The Collective Wisdom in Managing Public Pension Assets

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Mr. Chairman, Mr. Vice-Chairman, Commissioners, thank you for having me here today. I was asked to come to share my thoughts on the issues of performance, transparency, and fees in the context of state pension plans. I am here as an experienced institutional investment advisor, having worked with literally hundreds of public pension systems over the last 40 years. I have advised some of the largest US state and federal pensions through my career on all aspects of their investing. These include CalPERS, CalSTRS, Connecticut RS, DC Retirement System, Federal Retirement Thrift Investment Board, Iowa PERS, Maine PERS, Massachusetts PRIM, Nebraska DB, New Mexico PERA, Ohio PERS, STRS Ohio, Ohio Police & Fire, Oregon PERS, The Pension Benefit Guaranty Corporation, Pennsylvania SERS, Pennsylvania PSERS, New Jersey SIC, Rhode Island ERS, Texas CDRS, Virginia RS, and Wisconsin (SWIB). You can see that my credentials come from the school of hard knocks. As an investment consultant I have introduced and helped guide the use of both low-cost index funds and higher-cost private equity, seeing an important role for both. I have been intimately involved in virtually all aspects of pension investing as an advisor to pension boards and staffs. My objective in the next 20 minutes is to share what insight I have into the issues that I think the Commission is most interested in, providing perhaps a different perspective from several of the outsiders you have already heard from.

Let me start with Slide 1, which I call "The Inconvenient Truth" in state pensions. You have already heard this narrative in prior meetings. Actuarial rates have been too high for too long compared to the returns pensions earned. The high actuarial rates caused contributions to be too low, eroding pension funding rates from near unity (100%) in 2000 to roughly 70% today. Justifiably, all stakeholders in public pensions understand this is a problem and want to fix it.

I understand that one important Commission task is reviewing the state's investment strategies. No investment strategy is more important than the asset allocation adopted as policy by individual pension boards. Studies show that the choice and weighting to individual asset classes have the greatest impact on long term pension return and risk. So, the first question is whether the problem is the investment strategy or the actuarial rate? Or both? Are pension boards making asset allocation decisions that offer the best chance of achieving pension security, or not?

You have already heard testimony on long term asset allocation trends, which I won't repeat here. Instead I want to impress on you that public pensions "cluster" in almost all their investment decisions, and no more so than asset allocation, covered in Slide 2. There are several reasons. Foremost is the role of the "prudent person" in fiduciary law. Investment decisions by board members are heavily influenced by what other pensions are doing, a proxy for prudent person, and in the small community of public pensions, everybody knows what everyone else is doing. This is reinforced by the handful of investment consultants that guide asset allocation decision-making using mostly the same models and inputs.

Importantly, this all leads to similar asset allocation policies, groomed by the collective wisdom of the boards and investment professionals, and producing returns that the financial markets will allow them to earn, not what the actuaries assume they will achieve. As fiduciaries, boards are continually balancing the pull of high actuarial rates against the push of higher risk that achieving these high rates would entail. Most pensions end up in roughly the same place, as Slide 3 shows, where return and risk for state pensions cluster tightly between a commonly used low risk bond index and a higher risk stock index.

State pensions fail in asset allocation when they give up too soon on their existing asset mix, for example, moving from lower to higher risk strategies near the top of the market or moving from higher to lower risk strategies after a market downturn. Sticking with the existing asset allocation strategy has proven as important to long term performance as which strategy you choose.

Let me also add that, statistically, state pension asset allocation has been independent of funding ratio. This means that state pensions generally ignore, or act as if they ignore, funding ratios in setting asset allocation. Anecdotally, that has also been my experience and is not necessarily a bad thing. Boards have generally viewed pension funding as an actuarial issue, not an investment issue, seeing themselves as setting prudent investment policies with expected returns that actuaries should then use to set funding amounts. An unfortunate post-Global Financial Crisis perversion has been to pressure Boards to change investment policies to be consistent with high actuarial rates and their low funding schedules, rather than fiduciary standards.

In summary, my opinion is that the health of state pension systems has not been compromised by current or past asset allocation practices.

Staying on the topic of investment strategy is the question of active versus passive management. First, let me say that public pension systems were some of the earliest and largest investors in index funds, because of their low fees, good performance, and the ability to get monies invested or divested quickly. None of that has changed and index funds now represent close to 70% of state pension US equity allocations and 20% of total assets.

The attraction of index funds though is not all consuming. First, there are asset classes where indexing is not possible, like private equity and private real estate. Second, there is concern with trade execution and price dislocation for index funds that track securities that are not traded on exchanges, such as high yield bonds and loans. Third, there are some asset classes that are viewed as price inefficient where investors believe active management can add to return, net of higher fees. These include small cap stocks, high yield bonds, and non-US stocks. Most state pensions use a combination of active and passive management for these asset classes, with very few 100% active or 100% passive.

Slides 4 and 5 illustrate some of the thinking behind active and passive investing. Both slides report 10-year performance for state pensions by asset class. Slide 5 provides asset class returns for individual state pension systems while Slide 6 consolidates asset class performance into a single asset class average. Also shown are the most common asset class benchmarks, which can be viewed as a proxy for passive management for the asset class.

US equity allocations generally trail index funds, represented by the Russell 3000 index, suggesting that perhaps more or all of that asset class should be indexed. However, for fixed income and non-US equity state pension returns generally outperformed index funds. State pension boards regularly weigh past performance and fees in deciding how much of every asset class to allocate to index funds.

Key to the well-functioning of a market system is the reallocation of capital from bad performing companies to good performing companies. This function was largely broken in the 1970s as companies grew to become large underperforming conglomerates without outside forces that could change management behavior. Terms like “entrenched management”, “enriched management” and “conglomerate discount” came to unhappily describe corporate America. At the time, corporate pensions dominated the institutional landscape and their proxy policies were to strictly vote with management so as not to rock their own boats. This capital dysfunction was corrected when large state pensions began using private equity, proxy voting, and high yield (junk) bonds to dislodge bad management and capital from poor performing companies. Private equity and high yield bonds not only directly benefited state pensions through their higher returns but also indirectly benefited index funds through merger and acquisition premiums, a form of economic “externality” that bequeaths a part of the wealth creation of private equity to index investors.

Slide 6 reports the net-of-fee performance of private equity for individual state pensions and a composite return for 16 years ending fiscal 2017. Without exception, state pension private equity returns exceeded an equivalent public equity return with the average private equity return equaling 10.7%, compared to 6.6% for the public equity markets. The difference of 3.1% per year, if repeated over the next 10 years, would produce a cumulative 87% in additional return compared to the index fund alternative. Considering past performance, it is surprising that the average state pension allocation to private equity is less than 10% of total assets.

Previous testimony has suggested that private equity has lost its performance edge versus public equity. And it is true that, post the Global Financial Crisis, state pension private equity returns have exceeded public equities by a smaller 1%, compared to the 3% longer term average. However, drawing forward-looking conclusions from this data is premature. Historical return patterns show that most of the outperformance in private equity occurs when the public markets turn bearish, because (1) lagged private equity valuations get a chance to catch up to public valuations and (2) the value-driven strategies of private equity are most effective in stock market downturns.

If I may briefly go back to the subject of asset allocation and speak to the issue of private equity and liquidity management, which had been generally overlooked in asset allocation. Trustees learned from the Global Financial Crisis that asset allocation targets to private equity, and private assets more generally, need to take account of the cash flow needs of the pension system and the potential for large variances in actual versus target asset allocation during market downturns. Prior to the Global Financial Crisis, many large endowments, including Princeton and Stanford, had outsized allocations and unfunded commitments to private assets, well exceeding 50% of their total assets. The Crisis forced these and other endowments into potential distressed sales of their illiquid assets and unfunded commitments to meet then current spending needs. Fortunately, distressed sales were largely averted as the markets rebounded and private asset managers delayed calling uncommitted capital. But the experience was a “lesson learned” and today state pensions routinely incorporate liquidity management when stress testing their asset allocation policies. My own experience working with pensions and endowments is that allocations to private assets above 40% of total assets requires a detailed liquidity plan as part of an overall asset allocation study. Currently, the average allocation to private assets among state pensions equals 25% of total assets.

Let's turn now to manager fees because despite strong historical returns produced by private equity, it is also where most state pensions spend the most in fees. One of the challenges in understanding private equity fees is that they can't be expressed as a fixed percentage of assets. In addition, there are several fee components and each component can vary depending upon performance and time.

Fee components and levels are spelled out in private equity partnership agreements, which are negotiated between the managers and investors before the partnership is activated. Large state pensions have historically played an active role in negotiating private equity partnership fees and terms and are not simply "price takers."

Slide 7 provides total fee estimates for a typical private equity partnership for different levels of gross-of-fee partnership return (IRR). Note on the right-hand side of Slide 7 the fee components and fee rates for a typical partnership. Collectively, these fee components and rates produce different fees-as-a-percent-of-invested-assets, the common measure of expressing fee rates, for different levels of gross partnership return. This uncertainty in combined private equity fee rates is frustrating when trying to answer the simple question "what am I paying for private equity." But as Slide 7 shows paying more in combined fees is probably a good thing because your net-of-fee performance is better.

Our fee analysis using Monte Carlo simulation to capture differing possible return outcomes yields an expected combined private equity fee equal to 3.73% of invested assets, which represents approximately 25% of gross profits.

How might investment professionals pass judgement on these fees? Well the 25% of profits would likely seem very reasonable to investors in private assets. On the other hand, the 3.73% combined fee as a percent of invested assets might strike investors accustomed to traditional asset fee rates as extraordinarily high. "Fee fairness" is difficult to assess but in their allocations to private equity these fees are aggressively negotiated by state pensions against the backdrop of performance expectations and competitive pressures to access top performing funds.

My intent is to impress on the Commission that by no means is there an attitude of acceptance by state pensions when it comes to fees. In addition to pressing for best practices when it comes to partnership fees, state pensions are aggressively moving in two additional directions to lower fees. The first is co-investments which allow state pensions to potentially invest directly in the same deals as the manager puts into the fund, but at a much lower fee or no fee at all. The second is what is often called "strategic partnerships." These are bespoke agreements between a state pension and a highly valued manager where the state pension commits significant long-term capital to the manager across multiple years and strategies in return for lower management fees and netting of performance fees. These are important tools that state pensions can use to significantly reduce overall private equity fees.

In my final remarks I would like to first complement all the presenters that preceded me. Their analysis, opinions, and recommendations deserve serious consideration. But I do take exception to a narrative that a couple presenters put forward; that is the claim that state pension staff are hiding fees from the public for fear of losing their jobs. I can tell you from personal experience over many years that nothing is further from the truth. I have found staff across pension systems to be qualified, hard-working, ethical, and thinking first of the beneficiaries that the assets support. In fact, today, one of the most serious issues facing state pensions is keeping staff, particularly in the nation's state capitals where professional opportunities in public policy far outweigh the opportunities in investment policy.

Most likely, outsider distrust of pension staff comes from a lack of understanding that transparency itself is negotiated as part of the legal agreements underlying private equity and other private investments. Part of the agreed upon terms of these investments is confidentiality on the part of the investor, subject to legal redress.

Pension staffs are not turning over data to outside parties because they are abiding by these agreements, not because they are afraid for their jobs. Yes, state pensions could change these agreements and require transparency by their private equity managers as a condition of investment. Perhaps public policy overrides investment policy in this instance. But make no mistake, such action will likely result in lower returns, of some unknown magnitude, from adverse selection, particularly in today's favorable fundraising environment.

With that I conclude my testimony. Thank you, Mr. Chairman, for the opportunity to share my thoughts and I would welcome any questions you might have at this time.