for our large commitments and for being in the first closing of a fund.

We also aggressively negotiate the less obvious management fee terms as well, including hurdle rates and catch-up provisions. It is important to recognize that the long-term nature of our pension plan positions us to drive fees down even further because managers are generally willing to accept lower fees in exchange for stable, patient capital. Whenever possible, we attempt to make the most of this natural advantage.

One criticism of the fee savings plan we'd like to address relates to the profit-sharing fees. We've received questions about the possibility that total management fees – base fees plus profit-shares -- may increase under this plan. To be clear, the plan has at least a 9.6% reduction in base management fees. Base management fees are guaranteed no matter the performance. So, overall base management fees are going down. If we are so fortunate as to have very strong performance by the investment managers, then the profit-sharing component of total fees will go up. If the profit-share goes up, so does our investment income. For example, if a manager has a 20% profit share and earns $10 million above its benchmark, then PSERS is better off by $8 million while the manager collects an additional $2 million. Our interests are aligned. Higher investment income means lower required contributions and, by extension, lower taxes for the Commonwealth and school employers. In government, increased costs are generally frowned upon since increased taxes are required to fund them. In investment management, increased profit-sharing fees are funded by increased performance which has the opposite effect: decreased costs to the government as well as less taxes needed to fund the pension benefit. It's a win-win-win. It's a win for PSERS members, the taxpayer, and the investment manager. And importantly, a profit-share focuses the manager's efforts on performance rather than simply growing assets under management to collect more base fees, an activity that often reduces the likelihood of outperformance.

Another item to note is that we have not included in our fee savings plan any savings from not having to pay carried interest in our private equity co-investment program or reduced carried interest in our real estate co-investment program. The private equity co-investment program allows us to invest in private companies at no cost: no fee and no carry. The real estate co-investment program allows us to invest in private real estate at reduced fee and reduced carry. Based on the size and success of our private equity co-investment program alone, which has an internal rate of return of over 23%, the savings would be significant.

Also not included in our fee savings plan are other areas of consideration recommended by our investment consultants, including an increased pursuit of strategic partnerships; direct investing in private markets; secondary sales of non-core, fee-paying private markets funds; side-car co-investment vehicles; and non-management fee reductions for new investments such as 100% fee offsets.

Additionally, our size, longevity and reputation position us as the perfect partner for new managers who require an anchor investor. Such "seed investors" in new investment managers commonly negotiate a perpetual share of the revenue generated by the new manager, effectively transforming manager fees into a new profit center for PSERS. These are all areas that merit further exploration.

Best Practice Procurement

We are open to considering any fee savings recommendations that 1, enhance PSERS net-of-fee return; and 2, do not increase the risk of the investment program. The investment professionals at PSERS are always looking to negotiate the fairest fee deal possible. To that end, we've recently implemented a formal External Manager Fee Policy to document our objectives in fee negotiations. In addition, we've instituted a formal internal policy of reviewing all fee arrangements at least once every two and a half years to ensure that each fee arrangement is still appropriate. All fee negotiations are now formally documented and saved in our document management system in accordance with recommendations from the Auditor General.

Additional Recommendations – (GLEN GRELL)

You have asked us to come here today with ideas on how the General Assembly can help ensure the availability of PSERS pension benefits into the future.

We will present seven or so specific recommendations, however, we urge caution in any legislation to restrict the management of either fund by its respective Board. Frankly, when the General Assembly has acted on pension matters in the past, the results have ranged from modestly helpful to disastrous.

To illustrate, let me share 2 charts, which when considered in tandem tell a troublesome story.

On the top chart the blue line shows the average public fund percentage of Employer Contributions versus the ARC/ADC. The green line is the comparable rate of contributions to PSERS during the well-documented extended period of underfunding. It bottomed out at 27% in the year Act 120 was passed.

The good news is Act 120 put the Commonwealth on the climb to 100% annual funding – painful to school districts and the General Fund but essential to the health of the Fund.

The bottom chart shows how poor policy decisions (in this case mostly via legislation) can take a public pension fund from robust 128% funded in 2001 to 56% funded in FY 2016/2017. What happened?

- First, Act 9 granted benefit enhancements which were not only unfunded but also were made retroactive.
- Second, investment markets fell sharply after September 11 and the so-called Dot.com bubble.
- Third, in response, the Administration and General Assembly artificially suppressed the Employer Contribution Rate, thereby underfunding the plan for 10-12 years.

This sequence of events has strapped PSERS with a $44 billion unfunded liability which eats 75 cents of every employer contribution dollar we receive. And none of this had anything to do with manager fees.

With that backdrop, I offer these ideas for what the General Assembly should do- and several things they should not do – to support the System and its members.

1. **Require 100% annual funding of the ARC** so the last three years become the rule and not the exception.
2. Toward that end, **a constitutional amendment** requiring full actuarial funding of PSERS and SERS should be recommended and pursued.
3. **Require prefunding for any benefit enhancements/COLAs** that may be offered in the future to avoid adding any more debt to the system. These enhancements are not currently prefunded. When an enhancement is granted it immediately adds a debt (millions or billions) to the fund on top of existing pension debt. Prefunding will make the true costs of any enhancements transparent to all constituencies and prevent any unfunded mandates.
4. **Pass governance reforms which enable the PSERS Board to exercise greater autonomy and agility in its operations**. PSERS has a short list of such governance reforms but a prime and illustrative example is the ability of the PSERS Board to set the Agency complement and organizational structure. Currently, we have to go through the Office of Administration hiring process and receive approval from the Budget Office to increase staff complement. PSERS currently manages over $23 billion internally, making PSERS one of the largest money managers in Pennsylvania. Significant additional fee savings may be gained from bringing more assets internally to be managed. In fact, greater internal management is an essential element of any fee reduction plan. That, however, will require PSERS to get an approval to increase complement. We currently have 10

positions pending with the Budget Office. We appreciate the assistance we have eventually received from the Governor and the Budget Office but 18 months is too long to wait.

5. **Perhaps a missed opportunity, but both PSERS and SERS felt there was no reason to require each system to establish a Defined Contribution (DC) plan structure under Act 5.** When Act 5 was passed, two separate defined contribution plans needed to be created, which limited the ability to leverage the bargaining power of the Commonwealth in negotiating with third party service providers. Additionally, it required duplicative efforts by PSERS and SERS in management oversight of the DC plans. PSERS recommends making one organization responsible for the administration and oversight of the two DC plans. PSERS would support enabling legislation that would allow the two Funds to consolidate the DC plans at an opportune time once they are established.
6. **Consider establishing a Rate Stabilization Fund** or other form of reserve fund along the lines of a current proposal from Representative Frank Ryan. Similar, and perhaps in concert with a Rainy Day Fund, but dedicated to PSERS as a future cushion for school districts against increases in the employer contribution rate.
7. **Authorize PSERS to engage its own custodian bank.** – It is rare today for a State Treasurer to act as the statutory custodian for a public pension where the state's legislature has created an independent pension Board, but in Pennsylvania that's the case. The Treasurer, not PSERS' Board, has sole authority to select a custodian bank on behalf of PSERS' defined benefit plan. The custodian bank's client is Treasury, not PSERS. Treasury assesses PSERS approximately $2.5 million annually in fees attributable to Treasury's custodian bank contract, yet PSERS lacks any authority to require the custodian bank to meet service level standards. This situation creates not only operational risks and conflicts of interest but also real economic costs. PSERS has encountered and continues to encounter a profusion of errors and omissions by the custodian bank. For example, we regularly see the custodian bank not crediting us income it has received on our behalf in a complete and timely manner and charging us fees for account overdrafts actually caused by the bank's own actions. PSERS has had to assign a number of investment professionals to overcome the custodian bank's lax quality controls in order to safeguard the Fund's assets. These investment professionals could have been and should have been deployed in more productive activities. Unfortunately, Treasury staff, under several Treasurers, have been ineffectual in addressing our concerns or holding the custodian bank accountable. We recommend that the PSERS Board be given the statutory authority to directly hire and manage its own custodian bank relationship.

Finally, what not to do:

I ask you to remember the period prior to the mid-1990s, PSERS' universe of investment options was limited by statute. In 1994, Pennsylvania policymakers wisely chose to move PSERS away from these legal lists by statutorily providing the Board of Trustees with prudent person investment authority, broadening the Board's powers to invest the Fund's assets for benefit of the system's members. As noted in this testimony, the results of empowering the Board to invest in this manner have been overwhelmingly positive. Limiting the Board's authority again at this time would amount to a form of unnecessary and onerous regulation that would turn the clock back toward the days of legal lists, limiting the investment return potential of the fund, imposing arbitrary caps on fee arrangements, thereby increasing employer contributions and unnecessarily burdening the taxpayers of the Commonwealth with the resulting bill.

In closing, I urge you again to proceed with caution.

- Please avoid the knee-jerk approach to legislation.
- Avoid the "sounds good"/"looks good" reaction.
- Avoid legislating trendy concepts that tend to fall from favor faster than legislative bodies can react.
- Be deliberative in the approach to legislative proposals.
- Consult with the Systems and our consultants on the merits and risks associated with a proposal.

PSERS is a large complex system, and should any future recommendations from the Commission impact investment risk or returns; including changing the asset allocation or the actuarial assumption; there could be a significant negative impact on taxpayers and the General Fund. This is a rapidly changing investment industry, with new products and strategies emerging regularly. Don't tie the hands of our Trustees and Investment Office to participate and lead. Remember, just as there is in the commercial sector there are real costs associated with regulation and with a public pension fund those costs are reflected in the employer contribution rate.

Thank you for the opportunity to appear before you today. We will be happy to answer any questions you may have.