

COMMONWEALTH OF PENNSYLVANIA
JOINT STATE GOVERNMENT COMMISSION

PUBLIC PENSION MANAGEMENT & ASSET INVESTMENT
REVIEW COMMISSION HEARING

STATE CAPITOL
HARRISBURG, PA

IRVIS OFFICE BUILDING
ROOM G-50

THURSDAY, OCTOBER 25, 2018
9:30 A.M.

BEFORE:

REPRESENTATIVE MICHAEL TOBASH, CHAIRMAN
TREASURER JOSEPH TORSELLA, VICE-CHAIRMAN
JAMES BLOOM, COMMISSIONER
BERNIE GALLAGHER, COMMISSIONER
MICHAEL TORBERT, COMMISSIONER

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*Joint State Government Commission
Commonwealth of Pennsylvania*

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I N D E X

TESTIFIERS

* * *

<u>NAME</u>	<u>PAGE</u>
TERRI SANCHEZ EXECUTIVE DIRECTOR, STATE EMPLOYEES' RETIREMENT SYSTEM.....	11
BRYAN LEWIS CHIEF INVESTMENT OFFICER, STATE EMPLOYEES' RETIREMENT SYSTEM.....	17
GLEN GRELL EXECUTIVE DIRECTOR, PUBLIC SCHOOL EMPLOYEES' RETIREMENT SYSTEM.....	50
JIM GROSSMAN CHIEF INVESTMENT OFFICER, PUBLIC SCHOOL EMPLOYEES' RETIREMENT SYSTEM.....	60
ASHBY MONK, Ph.D. EXECUTIVE DIRECTOR, GLOBAL PROJECTS CENTER, STANFORD UNIVERSITY.....	97
MARCEL STAUB, Ph.D. FOUNDING PARTNER AND CEO, NOVARCA GROUP.....	139
STEPHEN NESBITT CHIEF INVESTMENT OFFICER, CLIFFWATER, LLC....	172
CHARLEY ELLIS, Ph.D. INVESTMENT CONSULTANT.....	195

SUBMITTED WRITTEN TESTIMONY

* * *

(See submitted written testimony and handouts online
at the Joint State Government Commission's website.)

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P R O C E E D I N G S

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CHAIRMAN TOBASH: Good morning and welcome everyone to our third and final hearing. The commission has done a good deal amount of work so far. I just want to welcome everyone, including testifiers and members of the audience and interested parties.

Seeing that we have got a quorum, we have all our commission members here this morning, I guess we'll get rid of some of the formalities. But the first thing we need to do is approve the minutes from the prior two meetings. I understand that the commissioners are in receipt of the July 30th, 2018 minutes from that meeting.

Can I have a motion to accept those minutes?

COMMISSIONER BLOOM: So moved.

COMMISSIONER TORBERT: Second.

CHAIRMAN TOBASH: Second?

Seeing a motion and second, all in favor.

(Unanimous vote.)

CHAIRMAN TOBASH: Thank you.

And September 20th, 2018 meeting, I believe we're all in receipt of those minutes, as well. A motion?

VICE-CHAIRMAN TORSELLA: So moved.

COMMISSIONER BLOOM: Second.

CHAIRMAN TOBASH: Second, thank you. Motion

1 and second, all those in favor.

2 (Unanimous vote.)

3 CHAIRMAN TOBASH: Okay. Thank you very much.

4 So as we continue to move down this path,
5 we've got a tremendous responsibility that continues to lie
6 in front of us and we're moving along very quickly.

7 And I just have to continue to say that I'm
8 gratified by the amount and willingness of world-class
9 testifiers to come to Pennsylvania to try and support our
10 efforts to be as effective as we can with retirement
11 benefits, the funds that we have under management right now,
12 and helping to improve the performance of our pension
13 organizations.

14 With that said, we will be moving along and
15 we will be challenged to get our report completed by the end
16 of our six-month period. There's much testimony that will
17 be, has been developed and will be incorporated into the
18 report.

19 And with that said, we've got a rough draft
20 that we've got right now. And we want to submit that and
21 put that into circulation to the commissioners at this point
22 in time.

23 As I mentioned, the first meeting that we had
24 was on May 30th and the report is due six months after that
25 and we've got an outline here that I want the commissioners

1 to have. And my hope is, at this point in time, that we'll
2 have an opportunity for each commissioner to take a look at
3 that outline and weigh in with the potential to offer some
4 additions, potentially some commentary on amendments, and an
5 opportunity to develop any additional information that they
6 think needs to be included in the final commission report.

7 With that said, at this point in time, this
8 is a rough draft outline. It is something that is not the
9 final product of the commission.

10 I can just say this, that the commission has
11 tried to be as inclusive as we possibly can in taking
12 testimony that has come forward, and sometimes with a little
13 bit of difficulty. I mean, as you can imagine, going out
14 into the investment arena, it is oftentimes difficult to get
15 people to come to Pennsylvania and offer their expertise.
16 Many have done so, but there were many others that were
17 approached. And the work that has been developed by the
18 commission through testimony, I think, is very important.
19 And I think it will help us, again, to have these systems
20 perform at a very high level.

21 At this point in time, we've distributed
22 that. And I just want to try and communicate a little bit
23 more of the potential time line.

24 My hope would be that prior to Thanksgiving,
25 that we have any additional information that other

1 commissioners would like to incorporate into our final
2 product. And that would be the week of Thanksgiving week,
3 or the week of the 19th of November.

4 So here's my request. We've gotten a rough
5 outline into the hands of the commissioners. If we can
6 develop any additions or alterations that they think would
7 be important, we'd like to have that information back prior
8 to the 19th of November. At that point in time, I would
9 encourage commission members to work with staff, to continue
10 to help develop that document.

11 And for a final approval of a document, it is
12 our intention, my intention, to have a meeting the week of
13 December 12th. So the week of December 12th is when we
14 would like to approve a final document that includes the
15 work that has been consolidated through the offices and the
16 testimony that we have received so far.

17 Commissioner Gallagher.

18 COMMISSIONER GALLAGHER: Thank you, Mr.
19 Chair. I appreciate the time line. That's helpful in terms
20 of the capacity of the commission and those helping us to
21 prepare the report.

22 I would like to just ask in terms of
23 logistics, in the effort of not duplicating efforts, how can
24 we best be more efficient in that if we're all working on
25 the same parts of this outline, that seems duplicative. How

1 can we avoid that? Do you have any thoughts on that?

2 CHAIRMAN TOBASH: Yeah. So I mean, again,
3 I'll thank the work of the Joint State Government
4 Commission. They are the logistic element of the
5 commission. So we have been communicating generally through
6 them and I think that the coordination will continue to be
7 done as such.

8 You know, Bernie, as this report comes
9 together, we'll be voting on a final product and we want you
10 to be able to work with, and other commissioners to be able
11 to work with staff. So let's coordinate through Joint State
12 Government. We'll be in close contact with our consultant,
13 Dr. Monk, as well as other people. Susan Boyle from the
14 House staff has been very helpful, the Treasurer's Office
15 has been helpful. We'll try and communicate to the best
16 that we can to make sure that all commentary is included in
17 the report.

18 COMMISSIONER GALLAGHER: Very good. Thank
19 you.

20 So is Joint State Government Commission
21 drafting the report, so we should just all send it in and
22 they'll integrate it?

23 CHAIRMAN TOBASH: So there will be different
24 elements of the report. Some of them will come from my
25 office, including the help of the legislative staff that

1 we've got here; the Treasurer, their office has also taken
2 much time and effort in coming to some conclusion and
3 opinion and they will include their work in the document;
4 other commissioners are welcome to do the same; and Joint
5 State Government will be the facilitator.

6 COMMISSIONER GALLAGHER: Fantastic.

7 You know, given that we're going to give
8 recommendations on transparency, as long as this whole
9 process is transparent, then I think it will work out great.

10 CHAIRMAN TOBASH: Great. Thank you very
11 much.

12 Seeing as we're going to continue to move
13 forward, it's our intent, prior to November 30th, to have a
14 rough draft, to finalize that draft for December 12th.
15 Again, we want to be as inclusive as we possibly can and I
16 think the process, quite frankly, has been gratifying to me.

17 You know, I knew that at the time that this
18 law was established and the commission was established, that
19 we would have a lot of work in front of us, and the
20 magnitude of work, quite frankly, was a little bit beyond
21 the scope that I expected. But with all hands on deck, I
22 really, truly believe that we will come up with a document
23 that is a laddered approach that can be given to the general
24 assembly in their effort to make sure that as an
25 organization that has established these retirement benefits

1 and, you know, these retirement organizations, that we are
2 keeping our eye on the ball to expect world-class
3 performance for Pennsylvanians, because they really are a
4 huge part of Pennsylvania's economy. And the fact that
5 retirees are expecting a benefit that they've been promised,
6 it's important for us to be mindful and make sure that we
7 are expecting the performance that we can truly obtain.

8 Is there any comments from any other
9 commissioners at this point in time?

10 (No response.)

11 CHAIRMAN TOBASH: Great. Okay. So we've got
12 a busy day in front of us. I'll talk about our first
13 technical difficulty of the day.

14 I believe that on the screens, you'll notice
15 that there is a presentation there, but that will not take
16 place until later in the session. And we're just going to
17 have that there. It's not what we are talking about.

18 I think, Dr. Monk, that will be your
19 presentation later on. But it's my understanding that SERS
20 and PSERS are not offering any graphics, and we are going to
21 hear from them, I believe, first. I think they are first
22 up.

23 So with that said, we've got recommendations
24 from the systems, Terri Sanchez, the executive director of
25 SERS; Bryan Lewis, their chief investment officer of the

1 State Employees' Retirement System will be our first
2 testifiers of the day. We're anxious to hear that
3 testimony.

4 I'll just note that on October 10th, I sent a
5 note. I think it's often very productive to be able to
6 testify and take a look at yourselves. And I think with an
7 early conversation after the commission was established, I
8 had an opportunity to talk to Ms. Sanchez, as well as Glen
9 Grell from PSERS. And there were some concerns about the
10 way the structures are set up and some opportunity that
11 those systems believe could be taken advantage of for them
12 to operate more effectively and perform better.

13 So with that said, we're anxious to hear
14 testimony today from both PSERS and SERS about just what
15 they see within their operations that might be changed in
16 order for them to operate at peak performance.

17 So welcome to the SERS testifiers. Thank you
18 very much.

19 Okay, Terri, go ahead, lead us off. Thank
20 you very much.

21 MS. SANCHEZ: Good morning. Thank you, Mr.
22 Chairman and members of the commission, for inviting the
23 State Employees' Retirement System here today to provide
24 testimony.

25 My name is Terri Sanchez and I'm the

1 executive director of the State Employees' Retirement
2 System. Joining me today to testify is Mr. Bryan Lewis, our
3 chief investment officer.

4 Bryan has been with SERS since 2016. I have
5 been with SERS since May of this year. And I can't think of
6 a better time to be with this organization. For SERS, it's
7 a time of tremendous change on many fronts, change that as
8 one who stands in a fiduciary status to the 240,000 members
9 of this system, I'm proud to be part of.

10 The State Employees' Retirement Board is in
11 the process of enhancing board governance by adopting
12 leading governance policies and practices that improve the
13 effectiveness of the board to better serve the needs of the
14 retirement system's members and employers with corresponding
15 benefits to the taxpayers of Pennsylvania. We're also
16 implementing one of the most comprehensive pieces of pension
17 legislation in the 95-year history of this organization, Act
18 5 of 2017. And we're evaluating how we can capitalize on
19 this opportunity to better serve all our members.

20 In addition, we have stepped up our efforts
21 to pursue quality investments at reasonable costs. We stand
22 strongly behind our steadfast dedication to honesty and
23 integrity, and we're working hard to further advance our
24 strong commitment towards providing as much transparency as
25 possible without breaching our standard of care and

1 fiduciary duties.

2 I hope you'll come to realize that the goals
3 of this commission and those of the State Employees'
4 Retirement System are more alike than different.

5 We're here today to respond to the goals of
6 this commission and those of the State Employees' Retirement
7 -- I'm sorry -- to the commission's request to receive the
8 benefit of our perspective on specific, workable actions
9 that can be taken to reduce investment expenses and improve
10 investment and investment-related operations and generate
11 actuarial savings of \$1.5 billion over 30 years from the
12 effective date of the legislation that created this
13 commission, Act 5 of 2017.

14 SERS has been committed to finding and
15 implementing positive practical approaches to strengthen the
16 operational efficiencies and oversight processes of the
17 system, with the ultimate goal of maximizing results for its
18 members and paying promised benefits, benefits that were
19 earned. These are responsibilities we do not take lightly.

20 Last year, the system paid approximately
21 \$3.3 billion in benefits to its members. Of that, more than
22 90 percent, about \$3 billion, was paid to members who live
23 right here in Pennsylvania. These \$3 billion represent
24 actual lifelines, providing important means of support and
25 even survival, not only for SERS members, but for the

1 thousands of small businesses across Pennsylvania that rely
2 on them as valued customers.

3 To put this in a long-term perspective, over
4 the 25 years, the SERS fund has earned over \$50 billion and
5 has paid \$48 billion in retirement benefits. The SERS Board
6 and team of investment professionals made difficult
7 investment decisions in the best interest of its members
8 through multiple market environments, cycles of suppressed
9 employer contributions, unfunded benefit enhancements,
10 legislative changes, and challenging political headwinds.
11 In spite of these challenges, SERS returned 8.4 percent and
12 outperformed a 60/40 index portfolio net of fees over the
13 same period.

14 In short, we take our responsibilities as
15 legal and fiduciary protectors of our members' retirement
16 funds very seriously. And I think that will become evident
17 throughout our testimony.

18 The fact is seeking relief from investment
19 fees is a way of life at SERS. The system has been reducing
20 investment manager expenses over the past several years, and
21 in the past year, has reduced annual investment manager
22 expenses by \$32 million. That would be 46 -- or expenses
23 have been reduced to 46 basis points.

24 We're happy to have the opportunity to share
25 our plans and perspectives and even some of the

1 accomplishments that have been realized since the beginning
2 of 2016. Before we get to those cost-saving items, however,
3 I'd like to take just a moment to assure the commission, our
4 members, and the public that the State Employees' Retirement
5 Board has an ongoing commitment to demonstrate transparency
6 in its reporting of fees and investment expenses while
7 working within our legal and fiduciary framework.

8 Each year, SERS reports investment and
9 investment-related expenses, including ongoing management
10 fees and performance or intent of fees to the general public
11 in two reports, our supplemental budget book and our
12 comprehensive annual financial report. Although SERS
13 reports management fees and expenses paid to private
14 partnerships, these amounts are typically returned to SERS
15 later in the investment cycle. These returned amounts,
16 however, are not retroactively adjusted in SERS fee
17 reporting. So if anything, these management fees and
18 expenses are overstated.

19 In an effort to ensure that all management
20 fees and expenses are calculated and audited in a
21 consistent, ongoing manner, SERS Office of Finance and
22 Administration has created and implemented internal controls
23 that comprise very detailed processes and methodologies.
24 It's a multistep process designed to ensure that all
25 relevant financial data reconciles and that management fees

1 are calculated accurately and reported properly, so we don't
2 pay more than the contractually negotiated amount.

3 Where the confusion comes in is with the term
4 profit sharing, what the industry refers to as carried
5 interest. It's our opinion and the opinion of some of the
6 previous testifiers, as well as others in the industry, that
7 carried interest is not a fee. In exchange for providing
8 the capital for an investment, SERS is entitled to the
9 majority, typically 80 percent, of the partnership profits.
10 The general partner then receives its share of the profits,
11 typically 20 percent, minus fees and expenses as noted. The
12 general partner profits are determined only after, one, all
13 prior management fees and expenses paid by SERS are returned
14 to SERS, and two, the capital contributed by SERS is also
15 returned to SERS. While we understand that the general
16 partner's 20 percent of the profits of a successful
17 investment could be a significant amount, this type of
18 compensation structure works very well to align the
19 interests of the general partner with those of SERS. When
20 the general partner succeeds, SERS succeeds. Typically, for
21 every dollar of profit the general partner receives, SERS
22 receives four.

23 That being said, because SERS and others in
24 the industry do not consider carried interest as a fee, it
25 isn't something that historically has been reported or

1 tracked by SERS. It was never hidden and there's nothing
2 shady going on here. It simply wasn't something that was
3 reported or tracked. And there's a very big difference
4 between one and the other.

5 We're working in the midst of an industry
6 where new standards are emerging and SERS is open to these
7 standards. In fact, State Employees' Retirement Board
8 Motion 2018-15, passed just this April, specifically
9 directed SERS staff to request general partners of new
10 investment opportunities in private markets to begin
11 adopting and completing the Institutional Limited Partner
12 Association fee disclosure template effective immediately.
13 Similar requests are being made of general partners of
14 existing investments in private markets effective January 1,
15 2019. So we are well underway in our efforts.

16 Thank you for your indulgence in letting me
17 shine some light on this important matter. I'll now turn
18 the microphone over to Bryan Lewis, our chief investment
19 officer, to discuss our ideas for cost savings.

20 MR. LEWIS: Thank you, Terri.

21 Let me first say that SERS believes that the
22 benchmark \$1.5 billion in actuarial savings stated by the
23 commission is an achievable goal. To arrive at that
24 conclusion, we worked closely with our actuarial partners at
25 Korn Ferry to perform projections as to what it would take

1 to reach the \$1.5 billion mark. Based on the projected
2 assets for each of the next 30 years, we estimate that in
3 the fund, if the fund were to reduce investment costs by 4.5
4 basis points and sustain that reduction in each of those 30
5 years, it will be sufficient to create an estimated
6 actuarial savings of \$1.5 billion as of June 2047.

7 For the record, we were working diligently on
8 ways to trim investment expenses even before Act 5 became
9 law.

10 Since the beginning of 2016, SERS implemented
11 a number of measures to reduce costs. We transferred
12 \$2.5 billion of actively managed public stocks and
13 strategies from active management into low-cost investment
14 strategies. At this point, nearly 80 percent of SERS public
15 stock portfolio is invested in low-cost investment
16 strategies. We negotiated lower fee structures with public
17 stock and fixed income managers as a part of our ongoing due
18 diligence, not because it was a new initiative, but because
19 it's a part of the process of managing a portfolio.

20 We liquidated eight hedge fund strategies and
21 transferred nearly \$900 million from these hedge funds to
22 strategies that include low-cost investments. We
23 consolidated fixed income portfolios to take advantage of
24 more favorable fee structures.

25 Within private equity, we negotiated to have

1 supplemental components to our investments called sidecars
2 that charge no fees, thereby reducing the management fee in
3 the total investment. We've invested in private equity
4 co-investment vehicles with no fees charged on committed
5 capital. We've gotten a 35 percent reduction in some cases
6 on the invested capital and a 50 percent reduction in the
7 general partner's profit sharing due to this agreement.

8 We reduced the number of private equity
9 managers in which SERS has invested and our pacing model
10 while increasing the size of our commitments, thereby
11 hitting certain investment size thresholds to reduce
12 management fees. We've also worked closely with our sister
13 system, PSERS, so that the two agencies who invested in the
14 same investment opportunity recently could benefit from
15 reduced fees based on that combined effort.

16 So naturally, we are proud of what we've
17 accomplished thus far, but we are not finished yet. At the
18 direction of SERS Board, we continue to work with our
19 consultants to pursue cost savings wherever feasible and
20 beneficial to the fund with investment risk and return
21 considered.

22 One cost reduction tactic is to participate
23 in no fee, no carry, or reduced fee, reduced carry
24 co-investments alongside general partners with whom SERS has
25 made primary fund commitments. These co-investments help

1 reduce the aggregate fee burden on dollars deployed with
2 general partners. As noted, we already are working with
3 several general partners who offer co-investments to SERS
4 and have expressed further interest in completing
5 co-investments.

6 Another key cost reduction SERS has begun
7 implementing is negotiating management fee reductions with
8 the eye towards founder's fees or first closer terms.
9 Private equity and real estate funds sometimes offer
10 incentives to first or early closers by offering management
11 fee discounts. Where possible, SERS can achieve these
12 discounts by committing to general partners in a first
13 close. The resulting management fee discounts can range
14 from five to twenty-five basis points.

15 Another way we continue to reduce investment
16 expenses related to management fees is through building
17 strategic partnerships with managers that invest across
18 various fund products. The formation of strategic
19 partnerships typically involves large commitments to
20 managers that are divided at an agreed upon ratio along
21 various strategies in which the manager actively invests.
22 Such partnerships are often diversified across
23 sub-strategies, geographies, and investment types, thereby
24 creating diversification within the broader portfolio.

25 SERS is also researching internal asset

1 management opportunities for both public and private markets
2 that are designed to reduce the amount of fees paid to
3 external managers. To ensure SERS is implementing a
4 best-in-class framework, we planned a contract with a
5 consultant to assess SERS' existing systems and processes,
6 identify operational risks, gaps in current infrastructure,
7 and human resource requirements, and then present a viable
8 solution that details the pros and cons of the various
9 options, systems, portfolio management, trading, middle and
10 back office functions, compliance, and risk management. And
11 we will also ask the consultant to help us evaluate the cost
12 of the successful implementation of an internal asset
13 management program.

14 With that, I'll turn back to Terri.

15 MS. SANCHEZ: Thank you, Bryan.

16 And thank you to the commission for asking us
17 for our perspective on what the general assembly can do to
18 help us improve efficiencies and reduce costs.

19 The State Employees' Retirement Board and
20 staff stand in direct fiduciary status to the fund. All of
21 the requests that follow are absolutely consistent with the
22 fiduciary responsibilities and duties of the board and staff
23 in administering the fund for the exclusive benefit of the
24 members with the skill and care that a person familiar with
25 such matters would exercise.

1 Specifically, we would ask that the board be
2 given the decision-making authority for organization,
3 position complement, and compensation for management
4 employees in place of the Commonwealth's Executive Board.

5 Having maximum flexibility in the ability to
6 increase our staffing complement will allow us to continue
7 with the cost-saving improvements that are already underway.
8 The addition of high quality, specialized staff in the
9 investment and investment accounting areas will help us to
10 improve our investment and financial operations and audit
11 capabilities and to reduce costs. Increasing our staffing
12 complement will also enhance our ongoing effort to implement
13 and grow our internal asset management capabilities. We've
14 seen the promise that this effort holds from our own
15 experience and from learning about the actions taken by some
16 of the elite public pension funds. Having control over the
17 ability to set compensation levels allows the board to
18 attract and retain high quality expertise.

19 We ask that the board be given greater
20 flexibility to more efficiently procure goods and services.
21 We ask that the board be given the ability to determine its
22 budget without having the Office of the Budget approve or
23 alter the board's budget requests. There is no entity
24 better positioned to make the necessary fiduciary decisions
25 regarding the investments and disbursements of any of the

1 moneys of the fund than the board.

2 In addition to the specific items listed
3 above, I would ask the general assembly to remember that
4 administrative limitations imposed upon the ability of the
5 board to efficiently administer the fund and manage SERS
6 operations and any restrictions on how the board can invest
7 the assets of the fund have consequences. Administrative
8 burdens or substantive restrictions can, to a greater or
9 lesser degree, increase costs or reduce the ability of the
10 board to achieve desired investment returns. This applies
11 to both current statutory regimes or future statutory
12 changes. The board must be given maximum administrative
13 flexibility and investment authority in its ability to
14 satisfy its fiduciary duties and obligations.

15 The items just stated are all important and
16 achievable goals, but there is one more that holds even
17 greater promise and would go a long way towards
18 demonstrating that Pennsylvania is serious about its
19 commitment to public pension reform. This is by far our
20 biggest ask, if you will. I ask the commission to consider
21 the benefits to the fund, to the members, and to the
22 Commonwealth of consistently paying the actuarially required
23 contributions to the fund year after year, as this
24 administration and the general assembly have done for what
25 is now the third year in a row -- and I thank you for

1 that -- an amount that combined with investment earnings
2 would be sufficient to pay promised benefits in full in a
3 cost effective manner. We have seen firsthand how
4 persistent underfunding can jeopardize a plan's
5 sustainability, eating away at the asset base, forcing
6 decisions to liquidate investments at the most inopportune
7 times, and pushing a retirement board to reach more returns
8 that it otherwise might not need to, returns that are often
9 reached through expensive investment alternatives.

10 At a previous hearing, we heard testimony
11 from other systems who had more passive, less expensive
12 investment strategies than SERS. It is important to note
13 that these systems acknowledged that had they not been in
14 the healthy financial position that they were, their
15 investment approach would not be possible. After years of
16 suppressed contribution rates, SERS is not in that position.
17 And given our position, alternative types of investments are
18 critical to meeting the assumed rate of return so that we
19 can continue to pay promised benefits in perpetuity.

20 None of us want to take unnecessary risks.
21 And quite frankly, as fiduciaries, we cannot and should not
22 take unnecessary risks.

23 Perhaps this commission can help position us
24 so that we can, in good conscience, move towards an asset
25 allocation where we not only look to get the best return for

1 the risks we take, but where we also can take less risks
2 overall and pay promised benefits cost effectively.

3 So how might you do that? One way would be
4 to recommend consideration of an amendment to the
5 Constitution that requires the legislature to incorporate
6 into the State Employees' Retirement Code a dedicated
7 funding source and a contribution payment amount that is
8 based on sound actuarial methods and assumptions consistent
9 with generally accepted actuarial standards of practice,
10 ensuring funding at an amount that cannot be impaired by the
11 changing priorities of elected officials, insulating it from
12 the unpredictability of the appropriations process, and
13 preventing the manipulation of amortization methods and
14 other funding deferral mechanisms that have cost the system
15 approximately \$8 billion since, through 2017. Those assets
16 could have offset the unfunded liability and provided more
17 investment flexibility to the retirement board, flexibility
18 that may well have included an asset allocation with more
19 lower cost investments.

20 What has been suggested here is a heavy lift,
21 no doubt, but it is a lift that several states have already
22 made, some in reaction to situations much more dire than
23 ours. But perhaps Pennsylvania has an opportunity to be
24 proactive and attempt to implement elements of the
25 Government Finance Officers Association funding best policy,

1 best practices and of the Conference of Consulting Actuaries
2 funding policies and practice guidelines now, preserving the
3 good that this administration and general assembly have
4 accomplished and ensuring that future administrations and
5 general assemblies do the same.

6 Thank you for your time and your attention to
7 this critical issue. And we're happy to take your
8 questions.

9 CHAIRMAN TOBASH: Ms. Sanchez, Mr. Lewis,
10 thank you so much for your testimony. It's really
11 important, your perspective is really important. And you're
12 right. There's a lot of heavy lifting that needs to be
13 done.

14 And I just want to acknowledge the fact that
15 the Auditor General did an audit of your organization, I
16 think, in July of 2017, and it acknowledges some of your
17 work towards fee savings. And we're gratified to hear, I
18 think, that you believe that you can get to 1.5 billion in
19 savings. That's terrific. That's a terrific prospect for
20 the future of the Commonwealth and for the participants in
21 these plans.

22 There were many people in 2010 that didn't
23 think we could stick with a payment schedule to get to the
24 arc. And I can tell you, I think that the general assembly
25 has gotten a wake-up call with our massive underfunding

1 right now and we certainly don't want to go back to days of
2 underfunding systems that are so very important, as we
3 continue to dig our way out of the hole.

4 And I also thank you for your initial
5 comments that we are very much aligned, and I hope that this
6 relationship works out to be a very fruitful one in that
7 recommendations that are delivered to the general assembly
8 and the administration and inevitably the system, SERS, are
9 acted upon and we can maybe even do better than that
10 1.5 billion.

11 I hear some of your recommendations to the
12 commission and your belief. And I have not been in this
13 room very often where I haven't heard "less mandates and
14 more money." It's a popular theme among every organization
15 that we deal with, and I get it and I understand it. And I
16 think that you're spot on in pointing out the fact that
17 underfunding over a long period of time has gotten us in the
18 circumstances that we find ourselves in right now.

19 But as far as more specifically in the
20 governance area, you talk about more flexibility with your
21 board. Is there any other governance changes that you
22 believe could be implemented to the way that these systems,
23 your system in particular, is managed to make you more
24 effective and end up being able to deliver better results?

25 MS. SANCHEZ: Do you want me to start on

1 that?

2 MR. LEWIS: Sure.

3 MS. SANCHEZ: I think there are some things
4 that we can do to improve our governance. In fact, we're
5 currently in the process of implementing a number of
6 governance improvements that we had taken on when we did a
7 study of -- the board had a study done a few years ago by
8 Funston. And specifically, we asked them to come in and
9 take a look at the board's governance structure and
10 processes. They worked on that for well over two years and
11 I am very happy to say that just at the last board meeting,
12 we approved a number of changes and we're approving more
13 that will take effect around January 1st of 2019, and those
14 things should have a significant impact on the way, on the
15 efficiency and how the board operates. The board itself is
16 very happy to have those things implemented.

17 MR. LEWIS: I would say from the investment
18 perspective, I would reiterate our ask for the board to have
19 the ability to have complete complement and budget control
20 to give us the resources and the flexibility and speed to be
21 able to set up an organization to be able to most
22 efficiently manage the assets.

23 So we talked about internal management as a
24 possible opportunity for us. As I'm sure you've heard
25 before, there's an initial investment for staff and systems

1 to build up in order to achieve those long-term cost
2 savings. Particularly within private investments, we see
3 some of the world class and top pension funds have very
4 sizable staffs, but they also have very minimal costs as it
5 relates to these types of investments. And so it's my
6 understanding, under the current process of both staffing,
7 complement approval, and budgeting, it's sometimes not as
8 dynamic as the system may need to be able to build out the
9 scope in an effective manner to reach the efficiencies that
10 we would like, again, in a timely manner.

11 CHAIRMAN TOBASH: So I mean, the system was
12 established, I think, in 1923, so you're going to be 100
13 years old pretty soon. And I think the law that you're
14 acting under right now is from 1974. But you're exactly
15 right, the general assembly, they determine the retirement
16 classes and they determine the benefit levels and determine
17 the payment schedules and they determine, ultimately, the
18 governance. What do you think about the appointment process
19 and the way your boards are structured and made up?

20 MS. SANCHEZ: I think that's probably best
21 left up to the policymakers. We try to have a board, work
22 with whatever board that we have that leads our system and
23 support their initiatives. My most important thing is that
24 whatever board we have takes their duties as a fiduciary as
25 its foremost duty. However we can do that, I certainly

1 would be supportive of.

2 And I'm not saying that our current board
3 does not. I'm just saying, should there be any changes,
4 their role as a fiduciary to the members of our system is
5 most important.

6 CHAIRMAN TOBASH: Okay. Thanks.

7 So you work with your peers sometimes. Do
8 you see any other systems similar to yours that have
9 different board structures that you think are more effective
10 as a result?

11 MS. SANCHEZ: I haven't specifically spent a
12 lot of time looking at that, I'm sorry to say, but I can go
13 back and get some research and get that to the commission.

14 CHAIRMAN TOBASH: That's great. I just want
15 to bring up two other terms really quickly. I don't want to
16 take too much time here.

17 But we live in a world right now where two
18 terms are held in high regard, number one confidentiality,
19 number two transparency, right? They're both -- but they're
20 competing interests at some point in time. Just tell me a
21 little bit about the culture of SERS and the idea of
22 transparency as we evolve in a more transparent world and
23 the idea that ILPA now is setting up a framework that we can
24 operate, a blueprint that hopefully we can all operate
25 within that makes us a little bit more visible.

1 MR. LEWIS: From an investment reporting
2 perspective, we've seen the industry become a lot more
3 transparent within the last five and ten years, particularly
4 within private equity and private real estate where the ILPA
5 template will become most useful for us in gaining the
6 information and having the ability to report it. It's, you
7 know, a welcomed change for not only us at SERS, but I think
8 the industry at large. And you know, we're completely
9 supportive of that and we look forward to working with our
10 GPs to make sure we get all that information to be able to
11 provide it and report it as requested, required, and in the
12 most transparent manner as possible.

13 CHAIRMAN TOBASH: Great. Thank you. Thank
14 you again.

15 Mr. Vice-Chairman, questions?

16 VICE-CHAIRMAN TORSELLA: Thank you, Mr.
17 Chairman. It's good to be here.

18 Thank you to everyone who's from the
19 commission, the commissioners, the Joint State Government
20 Commission to our witnesses.

21 And I note the hint from my fellow
22 commissioners. I'm the only person who got a jar of
23 mint-flavored chewing gum here this morning, so I assume
24 that is a message from someone to me.

25 Terri and Bryan, thank you.

1 I want to, number one, underscore what you
2 said about the importance of the arc. I think that -- the
3 importance of making the arc, and I think that's something
4 we can never say too much. It's been some good recent
5 history, but it's very recent history. And if it represents
6 a new chapter in a longer story, that's encouraging and
7 let's hope it does, and do our part to make it so.

8 I also want to echo what the Chairman said
9 about the efforts that you have made to reduce investment
10 costs, which are broader than just fees, but costs. And as
11 I said yesterday, I think the change from 2016 to 2017 is
12 worthy of note and praise. I think that's a substantial
13 reduction in the basis point cost of investing the funds and
14 SERS deserves applause for that. I have issues with what
15 we're not reporting yet, but believe that you are headed in
16 the right direction getting there. And that year over year,
17 that represents real progress and should be held up for
18 praise.

19 I want to ask you, the savings that you've
20 achieved, do you believe any of them have come at the
21 expense of return?

22 MR. LEWIS: I would say that in some cases on
23 the public side, in the short term, the answer is no. I
24 would say in the private investments that will remain to be
25 seen, as you're well aware of the structures and how the

1 fees and expenses are calculated and discounted. And there
2 are longer time periods just from an investment horizon.
3 But I would say on the public side, the efforts that we have
4 taken have not impacted the returns.

5 VICE-CHAIRMAN TORSELLA: Sure. But on the
6 private side, believe the side of the judgment of history.
7 When you made your changes, you believed you were -- you
8 could both achieve the savings and the return?

9 MR. LEWIS: Yes, both considerations, and I
10 believe we can.

11 VICE-CHAIRMAN TORSELLA: Okay. On the
12 discussion about resources and complements and autonomy, I
13 want to ask if that request is made in the context of
14 thinking about SERS or thinking about how SERS and PSERS
15 might work together in a different future where there's some
16 more explicit cooperation and consolidation.

17 MR. LEWIS: I would say, my thought in making
18 that request is under the current construct and operating
19 environment. However, the basis of that request is based on
20 broader industry practice and examples of success of having
21 the right number of investment professionals to manage the
22 assets that a plan is responsible for.

23 But I would say in general terms, both
24 organizations or all organizations, even if we are, as we
25 have done in certain limited, yet productive ways, worked

1 together, having enough resources to coordinate effectively
2 is very important. And so I would not say that -- PSERS
3 will have to speak on their own behalf as it relates to
4 their needs and their requirements. But I think for any
5 organization managing over \$30 billion, it's important to
6 make sure you have enough of the appropriate resources to do
7 that.

8 VICE-CHAIRMAN TORSELLA: Sure. And the point
9 on alternatives -- and I don't think I heard the testimony
10 of some of the other state systems quite the same way you
11 did. I thought they were talking about something broader
12 than a focus on costs. They were talking about the
13 particular ways they operated with a lot of in-house and
14 some other, a certain degree of autonomy, but we can get
15 some clarification.

16 But on the idea that alternatives are the
17 only sure way of achieving higher returns, I guess I'd like
18 you to talk about the experience at SERS with real estate
19 and hedge funds in recent history with what kind of
20 implications -- and again, history, you're not responsible
21 for the history of the fund. You're both relatively new to
22 the fund and have been moving in some great directions, but
23 as an object lesson in how much we can say for certain
24 what's going to work when we pay for those investments.

25 MR. LEWIS: I think I'd like to take the

1 approach of answering the question and saying that we don't
2 believe that alternatives are the only way. We don't also
3 believe that what the other CIOs who presented here earlier
4 stated that, that it was an either/or.

5 It's our, the organization, based on the
6 investment policy and strategic plan, it's our belief that
7 we are required to provide a well diversified portfolio that
8 will give us the best opportunity to meet our required
9 return in all market environments. And it is our belief
10 that alternatives, as a percentage of the portfolio, will
11 give us a better opportunity to meet the required return
12 over longer market cycles.

13 As you know from our asset allocation,
14 60 percent of our portfolio, over 60 percent of our
15 portfolio is in public markets as it stands today. And
16 there is no concerted effort to reduce the importance of
17 public markets and public investments in the portfolio.
18 They provide great benefits, such as liquidity, the ability
19 for us to pay benefits in an efficient and less detrimental
20 way. However, we do believe given the expected returns
21 going forward and the market environments that alternatives
22 have a place within a well diversified portfolio.

23 VICE-CHAIRMAN TORSELLA: Thank you.

24 CHAIRMAN TOBASH: Commissioner Gallagher.

25 COMMISSIONER GALLAGHER: Thank you,

1 Mr. Chair.

2 And thank you. You know, Ms. Sanchez and
3 Mr. Lewis, I'm still stunned by the fact that the system has
4 provided \$50 billion in benefits to our annuitants and
5 retirees out there. And I can see that being a tremendous
6 gyroscope to our economy in Pennsylvania. So thank you for
7 making that happen every day.

8 And again, I'm still staggered that, I'm
9 shocked that some of the policy decisions that were made
10 under this roof not that long ago cost our system
11 \$8 billion, and you're in the position of needing to pick up
12 the pieces. So thank you for enduring that and doing the
13 best you can every day.

14 My question is this, there's been some
15 emotionally charged headlines recently accusing the system
16 of hiding fees. Over the last eight years, I've been
17 working on pension issues and specifically five years at the
18 board level at SERS. I've seen nothing but that -- nothing
19 to that. There's been nothing whatsoever but transparency
20 and full disclosure on everything that the system is doing
21 operationally. I was flabbergasted seeing these headlines
22 as they started rolling through shortly after the last
23 commission meeting that were -- statements were made and
24 testimony was provided that I found to be patently
25 misleading based on my expertise in this subject area.

1 Can you both clarify for the record, is SERS
2 hiding fees?

3 MS. SANCHEZ: No, plain and simple.

4 MR. LEWIS: No.

5 COMMISSIONER GALLAGHER: Thank you,
6 appreciate that.

7 So I understood, for the report, the system
8 is not hiding fees. However, I would hope that some
9 headlines in the near future would reflect a more fair and
10 balanced approach to what the systems are doing that's
11 positive, on a moving forward basis. Thank you.

12 CHAIRMAN TOBASH: Thank you.

13 Commissioner Torbert.

14 COMMISSIONER TORBERT: As a retired portfolio
15 manager in a wealth management and trust department,
16 fiduciary was always a big word. It scared a lot of
17 bankers. It didn't bother us in our department, but it sure
18 bothered, or worried them, because you always have to put
19 the client first, so that means you have to be transparent,
20 you have to be open, and you have to make sure that they
21 have a comfort level. But I was always on the individual
22 side, not on the institutional side. So there's a little
23 bit of difference there, but the bottom line is always the
24 client. And to me that was always the strong point of
25 anything I ever did.

1 Having said that, I laud you for all the work
2 you're currently doing regarding, you know, the fees and the
3 investments that you're already doing. Most of yours is in
4 public equities. I was always used to public equities,
5 whether they be bonds or stocks or whatever. And I always,
6 we always wanted to make sure that we had liquidity and
7 that's what concerns me about the private equities.

8 Now, I see a need for private equity, but it
9 also concerns me about the length of time that you're kind
10 of locked into them when you're in a fiduciary capacity. So
11 anytime you can bring that down and make sure those fees are
12 as transparent as possible -- which sounds like you are
13 doing that.

14 I was very delighted to hear that you
15 currently work with PSERS. I was under the impression years
16 ago, and even before I got on this commission, that they
17 were two separate entities and they didn't really work
18 together a lot. So to me, that made no sense because if I
19 have a family relationship, you may have 10 accounts in that
20 relationship. Well, guess what? It all gets combined for
21 fee purposes. And so it made sense for, well, you have
22 Pennsylvania and you have the two systems. It makes sense
23 that you work together if you're working on the same
24 investments to bring down the costs. That's the way I did
25 it. So I'm glad to hear you're all doing that. And

1 hopefully I'll hear that from PSERS, as well.

2 I mentioned liquidity. And funding is always
3 a subject that comes up in a lot of the -- you know, people
4 that have been testifying here, so a consistent funding from
5 the legislature is probably important, as well.

6 I was on a school board for eight years in
7 the Allentown area. And, you know, at times the funding was
8 up and at times the percentage went down a little bit. So a
9 constant funding probably makes a whole lot of sense,
10 especially in the marketplace that we have now.

11 So thank you very much for your work and
12 continued success.

13 CHAIRMAN TOBASH: Thank you.

14 Commissioner Bloom.

15 COMMISSIONER BLOOM: Thank you.

16 And thank you for your work. And I know that
17 in a sense you've just -- certainly, Terri, you've just
18 arrived. And I've seen you in action, I've seen the boards
19 in action. I've been at the last couple of meetings. And
20 it's been very impressive.

21 The idea of -- which was addressed here a
22 couple of seconds ago -- about hiding fees, that's probably
23 a bad choice of words. But in order to compare how the
24 systems would have done if their money was in public markets
25 as opposed to private markets, you really have to know what

1 the carried interest is because that's part of a calculation
2 to make a comparison between returns from the public and
3 private as to how much you would have put up, and I think
4 that's kind of where the missing money is. So I just wanted
5 to kind of clarify that.

6 And I don't think anybody hid. I think
7 that's normal practice in a lot of places. It's not a good
8 practice, and it's obvious that SERS and your board are
9 addressing that issue. And I think that's very important.

10 Now I'd like to get into the weeds. And, Mr.
11 Chairman, if I'm too much into the weeds, please correct me
12 or tell me to quiet down.

13 You have about, as I can see, about 450 GPs,
14 general partners, in private equity. Some of those are
15 performing, some of those you've labeled as underperforming
16 assets. And you're going to do something to try and market
17 those, I believe, and move them out.

18 I have a bit of -- I'm not an accountant, but
19 I have a bit of auditing experience. So if you have 450
20 GPs -- I don't know that my number is right, but I think
21 it's over 400. You've got 400 -- according to what I heard
22 yesterday, there are 400 or so accounting firms that are
23 coming back and telling you that their net asset values are
24 good. I don't know whether those accounting firms are
25 simply reviewing the general partners' numbers or whether

1 they're reviewing the, some of the investments of the
2 general partners, because now you're talking about thousands
3 of companies.

4 How confident are you in the net asset value
5 numbers that you get? Some of those in the ones that are
6 underperforming -- I've had some experience in this -- are
7 probably less than what you're currently reporting. And if
8 you're going to sell them, you must have some idea about
9 what that price is. And if that price is less than what
10 you're valuating it now, when you take your audit snapshot,
11 that's where they -- in my opinion, that's where they should
12 be priced.

13 The other thing I was told is, in speaking to
14 various people from the pension funds, is that the active,
15 large net asset values that you get are probably
16 undervalued, that they are probably valued at about 90
17 percent, 85 percent, of what they're going to be sold at,
18 okay? Again, back to the auditing, they should be valued at
19 what they're worth. I mean, if the general partner thinks
20 they're worth \$50 million and they're telling you they're
21 worth \$40 million, it's not accurate.

22 So somewhere -- it kind of skews your overall
23 numbers in what you're reporting as to what your net assets
24 are, if any of this is right. So maybe you could address
25 that for one or two minutes, because I've probably taken up

1 too much time.

2 Am I too far in the weeds?

3 CHAIRMAN TOBASH: We're okay.

4 COMMISSIONER BLOOM: Thank you.

5 MR. LEWIS: Sure. Let me address a few of
6 the points.

7 You're correct. We do have a lot of general
8 partner relationships. I think the number 450 is slightly
9 higher than my count. However, we have gone through a
10 process of identifying what we call core versus noncore. So
11 managers that have performed and we feel as though we want
12 to continue to have relationships with because their
13 strategies fit within our strategic investment plan.

14 Those noncore relationships have been
15 transferred, due to board approval and action, to an asset
16 management firm that has, that will take over the
17 administration of those noncore funds. According to my
18 account, that's approximately 162 relationships.

19 That fund will become the day-to-day
20 administrator with oversight by the SERS Investment Office
21 staff and the board. So there's been no ceding of ownership
22 or control of decision-making with this process. We, in
23 effect, due to understaffing, have outsourced the day-to-day
24 management and interaction of what we're calling these
25 noncore funds.

1 So we feel that this firm will be able to
2 help us and provide us with opportunities on the best ways
3 to either end those relationships, determine a secondary
4 market value, or manage them through termination of the
5 agreement. And so that was an operational decision.

6 As it relates to the NAV and calculation of
7 the information, I am and the staff is, very confident that
8 the information that we reported in the budget book and CAFR
9 for a number of years, not just recently with myself and
10 Terri joining, throughout history has been accurate. And
11 there's a process that has been in place to help evaluate
12 the accuracy of the data not only that we receive, but also
13 the data that we report.

14 So each of our GPs have audited financial
15 statements that are audited by the largest Big Four
16 accounting firms and folks who specialize in investment
17 accounting, not only on their calculations, but also on
18 their valuations. That information that we receive, we have
19 an internal investment accounting department that also has
20 processes and procedures that checks and validates
21 information that we receive.

22 And then the third important component is we
23 also, SERS, we have an auditor who comes in and will check,
24 not only this process, calculation, to make sure that it is
25 valid and there are no -- and there have been no material

1 findings through this process for a number of years of any
2 inaccurate information.

3 A final component that we have is our private
4 equity consultant has -- we have a relationship with their
5 back office and operation team. They come to our office
6 twice a year to do a review of the private equity
7 information in-house, as well as continued conversation
8 between the investment staff and office.

9 Now, this connects a couple of points. One,
10 it's a fourth layer of checking on our information as it's
11 received, but finally, this, too, was another example, Mr.
12 Chairman, with the right complement, with the ability to
13 hire and invest, this is an activity that could be done
14 internally, potentially at a reduced cost. But right now we
15 utilize the expertise of a private equity consultant and
16 their operations team to help us out.

17 COMMISSIONER BLOOM: When you decided what
18 was noncore, was there any conversation about what the value
19 of the noncore would be on the secondary market? And that's
20 really a loaded question because if you say "yes," then that
21 value is the value you should be reporting. So do you have
22 any comment on what you think the percentage is, the haircut
23 is, on the noncore?

24 MR. LEWIS: I would say that the valuation on
25 the noncore has not been completed as of yet to determine a

1 full secondary value. But that is a part of the process
2 that the board will be presenting in future meetings.

3 COMMISSIONER BLOOM: Thank you very much.

4 I'm sorry about the tough questions, but it's
5 just something that I have been talking about since the very
6 beginning of this process.

7 Thank you so much, both of you, and we
8 appreciate the work that you're doing.

9 CHAIRMAN TOBASH: Commissioner Bloom, thank
10 you so much for that question.

11 I think it's important for us to have heard
12 the direction that you're going with those general partner
13 relationships.

14 And I think you have one follow-up question,
15 Mr. Vice-Chair?

16 VICE-CHAIRMAN TORSELLA: I do. Just
17 following up on something that Commissioner Bloom said.

18 Again, understanding that, in the world of
19 private equity, things have changed a lot in 10 years, and
20 at SERS, things have changed a lot in 10 years, and forget
21 how we got here, but is -- if I understand from your
22 testimony, that you haven't historically reported or tracked
23 carried interest. Just to -- let's agree, we won't call it
24 a fee. But is carried interest a profit share? Is it a
25 cost of investing, in your view?

1 MR. LEWIS: It is not a cost of investing, in
2 my view. It is a benefit of outperformance for both the GP
3 and the LP.

4 VICE-CHAIRMAN TORSELLA: So you don't view it
5 as a cost?

6 MR. LEWIS: I don't view it as a cost.

7 VICE-CHAIRMAN TORSELLA: Should it be
8 reported and tracked?

9 MR. LEWIS: I agree that it can be reported
10 and tracked. I'm comfortable with that.

11 CHAIRMAN TOBASH: Okay. Thank you. And just
12 one final question and we'll get on to our next testifier.

13 Commissioner Torbert.

14 COMMISSIONER TORBERT: Going back to that
15 liquidity idea. Do you have a time line or a time horizon,
16 when you get into a private equity, as to how long you're
17 willing to be locked in?

18 MR. LEWIS: Yes. So we manage liquidity on,
19 we monitor it on a daily basis and we report out our
20 liquidity to our board at every board meeting. So folks are
21 fully aware of the liquidity that we have. And we have a
22 liquidity schedule that me and my team monitor as it relates
23 to daily, monthly, quarterly, and annual liquidity
24 availability of different types of investments.

25 So through that process, when we recommend to

1 the board to make a commitment for any type of vehicle, be
2 it private credit, private real estate, private equity
3 broadly, we have a good understanding of the amount of time,
4 based on the general time frame for these relationships in a
5 private equity agreement, will be 10 years with the
6 possibility of two years of extension.

7 However, it's important to note that it
8 doesn't mean that all of your capital is locked up for that
9 entire period. Because of the mechanics of the investment
10 process, when a commitment is made, while we are responsible
11 for making sure we have liquidity, if that capital is
12 called, generally all the capital is not called at one time
13 and all the capital is not retained until the end of the
14 contract period. So there are constant calls and
15 distributions that we also track and maintain to make sure
16 that we have enough liquidity to meet the private needs.

17 But more importantly, Mr. Commissioner, is
18 the fact that our liquidity focus is on making sure we have
19 the ability to make our monthly payments to our members.
20 And so we have more than multiple time periods of liquidity
21 allocation, as well as scenario analyses, that we run in
22 different time periods. For example, if we don't receive
23 contributions from our employer, then we have to still have
24 enough liquidity to be able to pay our members.

25 If, as we have over the last three years, we

1 do continue to receive -- and we hope that is the case. It
2 makes it a whole lot easier to manage liquidity when you
3 have a dedicated and disciplined funding policy. We have
4 those, and we've been operating under that scenario for the
5 last three years.

6 And so when we think about where liquidity
7 comes from, how much liquidity we have in the portfolio, the
8 majority of those conversations are on the public side of
9 the house that you're familiar with, which again, is over
10 60 percent of our portfolio right now.

11 COMMISSIONER TORBERT: Then one quick last
12 one. Can you do market-to-markets on your private equity on
13 a regular basis or any kind of basis?

14 MR. LEWIS: Well, one of the challenges with
15 private equity is just within the name, right? Private and
16 when they're valued. So we report on the valuations on a
17 quarterly basis to our board, but even that information is
18 in a quarter lag because of the valuation process. So in
19 the traditional public market-to-market sense, the structure
20 would not allow for that, but again, we do get valuation
21 updates and monitor valuations on a regular basis.

22 COMMISSIONER TORBERT: Thank you.

23 COMMISSIONER BLOOM: One second, Mr.
24 Chairman. I have one just quick follow-up.

25 It's more of a statement, I think, than a

1 question, that, in response to what Commissioner Torbert
2 said, that all of private equity, and frankly, real estate
3 and other investments, too, are based on estimates. And I
4 think what the industry term is unobservable data. So in a
5 sense, they are, albeit very educated, there is -- for want
6 of a better word, they're approximations or guesses on what
7 the value of these are, when they are in the intermediate
8 state.

9 CHAIRMAN TOBASH: Again, I thank you for your
10 testimony. I've asked this for all testifiers, and it's
11 particularly important for the two systems, just ask for
12 your availability as we get down the stretch. I know you
13 have an awful lot to do, but your understanding of your
14 operation is really important as we get down the stretch
15 here and complete this. So your ability to communicate with
16 our consultant or commission is really important for us.
17 Again, thank you for all the work you're doing on behalf of
18 the Commonwealth of Pennsylvania's retirees and everybody.
19 Thank you very much for your testimony.

20 MS. SANCHEZ: Again, thank you for the
21 opportunity for Bryan and I to be here on behalf of the
22 State Employees' Retirement Board.

23 CHAIRMAN TOBASH: Great. Okay. As they exit
24 the stage, I'm going to introduce our next set of testifiers
25 from the Public School Employees' Retirement System. We've

1 got Mr. Glen Grell, who is a former colleague of mine, was
2 with the general assembly from -- wow, Glen, I'm not even
3 sure. He was first elected in 2004 and I'm not sure of the
4 date that you left service --

5 MR. GRELL: 2015.

6 CHAIRMAN TOBASH: -- but we appreciate your
7 continued service here to the Commonwealth of Pennsylvania.

8 Glen has worn many different hats here in the
9 Commonwealth, including being a Shippensburg University
10 Council of Trustee member since 1995. And he is joined by
11 Jim Grossman, who is the chief investment officer for PSERS.
12 And we see that you are bringing Tony along with you, as
13 well. So you've got backup.

14 And, Jim, welcome, an Elizabethtown graduate.
15 I didn't realize that. Myself, as well, so that's really
16 great. We appreciate you being here today. And as I
17 mentioned before, the commission is interested in hearing
18 about, specifically, how your organization can help this
19 commission produce its charge on a number of fronts, cost
20 savings, certainly stress testing, transparency are all in
21 the wheelhouse of what we're trying to accomplish here. And
22 I thank you for being here and we are anxious to hear your
23 testimony. Thank you.

24 MR. GRELL: Good morning. And thank you for
25 the opportunity to be here. Chairman Tobash, good to see

1 you, Treasurer Torsella, and members of the commission.

2 Good morning. My name is Glen Grell. I'm
3 the executive director of PSERS, and with me today is Jim
4 Grossman, our chief investment officer.

5 First, I want to thank those commission
6 members who, I believe it was all of you, who attended our
7 August board meeting and our committee meetings, which
8 included our asset liability study and our asset allocation
9 process. We hope your attendance at that meeting gave you a
10 clearer understanding of how PSERS approaches those
11 important processes.

12 Also, thanks to Commissioner Bloom, who
13 joined us at our recent October board and committee
14 meetings, as well as him having a one-on-one meeting with
15 Jim Grossman recently.

16 Before we present our ongoing fee savings and
17 efficiency recommendations, I want to take a few moments
18 just to address what we believe is a false narrative that's
19 been created and circulated, and unfortunately continues to
20 be circulated, surrounding these hearings regarding PSERS.
21 To date, PSERS has taken the high road and not engaged in
22 any kind of negative public debate on these topics. We
23 prefer to engage in these issues in a thoughtful,
24 professional, factual, and principled manner.

25 Having said that, we believe the right time

1 to address some of those outrageous allegations is at
2 today's hearing when we finally have an opportunity to
3 address the entire commission in person. PSERS has a duty
4 and responsibility to address these allegations and what we
5 believe are politically motivated hyperbole about hiding
6 fees and wasting system assets. Wasting is a touch word, a
7 very sensitive word with any fiduciary. And that particular
8 narrative has to be addressed.

9 Two points to make regarding this public
10 commentary. One, PSERS does not waste system assets. This
11 is a fact and in our view, it's not up for debate. Saying
12 PSERS wasted funds is irresponsible and insulting to every
13 PSERS employee who works hard each day, each and every day,
14 on behalf of our members with only the best interests of our
15 members in mind. This false narrative also disparages our
16 board members, who volunteer and devote a significant amount
17 of their time and expertise to serve on the PSERS Board.

18 As those of you who have attended PSERS
19 committee and board meetings know, these meeting are very
20 long. The board packet contains thorough and extensive due
21 diligence write-ups on investment opportunities, as well as
22 detailed materials on the often overlooked benefits
23 administration side of the agency. The ensuing discussion
24 at board meetings can result in questions, dialogue, and
25 vigorous debate on potential investments and other

1 administrative agenda items.

2 The assertion, the specific assertion is that
3 PSERS wasted 3.9 billion in fees to Wall Street managers.
4 The fact is that PSERS engages and compensates money
5 managers in areas where we can't internally manage the
6 investment and only after due diligence of the manager. We
7 carefully track the manager and the investment to make sure
8 we are getting value for these fees, and we report asset
9 class and manager performance to our board of trustees.
10 While not every investment is productive and we frequently
11 terminate underperforming managers, the value of these
12 external managers fully justifies the fees paid.

13 Over the past 20 fiscal years, PSERS has
14 outperformed the global 60/40 portfolio by 84 basis points.
15 In dollars, PSERS generated 10 billion in performance above
16 a global 60/40 passive portfolio at a cost of 6.9 billion.
17 Net investment income during the past 20 years was
18 approximately 62 billion, but it would have been only
19 52 billion had we followed a passive, no-cost global 60/40
20 index portfolio. Hardly a waste of system assets, in our
21 view.

22 Point number two, PSERS does not hide fees.
23 And maybe I'm preempting Commissioner Gallagher's question.

24 Another charge of this commission is that
25 funds have hidden billions of dollars in fees. On the

1 contrary, PSERS has long been a leader in fee transparency.
2 While the Government Accounting Standards Board, known as
3 GASB, only requires the reporting of, quote, readily
4 separable fees, PSERS professionals have gone above and
5 beyond the reporting requirements of the GASB, releasing
6 both readily separable, as well as not readily separable
7 fees. PSERS discloses them annually in our comprehensive
8 annual financial report, our annual budget request to the
9 general assembly, and in an annual presentation to the board
10 of trustees. At PSERS, we've paid strict adherence to the
11 reporting standards and we take great pride in having been
12 recognized for 34 straight years for excellence in public
13 financial reporting.

14 CHAIRMAN TOBASH: Mr. Grell, thank you for
15 addressing these things. I just want to get back to a
16 point. And if you want to submit some your comments for the
17 record, I'm happy to do that. But this commission is
18 specifically charged with a task, and I've asked both SERS
19 and your organization to come forward. And in the letter
20 dated October 10th and in previous conversations, we talked
21 about your appearance and testimony before the commission as
22 an opportunity for the commission members to receive the
23 benefit of your perspective on workable actions.

24 I specifically asked, that we have been
25 established in assisting you and we want to be partners in

1 this. And I think we've got great expertise from throughout
2 the country and sometimes throughout the world at lowering
3 costs while meeting or exceeding your established discount
4 rates.

5 I don't want to get into a debate here on
6 what you have done in the past, but preferably, we'd like to
7 hear from the systems on what changes you believe need to be
8 implemented for you to operate better. And we live in a
9 very public world. So I'm interested to hear that.

10 And if you want to offer commentary on your
11 testimony, we will do our very best to include it in our
12 submission. But at this point in time, I really believe
13 that your time is better spent talking about what
14 implementations might be recommended to help you perform at
15 an even higher level than you are claiming you have
16 performed so far.

17 MR. GRELL: In that case, I will simple refer
18 to the discussion that Executive Director Sanchez had on the
19 same subject, which you didn't cut off, and I'll continue
20 discussing this topic with anybody that's interested in the
21 hall after our testimony.

22 CHAIRMAN TOBASH: Thank you.

23 MR. GRELL: I will then move on.

24 COMMISSIONER GALLAGHER: Mr. Chair, you know,
25 it seems to me that the subject that Mr. Grell was speaking

1 to is germane to the charges of our commission in terms of
2 fees and transparency. So I didn't hear anything outside
3 the realm of our charges.

4 But you know, again, I recognize that you
5 sent that letter, but that was just from one commission
6 member, but not from the commission. And I would like to
7 hear this.

8 CHAIRMAN TOBASH: So, Commissioner Gallagher,
9 you have an opportunity to ask questions and if you want to
10 ask them in this vein and you want to have PSERS respond in
11 that regard, then we'll allow that at that point in time.

12 But if we could move on to the part of your
13 testimony that talks about what we might do to improve your
14 system from your perspective, I would much appreciate that.

15 MR. GRELL: Okay. The remainder of my
16 comments on carried interest and whether or not PSERS hides
17 fees is included in the written testimony and I'll be happy
18 to further discuss it in the question and answer.

19 Before then, moving to the testimony
20 specifically on our fee reduction plan, which has been
21 submitted and approved by our board, I want to offer some
22 research and analysis that we've compiled while waiting for
23 our opportunity to appear before the commission.

24 You're correct, Chairman Tobash, you did make
25 it clear not to dwell on our views of your prior witnesses,

1 and we're not going to do that and you were not interested
2 in explanations of how we operate. So for the record, we're
3 simply going to submit a bundle of materials for the
4 commission's consideration. We have what we've referred to
5 as a compendium of research, which we believe we've itemized
6 about 35 or so pieces of research. This is the information
7 that we're going to leave with you. (Indicating.)

8 We believe it is relevant to the issues
9 you're considering and it's also indicative of the kinds of
10 information that we rely upon regularly to inform the
11 approach that we take and we recommend to our board in terms
12 of managing the portfolio. So I will just submit one copy
13 of that information for the record.

14 Moving then to the subject of manager fees
15 and efforts to reduce them. I want to take you back about
16 three years ago, shortly after I became the executive
17 director of PSERS. At that time, Governor Wolf, newly
18 elected, had expressed an interest in the investment
19 operations at both of the funds. We were asked to meet with
20 Governor Wolf and to review our investment policies and our
21 strategies. In an effort to be professional and thorough,
22 PSERS prepared a slide deck of about 50 pages or so, which
23 we have a copy and we'll present to the commission, as well.

24 The point here is that PSERS has been focused
25 on monitoring, measuring, and controlling external manager

1 fees every day since I've been the executive director. This
2 is not a new priority at PSERS.

3 It was very clear in our discussion and
4 presentation to the Governor that he had personally reviewed
5 all the information we presented and had a complete grasp of
6 the information provided. He asked some questions regarding
7 why PSERS managed funds internally, when we managed
8 externally, how we monitor managers, how we decide between
9 active and passive managers. And he expressed an interest
10 in keeping external manager fees as low as possible. But we
11 quickly moved on to other subjects, having, we believe,
12 satisfied his concerns about our approach.

13 In the ensuing year, we reduced our reliance
14 on external managers and we requested additional complement
15 positions to further support PSERS' internal investment
16 operations. This move to expand internal management
17 significantly lowered external manager fees while we awaited
18 the additional complement. In fact, the Governor issued a
19 press statement in March 2016 noting our accomplishment.

20 Unfortunately, the further reduction was
21 stalled when it took us approximately 18 months to receive
22 approval for seven of the fifteen additional investment
23 office positions we had requested. And that goes to
24 something that Director Sanchez mentioned in terms of
25 autonomy and control over our complement. The seven

1 positions, once they were approved, were filled and they
2 have continued to add significant talent to our investment
3 office, which now includes, among other qualifications, 13
4 chartered financial analysts and 16 MBAs.

5 Like other large public pension funds with
6 best-in-class internal investment operations, we believe a
7 part of the solution to large external manager fees is to
8 build a strong internal investment platform with the skills
9 and the tools necessary to engage in the kind of
10 sophisticated pension asset management that other comparable
11 public funds do. PSERS investment professionals currently
12 manage 19 portfolios in-house with net asset value of over
13 \$23 billion in-house, saving approximately \$39 million a
14 year in external manager fees. The amount managed
15 internally has increased from \$6 billion just three years
16 ago, from 30 percent to the fund's assets to 36 percent
17 today.

18 At this point, I'd like to turn over the next
19 portion of our testimony to CIO Jim Grossman to present
20 PSERS' fee savings plan. This plan was created in response
21 to Act 5 when we saw the provision that would target the
22 \$1.5 billion savings, and also in response to Treasurer
23 Torsella's sponsored board resolution challenging PSERS
24 investment professionals to work with our consultants to
25 create a fee savings plan. The plan was presented and

1 adopted by the board at the August 2018 meeting. However,
2 the plan is a fluid and flexible plan of action, which will
3 adapt and change as necessary going forward.

4 At this point, I'll let Mr. Grossman talk
5 about the...

6 MR. GROSSMAN: Thanks, Glen.

7 Thank you, Commissioners.

8 Section 8538 of Act 5 established a goal for
9 PSERS to develop a plan to save \$1.5 billion in management
10 fees over 30 years. PSERS Retirement Board Resolution
11 2017-41 passed December 8th, 2017, was developed by the
12 Treasurer and our executive director. It directed PSERS
13 investment professionals and the board's investment
14 consultants to come up with a fee savings plan to present to
15 the board. PSERS investment professionals presented such a
16 plan at its August 2018 board meeting. The plan focused on
17 investment manager cost efficiency, assumed no changes to
18 the strategic asset allocation, included those portions of
19 the asset allocation where we expected fees to increase in
20 the future, and was to be implemented over three years.
21 Annual savings were converted to cumulative compounded
22 savings over a 30-year period.

23 PSERS investment professionals took a
24 two-pronged approach to generate fee savings. The first was
25 establish a fee plan to renegotiate management fee

1 arrangements to create a better alignment of interests
2 between PSERS and each investment manager. The goal was to
3 decrease the guaranteed fees or base fees in exchange for a
4 profit sharing arrangement on returns above a negotiated
5 benchmark. Estimated savings from these reduced guaranteed
6 fees amounted to over \$1.5 billion compounded over 30 years.

7 The second was to expand internal management
8 and bring additional assets in-house at a lower cost than
9 external management. Net of the cost of an additional nine
10 investment professionals needed, we estimated a savings of
11 over \$900 million compounded over 30 years. Together the
12 cumulative fee savings are \$2.4 billion compounded over 30
13 years, which represent a 9.6 percent annual reduction in
14 base management fees. The detailed presentation is posted
15 on our website and has been provided to the commission, and
16 a copy looks like this. (Indicating.)

17 The fee savings plan crafted is by no means
18 an end to our efforts to reduce management fees and better
19 align the interests of the investment managers with PSERS.
20 Since the plan was prepared, we've identified over
21 \$350 million in additional cumulative base fee savings
22 compounded over 30 years. The cumulative fee savings have
23 now increased to \$2.8 billion compounded over 30 years, a
24 10.4 percent annual reduction in base management fees.

25 In addition, we've aggressively negotiated

1 management fee deals with new managers and mandates. In two
2 cases recently, we entered into agreements with zero base
3 management fees, and the investment manager only gets his
4 share of the profits generated. Plus, we are currently
5 negotiating two other similar deals.

6 In other cases, we have continued our
7 longstanding practice of obtaining fee discounts for our
8 large commitments and for being in the first closing of a
9 fund. We also aggressively negotiate the less obvious
10 management fee terms as well, including hurdle rates and
11 catch-up provisions.

12 It is important to recognize that the
13 long-term nature of our pension plan positions us to drive
14 fees down even further because managers are generally
15 willing to accept lower fees in exchange for stable, patient
16 capital. Whenever possible, we attempt to make the most of
17 this natural advantage.

18 One criticism of the fee savings we'd like to
19 address relates to the profit sharing fees. We received
20 questions about the possibility that the total management
21 fees, base fees plus profit shares, may increase under this
22 plan. To be clear, the plan has at least a 9.6 percent
23 reduction in base management fees. Base management fees are
24 guaranteed no matter the performance. So overall, base
25 management fees are going down.

1 If we are so fortunate as to have very strong
2 performance by the investment managers, then the profit
3 sharing component of the total fees will go up. If profit
4 share goes up, so does our investment income. For example,
5 if a manager has a 20 percent profit share and earns
6 \$10 million above their benchmark, then PSERS is better off
7 by \$8 million, while the manager collects an additional
8 2 million. Our interests are aligned. Higher investment
9 income means lower required contributions, and by extension,
10 lower taxes for the Commonwealth and school employers.

11 In government, increased costs are generally
12 frowned upon since increased taxes are required to fund
13 them. In investment management, increased profit sharing
14 fees are funded by increased performance, which has the
15 opposite effect, decreased cost to the government, as well
16 as less taxes needed to fund the pension benefit. It's a
17 win-win-win. It's a win for PSERS members, the taxpayer,
18 and the investment manager. And importantly, a profit share
19 focuses the manager's efforts on performance rather than
20 simply growing assets under management to collect more base
21 fees, an activity that often reduces the likelihood of
22 outperformance.

23 Another item to note that we have not
24 included in our fee savings plan are any savings from not
25 having to pay carried interest in our private equity

1 co-investment program or reduced carried interest in our
2 real estate co-investment program. The private equity
3 co-investment program allows us to invest in private
4 companies at no cost, no fee, no carry. The real estate
5 co-investment program allows us to invest in private real
6 estate at reduced fee and reduced carry. Based on the size
7 and success of our private equity co-investment program
8 alone, which has an internal rate of return of over
9 23 percent, the savings would be significant.

10 Also not included in our fee savings plan are
11 other areas of consideration recommended by our investment
12 consultants, including an increased pursuit of strategic
13 partnerships, direct investing in private markets, secondary
14 sales of noncore, fee paying, private market funds, sidecar
15 co-investment vehicles, and nonmanagement fee reductions for
16 new investments, such as 100 percent fee offsets.

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

24 We are open to considering any fee savings
25 recommendations that, one, enhance PSERS' net of fee return,

1 and two, do not increase the risk of the investment program.
2 The investment professionals at PSERS are always looking to
3 negotiate the fairest fee deal possible. To that end, we
4 have recently implemented a formal external manager fee
5 policy to document our objectives and fee negotiations.

6 In addition, we have instituted a formal
7 internal policy of reviewing all fee arrangements at
8 least once every two and a half years to ensure that
9 each fee arrangement is still appropriate. All fee
10 negotiations are now formally documented and saved in
11 our document management system in accordance with the
12 recommendations from the Auditor General.

13 Now I'll turn it back over to Glen to cover
14 our recommendations. Thank you.

15 MR. GRELL: Thank you.

16 The next portion of my testimony has to do
17 with the funding of the plan, which I believe was
18 sufficiently covered in the previous testimony by SERS.
19 However, just -- and my testimony is in the written
20 testimony. However, I wanted to draw your attention to the
21 chart that I take whenever I make a presentation to the
22 public, because really, proper funding is the key to the
23 long-term sustainability of these plans.

24 I won't dwell on it, but the top chart shows
25 the average payment toward the annual required --

1 actuarially required contribution of public pension funds
2 over the period from fiscal 2002 to present. The blue line
3 represents what peer funds we're receiving from their
4 employer contributions ranging from the 80 to 90 to 100
5 percent range. The green line, unfortunately, is the PSERS
6 line, which shows that period that we all acknowledge of
7 significant underfunding of the plan, reaching the low level
8 of 27 percent. We received 27 percent of the arc in 2010.
9 Fortunately, the passage of Act 120 in 2010 took us on that
10 steady climb from 27 percent to 100 percent actuarial
11 funding on an annual basis. And that point cannot be
12 overlooked.

13 The lower chart shows what can happen to a
14 public pension fund based on poor policy decisions. Taking
15 us from 123, almost 124 percent funded in 2001, to
16 56 percent now.

17 What happened during that period? Three
18 things basically happened. One, Act 9 passed by the general
19 assembly created benefit enhancements, which were not only
20 unfunded benefit enhancements, but they were also made
21 retroactive. Second, the investment markets fell sharply
22 after September 11th and the so called dot-com bubble,
23 clearly not a legislative act. But third, the response to
24 that was to artificially suppress the employer contribution
25 rate as shown on the top chart for the ensuing 12 years.

1 With that backdrop, the consequence of all of
2 that is that we have a \$44 billion unfunded liability, which
3 eats up 75 cents of every employer contribution dollar that
4 comes into PSERS. And none of this had anything to do with
5 external manager fees or costs of the system.

6 With that backdrop, I offer these suggestions
7 for what the general assembly should do and a couple of
8 things we believe they should not do to support the system
9 and its members. One, again, piggybacking on SERS'
10 testimony, require 100 percent annual funding of the arc so
11 that the last three years shown on this chart become the
12 rule and not the exception. Second, we also echo the
13 support for a constitutional amendment requiring full
14 actuarial funding. Three, require prefunding of any benefit
15 enhancement or COLA that may be offered in the future to
16 avoid adding any more debt to the system.

17 These enhancements are not currently and have
18 not in the past been prefunded. When an enhancement is
19 granted, it immediately adds debt, millions or billions of
20 dollars of debt, to the fund on top of the existing pension
21 debt. Prefunding will make the true costs of any
22 enhancements transparent to all constituencies and prevent
23 any unfunded mandates.

24 Fourth, pass governance reforms which enable
25 PSERS' Board to exercise greater autonomy and agility in its

1 operations. PSERS has a short list of such governance
2 reforms and many of them were mentioned earlier by Director
3 Sanchez. But a prime and illustrative example is the
4 ability of PSERS' board to set the agency complement and its
5 organizational structure. Currently we have to go through
6 the Office of Administration hiring process and we have to
7 receive approval from the Budget Office to increase our
8 staff complement.

9 PSERS manages \$23 billion internally, making
10 PSERS one of the largest money managers in Pennsylvania.
11 Significant additional fee savings may be gained by bringing
12 more assets internally to be managed. In fact, greater
13 internal management is an essential element of our fee
14 reduction plan, and frankly, any fee reduction plan. That,
15 however, will require PSERS to get an approval to increase
16 its complement. We currently have 10 positions pending with
17 the Budget Office. We appreciate the assistance we have
18 eventually received from the Governor and the Budget Office,
19 but frankly, 18 months is too long to wait to make
20 complement increases.

21 Fifth recommendation, and perhaps this is a
22 missed opportunity, but as Act 5 was being developed, both
23 PSERS and SERS felt and expressed that there was no reason
24 to require each system to establish a defined contribution
25 plan structure. When Act 5 was passed, two separate defined

1 contribution plans needed to be created, which limited the
2 ability to leverage the bargaining power of the Commonwealth
3 in negotiating third-party service providers. Additionally,
4 it required duplicative efforts by PSERS and SERS in the
5 management and oversight of the DC plans.

6 PSERS recommends making one organization
7 responsible for administration and oversight of the two DC
8 plans. PSERS would support enabling legislation that would
9 allow the two funds to consolidate the DC plans at an
10 opportune time once they are established.

11 Sixth, we'd recommend considering the
12 establishment of a rate stabilization fund or other form of
13 reserve fund along the lines of a current proposal, which
14 was sponsored by Representative Frank Ryan, similar, and
15 perhaps in concert with a rainy day fund, but dedicated to
16 PSERS as a future cushion for school districts against
17 increases in the employer contribution rate. Of course,
18 creating the fund alone is not sufficient unless it's
19 eventually funded as part of future budgets.

20 Seventh, authorize PSERS to engage its own
21 custodian bank. It is rare today for a state treasurer to
22 act as the statutory custodian for a public pension fund
23 where the state's legislature has created an independent
24 pension board, but in Pennsylvania, that's the case. The
25 Treasurer, not PSERS' Board, has sole authority to select

1 the custodian bank on behalf of PSERS' defined benefit plan.
2 The custodian bank client is Treasury, not PSERS.

3 Treasury assesses PSERS' approximately
4 \$2.5 million annually in fees attributable to Treasury's
5 custodian bank contract, yet PSERS lacks any authority to
6 require the custodian bank to meet service level standards.
7 This situation creates not only operational risks and
8 conflicts of interest, but also real economic costs. PSERS
9 has encountered and continues to encounter a profusion of
10 errors and omissions by the custodian bank. For example, we
11 regularly see the custodian bank not creating, or not
12 crediting us with income that is received on our behalf in a
13 complete and timely manner, and then charging us fees for
14 account overdrafts actually caused by the bank's own
15 actions.

16 PSERS has had to assign a number of
17 investment professionals to overcome the custodian bank's
18 lax quality control in order to safeguard the fund's assets.
19 These investment professionals could have been and should
20 have been deployed in more productive activities.
21 Unfortunately, Treasury staff, under several previous
22 treasurers, have been ineffectual in addressing our concerns
23 or holding the custodian bank accountable. We recommend
24 that PSERS Board be given statutory authority to directly
25 hire and manage our own custodian bank relationship.

1 Finally, what not to do. Now, I ask you to
2 remember the period prior to the mid-1990s. PSERS universe
3 of investment options was limited by statute. In 1994,
4 Pennsylvania policymakers wisely chose to move PSERS away
5 from these legal lists by statutorily providing the PSERS
6 Board of Trustees with prudent person investment authority
7 broadening the board's powers to invest the fund's assets
8 for the benefit of the system's members. As noted in this
9 testimony, the results of empowering the board to invest in
10 this manner have been overwhelmingly positive.

11 Limiting the board's authority again at this
12 time would amount to a form of unnecessary and onerous
13 regulation that would turn the clock back to the days of
14 legal lists, limiting the investment returns potential of
15 the fund. Imposing artificial caps on fee arrangements
16 would also increase employer contributions and unnecessarily
17 burden the taxpayers with the resulting bill.

18 In closing, I urge you to proceed with
19 caution. Please avoid the knee-jerk approach to
20 legislation. Avoid the "sounds good, looks good" kind of
21 reaction. Avoid legislating trendy concepts that tend to
22 fall from favor faster than a legislative body can normally
23 react. Be deliberative in the approach to legislative
24 proposals and please consult with the systems and our
25 consultants on the merits and risks associated with such

1 proposals.

2 PSERS, as you know, is a large system, large
3 and complex system. And should any future recommendations
4 from the commission impact investment returns, or risks,
5 including changing the asset allocation or the actuarial
6 assumptions, there could be a significant negative impact on
7 taxpayers and the general fund if it pushes the employer
8 contribution rate up. This is a rapidly changing investment
9 industry with new products and strategies emerging
10 regularly.

11 In fact, just this morning, as I was reading
12 my clips, I came across news, the reports of the fiduciary
13 investor symposium, which was held recently at Stanford.
14 And it's an interesting article. They brought in many very
15 well-known managers to talk about new strategies in fee
16 negotiations, fee structures, better alignment of interests,
17 emphasis on putting more fee on performance and less on
18 base. Just the kinds of things that Jim's been talking
19 about and that are included in our fee reduction proposal.
20 Don't tie the hands of our trustees and the investment
21 office to participate and lead in these kinds of initiatives
22 through legislation.

23 Remember just as there, in the commercial
24 sector, there are real costs associated with regulation, and
25 with a public pension fund, those costs are reflected not in

1 the prices to the consumer, but in this case, to the
2 employer contribution rate.

3 Thank you for the opportunity to appear here
4 today and we look forward to your questions.

5 CHAIRMAN TOBASH: Thank you so much,
6 Executive Director Grell.

7 And I just want to point out that you know
8 this, as well, possibly better than anyone. I mean, having
9 served in the general assembly from a time when the systems
10 were 100 percent funded to the arc to a time when they went
11 down to 27 percent and then rose back up, you know the
12 political aspect of this, oftentimes very frustrating for
13 members of the general assembly also. Now you're in a
14 position of helping manage this organization that is trying
15 to get itself back on level ground. So I appreciate, again,
16 your commitment.

17 And I also appreciate the fact that, you
18 know, the system reacting to Act 5 and talking about the
19 steps that you have taken to try and adopt new policies and
20 being as effective as you can. And I hope that the work of
21 this commission is helpful in regard to your continued
22 effort to do that.

23 I guess I have two basic questions, and I
24 asked one to Executive Director Sanchez. I'll be a little
25 more blunt with it.

1 If you were able to choose a governance board
2 that you would report to in a different method than the way
3 it's set up right now with appointees, how might that be?
4 Do you think there could be a change for the positive?

5 MR. GRELL: Well, since three of my board
6 members are represented on the commission, don't expect me
7 to speak ill of my board. Having said that --

8 CHAIRMAN TOBASH: I'd like you to be candid
9 to the commission because we want to have positive change.

10 MR. GRELL: Well, having said that, I mean, a
11 15-person board is large. At times, it's cumbersome, but
12 it's representative. And it, I believe -- has to represent
13 the diverse interest.

14 It has a component that represents the
15 employees who actually own the money that they're managing.
16 So I think, you know, the lay members are very important on
17 the board. The policymakers are represented through the
18 Governor's appointees, the ex officios, the members of the
19 legislature. So in that sense the taxpayer interest is
20 represented. But also the employer is represented on our
21 board. We have one elected school board member and we have
22 the executive director of the School Boards Association as
23 ex officio, so I think there's a balancing impact by having
24 those various constituencies represented on the board. And
25 I can think that diversity and that representative nature

1 more than compensates for the sometimes cumbersome need to
2 move a group of 15 folks.

3 CHAIRMAN TOBASH: Sure. So you think the
4 board structure is fine as is because of its representative
5 nature.

6 MR. GRELL: Well --

7 CHAIRMAN TOBASH: But a little bit difficult
8 to navigate. Fifteen is a large board.

9 MR. GRELL: It is. Maybe instead of, you
10 know, five members representing the employee group, that
11 could be three. Maybe instead of four legislators, that
12 could be two. Maybe instead of, you know, five ex officio,
13 that could be three. I mean, you could reduce it, but I
14 think you need to have that representation by both the
15 people who own the fund, the employers who pay into the
16 fund, and the policymakers who set the policy that governs
17 the fund.

18 CHAIRMAN TOBASH: You also brought up a point
19 which has sort of been absent. I know that Commissioner
20 Torbert brought it up at some point in time at a previous
21 hearing, of consolidation. We haven't heard a lot about it,
22 but it's in the minds of many people, that we've got two
23 large systems here. Not every state has got two systems, as
24 a matter of fact, few do.

25 You talked about consolidation of the DC

1 component, which is new. What is your thought on full
2 consolidation?

3 MR. GRELL: Well, I mean, we've been talking
4 about this and working on it since that June 2015 meeting
5 with the Governor. After we stopped talking about manager
6 fees, we started talking about what can the funds do
7 collaboratively? And at that time, I think the conversation
8 then expanded to several other funds, whether it was the
9 Swift Fund or some funds that the Department of Labor and
10 Industry controlled and the Insurance Department and
11 Treasury and PMRS. And we were all at the table talking
12 about what we could do to collaborate.

13 But at that time, the mission was, what can
14 we do to collaborate without any legislation? Nobody wanted
15 to do legislation. So the easiest way to do that was to
16 piggyback on the statutory powers that the Treasurer has,
17 and I believe those other miscellaneous funds have been
18 rolled into a relationship with Treasury, managing or
19 helping to manage those funds.

20 So we've tried to do what we consider low
21 hanging fruit in terms of collaborating and conversing and
22 working with our investment offices. But you know, we have
23 two separate funds, we have two separate management
24 structures, we have two separate missions. They are
25 generally the same, but you know, one fund is a mature fund

1 that has more retired members than active. The other is
2 not. There are a bundle of legal issues that go into this.

3 In fact, I think it was in May of 2017 --
4 well, it was before that. It was in 2016, the Governor's
5 Office of General Counsel presented a 30- or 40-page slide
6 presentation to the Budget Office laying out what some of
7 the legal impediments are, whether they're legal, statutory,
8 state, federal, a whole mix of fiduciary constraints on what
9 can be done structurally to combine the two funds.

10 Then, we were asked to go out, the Office of
11 General Counsel authorized us to engage outside counsel. So
12 we used, both SERS and PSERS collaborated with Duane Morris
13 and came up with some analyses of a couple of different
14 scenarios, whether it was a shared employee kind of setup
15 that, you know -- maybe employees from the investment office
16 at SERS could be become shared employees with PSERS.

17 So there's been a lot of thought and analysis
18 put into the kinds of things that could be done, whether
19 it's, you know, sharing facilities, sharing a headquarters,
20 sharing HR services, IT services, a print shop, a call
21 center, sharing consultants, sharing due diligence that we
22 do. And we've had -- and it's anecdotal. We've had a
23 couple of instances where PSERS and SERS were both looking
24 at the same deal, so we collaborated. In one case, we were
25 able to use our maybe bigger buying power to negotiate a

1 lower fee, not for us, but for SERS, but we're all in the
2 same family, so that was a good outcome. We'd like to do
3 more of that. But there really are limits to what can be
4 done without statutory change.

5 And so if that is something that the
6 commission is interested in, we're happy to share to the
7 extent that it's not attorney/client. But we're happy to
8 share legal analysis and our thoughts and what's been done
9 already over the past two or three years to look at how we
10 might bring the systems closer together.

11 CHAIRMAN TOBASH: That's really important and
12 productive. And we'll like to be in touch with you, again,
13 as we get down the stretch.

14 Just one last question briefly. So there is
15 a bill, and you mentioned, not knee-jerk legislative
16 reaction. And you know that oftentimes it can be very slow
17 moving. But there is a House bill, and we have
18 Representative Miller that's with us today. It came in
19 front of the general assembly, I think it passed the House
20 unanimously, I believe. It's House bill 1460. It has to do
21 with transparency. What is your system's position on that
22 piece of legislation?

23 MR. GRELL: Well, we typically don't take
24 formal positions on legislation. However, we are very
25 familiar with the bill. We had significant concerns with

1 the bill, whether we could even comply with some of the
2 provisions of the bill, which I think required us to go back
3 20 years and recreate gross of fees return on investments
4 that were long since over and done.

5 So we addressed those concerns when the bill
6 moved over to the Senate. There were amendments that were
7 done to the bill that we felt made the bill manageable,
8 something that we could actually comply with. So we were
9 technically neutral on the bill in the Senate after it was
10 amended and leaned to favor it because it included some Act
11 5 fixes that we really need between now and July 1st.

12 In the closing days of the legislative
13 session, my understanding is that there was an effort to
14 revert the bill back to the form from which it came out of
15 the House, which made it a complete nonstarter with us. We
16 didn't actively engage, but we made it known that our
17 neutrality on the bill would go away if it was reverted
18 back. And the things that we couldn't comply with were put
19 back in the bill.

20 CHAIRMAN TOBASH: Thank you very much. I
21 appreciate your testimony, again.

22 Vice-Chairman Torsella.

23 VICE-CHAIRMAN TORSELLA: Thank you, Chairman.

24 Thank you, Glen and Jim, for being here, for
25 your work. A question, first a request then an observation.

1 We've had some interesting conversations
2 about governance. And we've talked about them in the
3 context of representation and we also talk about, or you
4 talk about them in your testimony on the context of
5 autonomy.

6 Having spent some time in a previous life at
7 the Constitution Center thinking about governance in a
8 different way, I want to invite you to think about it and
9 make suggestions to us in the context of accountability and
10 checks and balances. And this may not go to form, it may go
11 the spirit, but it seems to me, given the stakes, given the
12 fiduciary obligations, given the, in some cases, unique
13 risks of PSERS' portfolio, the governance question is, are
14 we creating a climate in which understanding and challenging
15 those risks is being done, being done well, being welcomed?
16 Are we creating the necessary checks and balances on that,
17 particularly, if there's a desire for more autonomy and more
18 internal capacity? So I want to invite you to consider a
19 submission to the commission on that as we go forward.

20 MR. GRELL: I would say, you have been
21 helping to inform us and push us in that direction. And I
22 think it's welcome.

23 Some things that we've talked about for
24 years, for example, fiduciary counsel, is something that,
25 first of all, we couldn't do fiduciary counsel until we had

1 our own independent counsel from the Governor's Office. I
2 mean, the kinds of ideas that you've been bringing to the
3 board have been challenging in questioning us as a staff.
4 And I think we're responding.

5 The recent transparency resolution that we
6 did is moving us in a forward direction. And I mean, it's
7 always, change is always difficult. But we do appreciate
8 the challenge that you bring to the board. Challenge may be
9 not the right word. Pushing us, questioning us, it has
10 helped us. Just as when we went through the Auditor
11 General's audit, we didn't like the process, but in the end,
12 we think it made us stronger and we're looking at the issues
13 that you have brought to the table in the same fashion.

14 VICE-CHAIRMAN TORSELLA: Thanks.

15 Well, then, in the spirit of you
16 appreciating, let me ask a question. Appreciate may be a
17 strong word.

18 But by the way, the other thing I feel
19 compelled to say, I do think the importance of living up to
20 the obligations we as a state make to the people who work on
21 our behalf can't be said often enough, whether in chart or a
22 narrative. So as we said in the case of SERS, and
23 previously, the consequences of the arc have been dire and
24 the importance of continuing to meet them is paramount.

25 MR. GRELL: I think I just learned recently

1 that your mother is a member of PSERS?

2 VICE-CHAIRMAN TORSELLA: No, I'm sorry.
3 She's a member of SERS.

4 MR. GRELL: Oh, SERS. Oh, okay.

5 VICE-CHAIRMAN TORSELLA: She's a former
6 educator, but a member of SERS.

7 I do want to ask, though, in your testimony,
8 you talk about -- Jim, I think this was in your section --
9 total management fees, base fees plus profit shares. In
10 PSERS' CAFR, we list investment expenses and we have a dash
11 for profit share for some categories, but not for others
12 where we report them. And I know that derives from GASB and
13 what's readily separable and what isn't. But whether we
14 call it a fee, in your view, is carry a profit share, an
15 expense, an investment expense? Put aside to whom it should
16 be reported.

17 MR. GROSSMAN: It's funny that you bring that
18 up because I had a lot of soul searching on that one. I
19 mean, to give you a bit of my background, I came up through
20 the public market side and not the private market side. So
21 I spent a lot of time looking at how those fee structures
22 are set up for private equity. So when you think about it,
23 we are entering into a partnership where we are
24 contractually obligated to get 80 percent of the profits.
25 And the general partner, as part of the deal, is obligated,

1 gets 20 percent, essentially, of the cash flows. So I'm not
2 100 percent certain it is a fee. I mean, I would have told
3 you two or three --

4 VICE-CHAIRMAN TORSELLA: Not a fee, a cost,
5 an expense.

6 MR. GROSSMAN: I would have thought two or
7 three years ago, I would have probably agreed that I thought
8 it was a fee. Today I'm not as certain of that, as I
9 explore that a lot closer.

10 Do I believe it's a number that should be
11 disclosed? Yes, I do believe that. I think that is
12 something that is fair to say that we should be transparent
13 with it, we should be disclosing it. Should it be included
14 on the face of the CAFRs and investment expense? I'm not
15 100 percent positive I agree with that assessment. But I
16 would agree that we should be disclosing it.

17 VICE-CHAIRMAN TORSELLA: In the fiduciary
18 responsibility and disclosure department, I was glad that it
19 was disclosed at a board meeting to the fiduciaries
20 recently. Was that the first time that the PSERS Board
21 saw -- and again, I'm not -- I get private equity is
22 different than 10 years ago. Was that the first, to your
23 knowledge, the first time the PSERS Board had been, saw that
24 information?

25 MR. GROSSMAN: To the best of my knowledge,

1 that's the first time they saw that.

2 MR. GRELL: On individual deals, it's
3 discussed.

4 MR. GROSSMAN: Well, every --

5 VICE-CHAIRMAN TORSELLA: Sure. The terms
6 would show up when the deal is --

7 MR. GROSSMAN: Every deal that's approved by
8 the board, they see the terms. But from an actual
9 disclosure of the dollar amounts, it's probably the first
10 time that it's been disclosed.

11 VICE-CHAIRMAN TORSELLA: Great. Thanks.

12 CHAIRMAN TOBASH: Okay. And I could have
13 very well mentioned, but, Glen, you brought it up that the
14 Treasurer sits as a member of your board. And Commissioner
15 Gallagher has got a question. He also sits and works very
16 closely with both SERS and PSERS as a delegate to your board
17 operations.

18 So, Commissioner Gallagher.

19 COMMISSIONER GALLAGHER: Thank you,
20 Mr. Chair.

21 And again, you know, thank you and the staff
22 and the enormous lift that the entire organization, as well
23 as SERS organization, does every day. And thank you for
24 providing context.

25 I think when we talk about pensions, over the

1 last eight years I've worked on it, context has been
2 missing. And understanding why the systems are suffering is
3 mostly as a result of what were thought to be good policies
4 at the time, but unfortunately, proved to be otherwise. And
5 so this shows that when the employer contribution rate was
6 artificially suppressed, it starved the system, which brings
7 me to a question.

8 How does this funding insecurity lead to
9 asset allocation, which leads to asset selection? And then
10 when you're in that asset selection space, obviously, there
11 are costs associated with each type of investment vehicle,
12 so that's my core question.

13 But what I really want to leave you thinking
14 about is, we appreciate all the fantastic business, best
15 business practices that you're incorporating, you're
16 engaging on, you're looking for better ways -- the dialogue
17 just between Mr. Grell and the Treasurer is indicative of
18 that constructive conflict that brings about constructive
19 change. And so thank you for that.

20 And to that point, between the two systems,
21 what we're talking about here impacts one in every six
22 households. So you go down your street, statistically
23 speaking, every sixth house is somebody impacted by one of
24 these two systems. So thank you.

25 If you could, answer that question with

1 respect to funding insecurity.

2 MR. GROSSMAN: Sure.

3 When you look back, you know, through our
4 history, coming into the Great Recession, we probably looked
5 similar to a lot of other pension plans, very heavy in
6 equities, say about 70 percent, 30 percent in fixed income.
7 When we entered the crisis, assets fell significantly. You
8 know, we probably top ticked assets around \$70 billion and
9 we fell down to about \$40 billion. And that was just an
10 indication of the risk profile that the fund was taking. We
11 had 70 percent in equities, equities were cut in half.
12 That's a type of loss you're going to have.

13 At the bottom, towards the bottom of the
14 market, what we were facing was an uncertain funding future,
15 right? We knew at the time we were being severely
16 underfunded, the arc. Our cash flow went to about negative
17 eight percent of assets. So the contributions that we were
18 receiving at that time were short by eight percent of the
19 assets of the fund. So if the fund grew zero in that next
20 year, we would have eight percent less in assets. And if
21 you went through a period, a long protracted period of sort
22 of no returns, or God forbid, you had another drawdown after
23 that, we ran into issues where solvency could become an
24 issue.

25 So we stepped back and we said we really

1 couldn't accept that 70/30 type risk profile anymore. It
2 was way too risky. I mean, 70/30 risk profile, 95 percent
3 of your risk is coming from equities, very little from
4 others. You might as well be in all equities.

5 So we stepped back and we said, "Well, let's
6 diversify, let's diversify along a lot of different
7 spectrums," which we did to try to get a smoother return.

8 So what's the trade-off for the smoother
9 return? We sort of cut the tails, what we call the tails of
10 the distribution off. So we were hoping not to have any big
11 large drawdowns, but we also knew we were giving up upside,
12 we were going to have a big market rally. That was sort of
13 the trade that was made. More stability in the asset
14 allocation, and sort of see our way through the financial
15 crisis and to continued health.

16 And since then, it's actually worked out very
17 well. We're very pleased with how this balanced portfolio
18 has worked. We run a portfolio that's probably in the
19 bottom quartile of risk versus other pension plans. And the
20 stability of returns has been very, very strong.

21 As the funding has improved, we've modestly
22 taken on increased risk. We've done that through leverage.
23 So we felt we had a very balanced portfolio that worked very
24 well for us. So as funding has improved, we actually used
25 leverage to leverage that portfolio up a little bit, so

1 using modest leverage to get a balanced return.

2 Is that helpful?

3 COMMISSIONER GALLAGHER: Yes, it is. And
4 just one follow-up, and I apologize.

5 CHAIRMAN TOBASH: Just let me jump in for a
6 second.

7 Jim, can you just get a little bit closer to
8 that. I'm concerned that mic isn't working.

9 Glen, there's another one. I don't know if
10 it's helpful.

11 MR. GROSSMAN: Like that? Okay. Sorry about
12 that. Thank you.

13 COMMISSIONER GALLAGHER: Along those lines,
14 with respect to where we are, we're 60 percent funded. We
15 have a well diversified asset allocation. We had some other
16 CIOs present at the last commission hearing, all of which
17 are thought leaders in that space, from Idaho, South Dakota,
18 and from the Wisconsin system. And each were asked, you
19 know, "Could you do what you do, in terms of that
20 innovation, at 60 percent funded?" And all three said "no."
21 Can you just comment on that, please?

22 MR. GROSSMAN: Well, each plan has its own
23 specific, you know, benefit structures, legal structures,
24 funding structures, how comfortable they are, whether
25 they're going to see the full funding on a prospective basis

1 or not. So funds that have seen full funding on
2 a prospective basis are probably a little bit more
3 comfortable because they've never missed a benefit payment.

4 Obviously, we were, we've gone through three
5 years in a row, but to this point, you know -- and I guess
6 I'm not going to be comfortable until I see it through a
7 recession, whether the contribution rate will be maintained,
8 right? So we're at the best of times from an economic
9 standpoint, and we're meeting the arc.

10 I'm more interested in what's going to happen
11 in the worst of times when the, you know, need for
12 government spending will increase, the tax revenues will
13 fall, and then you're going to have to figure out how to
14 balance that budget. I'm not 100 percent convinced what
15 that's going to look like.

16 Whether the next recession is in 2020, 2021,
17 2022, there'll be another recession. There will be a
18 drawdown on government revenues, there will be a draw on
19 government services. How is that -- what's the balancing
20 act that's going to come from that? Will it be the pension
21 systems? Are they going to be the balancing act? Will the
22 general assembly need to raise taxes, which would be very
23 uncomfortable, in a recession, to try and find other revenue
24 sources or will they cut other spending?

25 Until we see that we can get through that or

1 we see a constitutional amendment -- say that the arc is
2 part of the requirement for a balanced budget, then, you
3 know, I think, to some extent we'll still want to be fairly
4 balanced, fairly conservative.

5 Now, having said that, we want to balanced a
6 portfolio with an expected return of seven and a quarter and
7 we believe the risk profile is very appropriate for what
8 we're doing today.

9 So does that answer your question?

10 COMMISSIONER GALLAGHER: Yeah.

11 MR. GROSSMAN: Okay.

12 CHAIRMAN TOBASH: Thank you.

13 Commissioner Torbert.

14 COMMISSIONER TORBERT: Just a couple of
15 comments.

16 And it's really gratifying to hear that you,
17 PSERS and SERS, work together. And the more you all can do
18 that, obviously, the better off we're all doing to be.

19 Kind of in line with what Chairman Tobash
20 said, asking about one ward maybe over two of them. As you
21 mentioned, there's probably a lot of ramifications, legal
22 ramifications, to that. But in my history of being on
23 boards, I've always found that a little bit smaller board is
24 easier to work with than a larger board. And so, I don't
25 know if that -- I'm not on your board, so you can ax these

1 guys, that's fine.

2 But anyway, just two comments. The other
3 questions I have, you pretty much answered them.

4 And by the way, my daughter is an elementary
5 school teacher.

6 CHAIRMAN TOBASH: Thank you.

7 Commissioner Bloom.

8 COMMISSIONER BLOOM: Thank you very much, Mr.
9 Chairman.

10 First, I wanted to thank both of you for, I
11 guess, putting up with me. And Jim Grossman, on last
12 Friday, spent three hours with me. And I must have been
13 driving him crazy. He never rushed me. He was just
14 terrific.

15 And, Glen, thank you for inviting me to your
16 meeting. And I don't think -- I think the same thing that I
17 said to the folks at SERS about hiding fees and why I think
18 there was an interest in trying to figure out, you know,
19 "what ifs," okay? And, you know, one of the great what ifs,
20 of course, is, "If the arc was paid, where would we be?"

21 The only question I really have and --
22 because I got all my auditing -- if you have anything to say
23 about the auditing questions I asked SERS, James, you can
24 just add that in. And if you don't, that's fine, too. I
25 think you were pretty comfortable that your valuations were

1 good. In fact, you were pretty comfortable that the SERS
2 valuations were good.

3 I just want to talk for a minute about
4 liquidity.

5 In a majority downturn in the market, between
6 private equity and venture capital and real estate, absolute
7 return, the drawdowns that are involved, the private
8 lending, do you have any liquidity concerns? My
9 calculation, off a sheet that you have -- I'm sorry I don't
10 have it here, I could read it off -- was about 65 percent of
11 your assets at this point were possibly in illiquid
12 vehicles. Do you have any uncomfortable level about where
13 you are as far as that's concerned?

14 I'm sorry I didn't ask you that on Friday. I
15 wouldn't have had to ask you today.

16 MR. GROSSMAN: That's a good question.

17 I'd look at our illiquid assets at around 45
18 or 50 percent, probably 45 is where I'd put them.

19 You know, when we do the asset allocation,
20 you know, we have a stress test on the liquidity of the
21 fund. Using fairly draconian expectations, very deep
22 recession without any recovery for a number of years, can we
23 withstand that from a liquidity standpoint? So we do look
24 at that very closely.

25 Would I want to increase illiquidity of the

1 fund 10, 15 percent from here? No, I think we're probably
2 where we're comfortable with.

3 You know, private equity is illiquid, private
4 real estate is illiquid, private credit, not as illiquid,
5 but illiquid, tends to have a shorter life span. So the
6 cash flows come back faster.

7 The absolute return or the hedge fund
8 portfolio, a lot of that is fairly liquid. A lot of that I
9 can turn around very quickly.

10 COMMISSIONER BLOOM: Yeah, I didn't mention
11 hedge funds. I know they're --

12 MR. GROSSMAN: Yeah, the absolute return
13 program, that would be the hedge funds, or where the hedge
14 funds would reside. Most of that is fairly liquid, that we
15 can get money back fairly quickly.

16 Risk priority is another one, where people
17 think it's illiquid. I -- you know, we reduced one percent
18 of the risk priority portfolio, it took me three days to do
19 it, to get the cash back. So I can turn that cash very
20 quickly. That's one of the things I really like about the
21 risk priority portfolio, it's a very balanced portfolio, but
22 it's a very liquid portfolio. So it gives me a balanced
23 exposure to the markets, but it also provides a big source
24 of liquidity, should I need it. And I can get that fairly
25 quickly.

1 So, no, I'm not too concerned. Right now, we
2 have jumped the cash balance of the fund up to about
3 six percent. We did that at the beginning of October. We
4 started -- we sort of sold -- part of the new asset
5 allocation that was approved by the board was to reduce
6 risk. As part of that, we did sell a significant amount of
7 assets, as well as raise cash.

8 COMMISSIONER BLOOM: Well, thank you very
9 much.

10 And again, I want to thank both of you for
11 putting up with me and my questions.

12 And anything on valuations, Jim?

13 MR. GROSSMAN: We talked about that. Again,
14 I think in the lines of, you know -- I think you were
15 talking to me about two different things.

16 So the valuations themselves, I do believe
17 tend to be conservative, from what we see on final sales, to
18 say about 10 percent. I think you said that in your
19 question.

20 Regarding the secondary sale that you were
21 talking about with SERS, while they may get a discount
22 trying to sell that in the secondary market, it doesn't
23 necessarily mean those assets are impaired. It just means
24 that the buyer of those assets has a higher return
25 expectation than may be left on the books at SERS. So those

1 assets may have an eight to ten percent return profile going
2 forward as they're noncore positions, maybe late-in-life
3 funds. A buyer may want a 20 percent return on those cash
4 flows, so they're going to demand a discount to buy those.
5 So they're not impaired from an accounting standpoint.

6 And from an accounting standpoint, an
7 impairment would be my cash flows from that investment I
8 expect to be less than the value on my books, in which case
9 you'd like them down to essentially what you expect those
10 cash flows to be.

11 I think in the case of most of those -- and I
12 don't know the funds individually, but my guess would be,
13 those valuations are right. They just may not have the
14 earnings power going forward, which is why a lot of funds
15 like to use secondary sales, so they can sort of clean out
16 sort of noncore funds and recycle that into funds that they
17 believe will have a higher return profile going forward.

18 But, you know, it's sort of a trade-off. You
19 have to look at it like, is that too large of a discount or
20 do you think that the secondary buyer is haircutting that
21 asset too much? You may want to hold that because that
22 return is better than you can get from recycling those
23 assets.

24 Does that help?

25 COMMISSIONER BLOOM: Yes, it does.

1 And thank you again, both of you.

2 MR. GROSSMAN: You're welcome.

3 CHAIRMAN TOBASH: Okay. Thank you. Thank
4 you very much. We hope that this commission is going to end
5 up being a challenging, but inevitably productive endeavor.

6 As I mentioned earlier, we would much
7 appreciate this open line of communication as we go down the
8 stretch.

9 With that said, we're going to ask our next
10 testifiers, Dr. Monk and Dr. Staub, to come forward and get
11 set up.

12 And if we could, could we just take five
13 minutes right now, while they are -- we're going to eat it
14 up, we're all going to push ourselves away from the table a
15 little bit quicker. We'll have less lunch, but we
16 appreciate the fact that you could stick around and answer
17 some additional questions. You're important -- your
18 testimony is very important.

19 So a five-minute leg stretch, then, Dr. Monk,
20 you are up next. Thank you.

21 (Recess.)

22 CHAIRMAN TOBASH: Okay. Seeing as the music
23 has stopped, it's time for everyone to find a chair, if
24 they're still available, so we can get on to the next part
25 of our presentation.

1 We have got Dr. Ashby Monk who is with us,
2 and is becoming not a stranger, in fact, a friend to our
3 organization and Harrisburg, the Capitol.

4 So we appreciate you being here today,
5 Dr. Monk, to help us as we start to wrap up testimony. And
6 your continued work to make sure that our consulting
7 document is as great as it could be.

8 And you are also joined by Marcel Staub.
9 Marcel is a founding partner and CEO of Novarca, an
10 independent consulting firm, focused on identifying
11 opportunities for cost saving and transparency for
12 institutional investors, which is extremely consistent with
13 what this commission is charged with doing. So we
14 appreciate you being here. Dr. Staub also studied law at
15 the University of Neuchâtel in Switzerland, and holds a
16 Swiss banking diploma and he sits on various companies and
17 boards.

18 We appreciate you both being here today and
19 we're anxious to hear your testimony. Thank you.

20 DR. MONK: Thank you, Mr. Chairman,
21 Vice-Chairman, and to all of the Commissioners. Once again,
22 it is a great pleasure and honor to be back here in front of
23 you today.

24 I admit that I'm excited about today. I
25 think this is the day where we begin to put forward

1 recommendations and potential solutions to solve the
2 problems of fees and costs and finding \$3 billion for the
3 state of Pennsylvania.

4 I think I'd first like to start by just
5 recognizing the prior panelists. In listening to their
6 remarks, I'm truly reminded that there is a single constant
7 that seems to bind everybody in this industry, and
8 especially this room, and that is that we want what's best
9 for the pension plan beneficiaries in the state. You know,
10 everybody may have different perspectives on how we get
11 there, but I think that central constant gives me a lot of
12 confidence that we're going to get to a solution that may be
13 difficult, may be challenging. But that we will push
14 forward and make the hard decisions to do what's in the
15 collective best interest. Sometimes thinking creatively,
16 sometimes doing the hard things in order to recapture that
17 wealth that's being funneled through to Wall Street and the
18 financial services intermediaries.

19 Joining me to testify is my good friend,
20 Marcel Staub, CEO of Novarca. If his shoulder looks sore,
21 it's because I twisted his arm heavily to get him to work on
22 this commission with us. This isn't his normal type of
23 project.

24 So, Marcel, it's awesome to have you here
25 with us.

1 I'm going to lead off with probably a
2 half-hour remarks talking through a number of issues. I'm
3 going to turn it over to Marcel.

4 And then with your permission, Mr. Chairman,
5 at that point, I think we will take questions. I'm open to
6 taking questions at any point if anybody wants to challenge
7 me, but I defer to you on the protocol.

8 In terms of the presentation, we want to find
9 paths for each plan to recoup 1.5 billion. I'm going to
10 start out in the first section talking about key drivers,
11 what we might call in our work investment and organizational
12 ingredients that can be integrated into the investment
13 strategy, the operational makeup of a pension plan that we
14 believe, after two decades of experience and research on the
15 topic, will help PSERS and SERS cut their costs, improve
16 their alignment of interest, and ideally, because that's
17 what this is really about, generate higher returns.

18 I'm going to run through these cost-savings
19 ingredients in detail. I'm going to describe them and their
20 key considerations because each cost-saving ingredient comes
21 with pros and cons, they come with challenges and
22 considerations. And so I will highlight how those paths
23 might be implemented. So it's not just, what are the paths
24 available, it is what is the path and then what is the
25 likelihood of them being implemented here?

1 In this respect, and it's come up a few times
2 already, I will spend a few slides talking about investment
3 governance, public pension plan governance, and the
4 requirement to have strong and oftentimes expert boards in
5 order to oversee complex and innovative investment
6 strategies. I will also come back to a topic that was
7 raised in the prior session just briefly, to talk through
8 some of the risk-adjusted return numbers.

9 And then drawing on the cost-saving
10 strategies, some of the findings from the risk-adjusted
11 return numbers, we will make recommendations at the end of
12 this presentation. We will offer a series of caveats and
13 qualifiers, but we're going to make two recommendations to
14 this commission on a path forward to save 1.5 billion per
15 plan over 30 years.

16 So if we just jump right into it and we think
17 about this in kind of generic terms, as an industry of
18 public pension plans -- and we think that these plans that
19 are here in the state of Pennsylvania are definitely not
20 alone in dealing with financial intermediaries and trying to
21 reduce the cost -- we see several ingredients that can help
22 them cut costs and improve efficiency. And the first one is
23 innovation.

24 So investment innovation is a way to change
25 the supply and demand of capital by doing things that others

1 are not. Now, I'm going to dig into this a little bit
2 because innovation is hard and it often goes against the
3 very nature of public pension plans in their design. But
4 innovation is undoubtedly a pathway to cutting costs and
5 improving outcomes, if done correctly.

6 The second key ingredient that I'll talk
7 about is a strategy simplification. So complexity is
8 increasingly pervasive in financial markets and the products
9 being consumed by pension plans to generate return. This
10 complexity comes with new costs and benefits. Oftentimes
11 those benefits are uncertain, but the costs are certain,
12 which means you can seek to remove complexity and remove
13 fees and costs and potentially increase performance.

14 To be clear, when you reduce complexity and
15 you simplify, it can imply a change in exposure and
16 different risk levels for the fund, so that's a
17 consideration that I will mention in my remarks.

18 The third ingredient that we're going to
19 review is what we call cost arbitrage, where we look for
20 similar risk factors in different markets at lower costs or
21 we look for new cheaper ways to access the same risk
22 factors, either in terms of products or assets.

23 And then lastly, and this is where Marcel
24 will end up taking a much deeper dive in his remarks,
25 monitoring and revisiting relationships with managers.

1 Taking what you have in the portfolio and simply looking to
2 get a better deal.

3 So I'd like to just point out that this is
4 just a framework, a simplification, to allow the commission
5 to think through what the potential ingredients are to
6 achieve your objectives. Certain things that I'm going to
7 be talking about include all aspects of these ingredients.
8 You know, you put a dash of this and a dash of that in your
9 cost-savings meal, if you will. With that in mind, let's
10 dive into the first ingredient.

11 Investment innovation refers to investors
12 breaking out from the constraints that many operate under,
13 okay? The truth is, in this space, pension plans are
14 conservative and often purpose built to be efficient, which
15 means innovation is often unheard of. Efficiency and
16 innovation, we know in the literature, run in direct
17 opposite directions. It's incredibly difficult to run an
18 efficient process and then seek to innovate that process at
19 the last minute. You're no longer running an efficient
20 process. And so where your focus is efficiency, innovation
21 can be challenging.

22 Prudent person rules, which often govern
23 these funds, strict interpretations of fiduciary duties of
24 these plans, also often push conservatism. They herd with
25 each other. The fact that these plans also tend to have

1 monopolies over their assets, as in they're going to have
2 these assets and control them come what may, tends to create
3 very odd incentives inside the organizations themselves.
4 The pension plans are not going to go out of business.
5 Stanford Management Company will always manage Stanford's
6 endowment. But the people inside those organizations will
7 change and shift over time, which again leads to incentives
8 inside these organizations not to get fired, what we call
9 managing career risk. Because the organization itself will
10 just persist. And that monopoly over assets and that lack
11 of death removes also one of the big drivers of innovation.
12 If an organization has no threat to die, then you're losing
13 that inspiration for innovation that exists in the private
14 sector. This is pervasive.

15 So when we think about innovation, we think
16 about organizations that are trying to overcome all of that,
17 all of those challenges. And if they can do an innovative
18 thing, they are deploying capital in places that are far
19 less competitive. They are buying products or investing in
20 managers that simply don't have the same demand for the
21 supply.

22 Some examples of investment innovation could
23 include seeding new managers, entering into new forms of
24 collaboration with peers or with partners. We heard a
25 little bit about that today in terms of the collaboration

1 going on between SERS and PSERS. Although it's in an
2 initial state, you heard about it. There's many other cases
3 of pension funds coming together to launch platform
4 companies to invest in energy or to build platforms to go
5 out and seed private equity managers. These types of
6 innovations are becoming more and more pervasive and they're
7 being launched almost exclusively based on the notion of
8 improving alignment of interests and reducing the fees and
9 costs captured by Wall Street. You're seeing more and more
10 pension funds using new corporate structures, so "platform
11 companies" has become a buzz word. Instead of setting up
12 with a limited partnership and a general partner, some
13 people are just buying companies and using those companies
14 as an extension of their internal team to go and do hydro
15 assets around the world, airports, toll roads. Real estate
16 operating companies have been in existence for 20, 30 years,
17 have proven very successful. Again, a completely innovative
18 way of getting your capital out into the physical assets in
19 the ground, but where you can do it, you can achieve better
20 alignment of interests.

21 And then there's also the rapid rise of new
22 technologies, artificial intelligence, alternative data.
23 The digitization of the built environment is providing
24 investors that have data capabilities with all kinds of new
25 ways of assessing and investing in products and assets.

1 Again, highly innovative, requires an innovation culture
2 that often doesn't exist inside a pension plan.

3 As a quick example of how investment
4 innovation can save money, looking at seeding. You can
5 think of seeding managers as taking a kind of
6 quasi-distressed manager approach. So as we know in the
7 business, when managers are in distress, we can generally
8 get a good deal. We look for managers that are struggling
9 and we go back to them and we say, "Hey, that fee is little
10 too high," or "that carry is a little too high, let's reset
11 because you're struggling and you're losing capital." The
12 interesting thing about seeding a new manager is you're
13 dealing with probably a wonderful manager who is distressed
14 only because he or she is setting up a new firm. And so
15 that distress has more to do with the stress of setting up a
16 firm, the crazy idea of breaking out away from the general
17 partner that had been funding them and beginning to build a
18 new general partner. And we've seen time and time again
19 that seeding can drive significant cost savings.

20 Using the example at the bottom of the page
21 here (indicating), which is probably illegible to just about
22 everybody in the room, I show that a program of seeding
23 which was a non-American pension plan, so a bit more of a
24 commercial governance arrangement than you find here,
25 managed to go out and seed over 10 new GPs and save

1 incredible amounts of cost. Again, incredibly innovative
2 approach, required teams on the ground, building
3 relationships with private equity managers, and it required
4 a board that had the wherewithal to delegate authorities,
5 oversee the process, manage the risks. The board was also
6 focused not only on managing the risks of the investment
7 portfolio, but managing the risks of the new asset
8 management businesses. So the board was overseeing a whole
9 new set of risks through reporting that it hadn't been
10 monitoring before in order to make that work. That's
11 innovation.

12 The next ingredient is strategy
13 simplification. I've already mentioned it. Complexity is
14 increasingly common in pension plans today. Sometimes that
15 complexity can offer unique risk reward dynamics. Sometimes
16 that complexity can lead to a financial crisis like it did
17 in 2007, 2008. When adopting complex strategies, it's
18 critical that pension funds -- and by that I mean the boards
19 and the staff -- need to really understand the products that
20 are being purchased.

21 While the benefits are sometimes hard to
22 judge -- as we found out, experience tells us that -- the
23 costs are usually much more certain. So complexity can be
24 costly and dangerous in a plan that is not properly
25 resourced to monitor and assess the complexities being

1 brought into the portfolio.

2 A simpler product tends to be cheaper than
3 the more complex strategies. The most notable example of
4 this, which I'm sure everybody has watched, is the shift in
5 public equity from active management to passive management.
6 It's been a massive shift over the last five years as huge
7 asset managers have begun to gobble up five, six trillion
8 dollars of passive inflows, which has also been largely
9 based on the research showing active management is a bit of
10 a fool's errand. And we can point you to a lot of the
11 research that says that. If you're so interested, it will
12 be in the report that we submit.

13 In terms of simplification -- I'm still on
14 that slide, a little bit hard to see the slide -- look, we
15 can talk about a few examples. Moving from active to
16 passive in public equities, move from private assets with
17 their large information asymmetry, illiquid risks, and a
18 lack of transparency to public markets. We've heard the
19 proponents and drawbacks of investing in private markets
20 versus public markets in previous hearings, so I don't want
21 to necessarily spend a lot of time talking about those in
22 pros and cons. But what I will mention are some of the
23 considerations that need to be thought of in the process of
24 simplifying an asset strategy -- investment strategy.

25 How will these new strategies change your

1 risk profile? The complex strategy was in theory or
2 ostensibly complex for a reason. You have to understand
3 what you're giving up in the process of simplification. Are
4 the simple strategies consistent with the characteristics of
5 the fund, the funding ratio, liquidity requirements? Note
6 that simple strategies can, in fact, be much more volatile
7 than say an absolute return strategy.

8 And so, even in a simple strategy, the board
9 needs to be on the next level. The board has to understand
10 that the big corrections occur in markets, like the one we
11 were experiencing over the past few days and seems to be
12 abating today. But the last thing you want to do is have a
13 lay board sell out of a simple strategy that is a passive
14 replicator at the bottom of a stock market crash, just as
15 the market is rebounding. So as you're building into a
16 simple strategy, just be aware that there are considerations
17 at the level of the board to ensure the board understands
18 that, as a long-term investor, there will be huge drawdowns
19 and returns, and that is what it means to be long-term.

20 In sum, simple strategies are simple to
21 understand. They can ensure low-cost access to the needed
22 risk factor, but they also sometimes require a very seasoned
23 and thoughtful board that has a ton of experience in
24 investing and can understand the long-term fluctuations that
25 are just pervasive in markets. That's ingredient number

1 two, simplification, removing complexity to remove cost.

2 Ingredient number three is what we call cost
3 arbitrage. And there are two components to cost arbitrage.
4 The first aspect is related to the risk factor or total fund
5 approach to asset allocation. Asset class labels can often
6 be misleading and investors have started, rightly in my
7 view, to base their investment portfolio construction on
8 risk in order to figure out how much return they are
9 generating per unit of risk, rather than simply filling
10 buckets and focusing on products and asset classes.

11 By taking this total portfolio approach,
12 which is sort of a risk-based factor approach, investors
13 avoid the pressure to buy or dispose of illiquid investments
14 at nonpreferable times. You're not just filling buckets of
15 private equity or infrastructure or whatever. You're
16 thinking about the underlying risks, and as a pension fund,
17 wondering which risk you can acquire at the best cost to
18 achieve your objectives.

19 Cost arbitrage can be achieved when looking
20 at investment products on a risk basis. Certain risk
21 exposures can now -- especially through the rise of certain
22 technologies, financial technologies and true
23 engineering-related technologies -- be achieved at lower
24 costs. For example, the expensive active management
25 strategies are now being redeveloped with technological

1 advancements so that they can be offered in a lower cost
2 product that achieves the similar risk-adjusted performance.
3 We call these enhanced factor strategies and they can be
4 accessed on a very cheap basis.

5 Okay, that's the first part of that
6 ingredient. The next part is what we call reintermediation
7 and internal management.

8 Look, we know from tons of research that
9 financial intermediaries are incredibly expensive. I think
10 the first 15 minutes of my last presentation went into the
11 core of how much wealth is being kind of sucked out of our
12 pension plans and into Wall Street and the financial
13 services industry. This isn't lost on most pension funds
14 around the world. It's definitely not lost on the people in
15 this room, that the use of intermediaries can be costly.

16 I think I quoted Thomas Philippon up there
17 (indicating) who wrote a wonderful paper in which he showed
18 that the per unit cost of intermediation in financial
19 markets -- I know that's a mouthful -- the per unit cost of
20 intermediation in financial markets is the same today as it
21 was a hundred years ago. So we've had a hundred years of
22 innovation and finance, and yet, it costs the same to move
23 money from here to there.

24 So cost arbitrage can also come in the form
25 of reintermediation or disintermediation. Reintermediation

1 refers to forming new partnerships with managers. Those
2 partnerships are ideally more aligned. We might think of
3 these where they are often invoked as evergreen funds or
4 platform companies or, you name it. We're seeing this all
5 over the place and it's all about achieving greater
6 alignment of interests.

7 Disintermediation is a bit different. It's
8 about internalizing investment management so as to source
9 assets directly. You're owning the same underlying asset.
10 You're just finding a different pathway to get it. As if
11 you were choosing to buy an asset in an internal market
12 rather than an external market. Cost arbitrage is
13 ultimately about replacing these expensive external teams
14 with an in-house team.

15 Now, insourcing can be more
16 resource-intensive in private markets compared with public
17 markets, but even there, the cost savings can be astounding.
18 I'll give you a little example.

19 We provide an example here (indicating) of
20 what the cost savings from internal management can be. This
21 is a quote I took from a friend of mine who used to be the
22 CEO of a major Canadian public pension plan. This is his
23 example.

24 Using an infrastructure investment portfolio
25 of 10 billion and comparing the external versus internal

1 cost, he walked us through a very simple framework and
2 showed incredible savings. So even with 40 people on staff
3 at this Canadian pension plan, paying them \$1 million per
4 year, total of 40 million, his model showed that it still
5 saved the plan 160 million a year. One hundred and sixty
6 million a year over thirty years is a big number.

7 So there's a number of assumptions made here.
8 And those high level numbers around internal management are
9 why "insourcing" was probably the biggest buzz word of the
10 last decade. Again, it's not lost on these pension plans
11 that they're being overcharged by GPs and are looking for a
12 new way.

13 The challenge is in insourcing and getting it
14 correctly, because there are a number of considerations. So
15 just as there were considerations about the simplification,
16 there are also lots of considerations around cost arbitrage,
17 especially with respect to internal management.

18 The first group of considerations refer to
19 the nature and characteristics of the fund in question. So
20 is internal management appropriate? Do you have the size?
21 Do you have the time horizon of liabilities? Do you have a
22 cash flow position? What are the characteristics? What are
23 the comparative advantages that we can identify that allow
24 you to make a case, a strong case, to manage assets
25 internally? Can you recruit talent? All these things need

1 to be considered.

2 Secondly -- and I will go into this in much
3 more detail in a moment -- there is a significant governance
4 requirement for doing internal management, significant.
5 This requires a level of governance oversight that I will
6 detail in depth after having done a research project in
7 2012. And I'll save that for when I get there.

8 Monitoring and renegotiating is our final
9 ingredient. In some ways it is the most palatable, although
10 it creates challenges for LPs, asset owners, pensions with
11 their managers, because it puts them in a confrontational
12 position at times. But the truth is, investment managers
13 are incredibly good at negotiating you out of money that's
14 yours.

15 I know many investment managers, for-profit
16 managers, that pay the money to send all their investor
17 relations people to the negotiating courses at Harvard. How
18 many of your pension staff have taken the negotiating course
19 at Harvard or at Wharton? These people are trained to
20 negotiate in incredibly smart ways. They are coming in with
21 a set of skills that is not often replicated at the pension
22 funds I work with.

23 Generally speaking, public market
24 negotiations offer more immediate rewards than private
25 markets. It's true that a private market negotiation can

1 have massive impacts. It's just that once you sign those
2 LPAs, it's done. It's very hard to go back and renegotiate
3 a limited partnership agreement.

4 I'd also mention that getting access to data
5 is incredibly important in private equity to carry out a
6 proper monitoring function. Investors should be accessing
7 things like cash flow data of portfolio companies so that
8 valuations and true performance, as in the value add, can be
9 obtained.

10 Making sure you get that cash flow data is
11 important, and you actually have to ask for it. Most don't
12 just provide it. But if you can get in there and you can
13 understand it, then you can use that information in a
14 follow-on negotiation. The value that you're adding isn't
15 what you say it is, and I'll prove it with my cash flow
16 data.

17 There's a bunch more sophisticated methods
18 today that are arriving that can help you in private
19 markets. I'm going to leave the public market discussion to
20 Marcel.

21 One thing I will flag before leaving this
22 topic is, in the monitoring and renegotiation kind of
23 ingredient, there is consolidation. Now, I admit that
24 consolidation could be seen as innovation, it could be seen
25 as cost arbitrage. But ultimately, what you're doing by

1 consolidating plans is giving yourself a stronger
2 negotiating position.

3 And so, while I don't think Marcel is going
4 to talk about that, our belief is there could be incredible
5 amounts of scale savings from mandates with external
6 managers just by simply combining portfolios. It doesn't
7 need to be entire funds, although I might encourage at least
8 an exploration of that idea. But it definitely could
9 include combining, say, a private equity allocation or an
10 absolute return allocation, just to move the state of
11 Pennsylvania past certain break points in fee negotiation
12 contracts.

13 Okay, those are the core ingredients. I
14 recognize it's a simple set of ingredients. It's four
15 ingredients, but it gives you a set of tools that we are
16 operating on, as your consultant, to think through how we
17 help you achieve your objectives.

18 Not every fund should utilize every
19 ingredient, okay? And so, I'm going to talk about
20 governance for the next 10 minutes, because I think without
21 a conversation around governance -- it's come up twice
22 already, clearly the commission is asking about it. Without
23 understanding the context of the plans here and the makeup
24 of the board and the way in which the governance structure
25 is established, I think we can't give a strong

1 recommendation as to which path to take.

2 I think governance is crucial. I think it's
3 probably the most important lever pension funds have to
4 achieve their objectives. And in the U.S. public pension
5 context, I'd say, in general, it is suboptimal for the time.
6 When it was established, it may have been optimal. For the
7 time, with the level of complexity we have in financial
8 markets and the level of complexity we are asking staff to
9 take in order to meet the expectations we saw on this chart
10 over here (indicating), I don't think the governance is
11 today fit for the job that we are asking pension plans to
12 do.

13 There's a tension between political and
14 democratic interests and expertise. And as investment
15 management has become a lot more complex, I would argue you
16 have to have the right skills and expertise on the board to
17 oversee the investment decisions of a fund.

18 I understand and see this as an incredibly
19 challenging dynamic. And the reason nobody solved it is
20 because there are no easy solutions, which is partly why I
21 am thrilled with this commission, because I think you have
22 an opportunity here to raise this to the front pages of
23 newspapers.

24 Sponsors have a legitimate desire and right
25 to oversee their plans. But that representative instinct

1 has to be balanced with the expertise needed to oversee
2 increasing complexity. I'm going to go into this in more
3 detail in a moment.

4 But as you begin to adopt some of these
5 innovative strategies that I've described -- internal
6 management, seeding, reintermediation -- you need an
7 appropriate governance budget. What we call governance
8 budget does not refer just to the dollar amount you pay a
9 board of directors to run. I want you to think of a
10 governance budget as the potential resources available to an
11 organization to manage that organization.

12 Governance budgets are akin to risk budgets.
13 The risk budget guides your ability to generate returns. We
14 know, there is no return without risk. A governance budget
15 guides your ability to oversee the risk being taken. They
16 are all connected.

17 In my work, we use governance budgets
18 specifically to mean resources available to a board and
19 staff in terms of knowledge, capabilities, commitment, the
20 process, the protocols of decision-making in order to
21 achieve your objectives. If you want to simplify it, it's
22 resources.

23 The reason a governance budget is important,
24 to understand stems from the fact it is critical to
25 understand the governance when considering adding new risks

1 or new complexities to fund new cost-savings initiatives.
2 So if we are going to go down the path of ingredients that
3 include internalization or innovation or more complexity, or
4 even less complexity, then we need to have a governance
5 budget that is appropriately aligned with those risks.

6 Our research has shown that one of the most
7 important factors driving success or failure of an
8 institutional investor over a long run are the procedures
9 used to nominate board members. The nomination procedures
10 should prioritize. This is today, this isn't 40 years ago.
11 Today they should prioritize commercial, financial, and
12 entrepreneurial expertise over political or stakeholder
13 affiliations.

14 The origins of these funds, I am aware, are
15 political. But their theater of operations is quite clearly
16 commercial. And so it is important to find board members
17 that can align with the operating environment and not just
18 represent the plan's origin. If we want to achieve our
19 objectives, we need to find a way to balance those two.

20 In 2012, Professor Gordon Clark and I did a
21 project on insourcing -- that's governance consideration
22 (indicating), that's our research (indicating), governance
23 budget -- we did a project on insourcing. The purpose of
24 doing this project was to look at how certain plans that we
25 were working with and studying could move assets from

1 external managers to internal managers.

2 We had the honor and pleasure to work with
3 the Australian superfund, which is today the largest
4 superfund in the country of Australia, starting in 2012, to
5 understand and advise them on their internalization project.
6 They moved assets from almost 100 percent external to almost
7 80 percent internal over that time period. They did so to
8 get better alignment of interests, better access, to
9 overcome capacity constraints with managers, to lower fees,
10 you name it.

11 We did 20 case studies from around the world.
12 It took us almost two years. We sought to understand how
13 the best funds on earth were bringing assets in-house. And
14 the output was long and detailed and way too academic, but
15 I'm going to give you a pyramid. And that pyramid hopefully
16 is simple enough for just about anybody to read without
17 falling asleep.

18 The pyramid is the ingredients required to
19 internalize assets successfully. I will acknowledge, it is
20 an ideal state. The number of plans that have this pyramid
21 in this form globally are probably 10. But this is the
22 ambition and this is where, if I was a board of directors
23 overseeing a pension plan with a fiduciary duty, every
24 single moment of every day I would be pushing my staff to
25 achieve this pyramid.

1 The pyramid starts with governance. You have
2 to have good governance in order to understand the business,
3 understand how to resource the business, understand how to
4 recruit talent, what it means to take risks, what a
5 derivative is, what all these things are. They don't
6 necessarily have to be finance talent, but they should have
7 experience either building businesses or running commercial
8 enterprises. Some component of the board needs it. Not all
9 the board.

10 If you look at the Australian context, they
11 usually have an administrative board and an investment
12 committee that does all the investment decisions. And
13 there's a subset of the board members on the investment
14 committee with a set of experts on the investment committee.
15 You get good governance.

16 And now that you have good governance in
17 place and you have a board of directors that has the power
18 to resource the organization, they have the expertise to
19 understand what's required, they can recruit talent. With
20 that talent, you want to incentivize these people to take
21 risks because ultimately, you're going to be asking them to
22 take risks later on as they internalize assets. You build a
23 compensation program that has a performance component. You
24 think about recruitment and retention. You think about
25 culture. You think about all those things.

1 With high-quality people and good governance,
2 you can begin to build out your organizational capabilities,
3 data, systems, legal, compliance, audit. These are the
4 foundations of good institutional investors. You have a
5 single source of truth database that is yours, that you can
6 trust to understand where your portfolio is today.

7 On top of your organizational capabilities,
8 you can begin to power risk systems. You have a governance
9 board, you have people, you have data, you can begin to
10 understand risk, your portfolio, and your enterprise. Now
11 you're starting to get true sensors around this organization
12 to be able to monitor it and watch it move.

13 With the risk system in place, we can now go
14 to the team and say, "Take risk. We need you to have a
15 culture of risk-taking. I know for a long time, you have
16 had the luxury of never ever being fired. Well, now we're
17 asking you to take some risks because this is an investment
18 business and the only way you generate return is through
19 risk-taking." So let's build that culture, in a context of
20 risk systems being powered by good data with great people,
21 and very smart oversight.

22 Now that you have a risk-taking culture, you
23 have to think very smartly about which assets you actually
24 internalize. Do we bring in-house fixed income or do we
25 bring in infrastructure? Do we do real estate directly or

1 do we do indexes? Every single choice is context specific.

2 The Alaska Permanent Fund runs fixed income
3 internally and does it very well. AustralianSuper runs
4 infrastructure. New Zealand Super runs global tactical
5 asset allocation. They run different things because they
6 have different comparative advantages that they've
7 identified. That's the smart asset allocation.

8 It's only at this point should the board be
9 delegating internal authority to anybody. With all this in
10 place, this foundation of excellence, the board can begin to
11 say to staff, "Here are your delegations, here are your
12 marching orders." If you start with a delegation early on,
13 and say, "We rely on staff to do these things," you're going
14 to risk having a major failure. And we've seen those
15 failures. We've seen people try to internalize assets and
16 have major failures.

17 So with all this in place, the board can be
18 confident that they are monitoring the mandates that are
19 being implemented through the risk systems, powered by the
20 data, with the good compliance, with the legal oversight,
21 all this stuff humming. Then you delegate.

22 With the delegation, you then move into -- I
23 skipped mandate definition because we don't need to talk
24 about how we define the mandates just yet.

25 Communications, now we're paying people real

1 money internally. We are building direct programs. Some of
2 those deals are going to absolutely go to zero. It's
3 inevitable. Your pension plan is going to do an investment
4 that goes to zero. Is the plan sponsor ready for that? Is
5 the board ready for an article that says, "This investment
6 we did went to zero, we missed something." We're taking
7 risks in this business. So some of those risks work out and
8 some don't.

9 And so you have to be proactive with your
10 communication externally to the world to help these
11 organizations understand what you're doing and why you're
12 doing it and why you're compensating in the way you do.
13 That communication should include incredible detail on
14 carried interest from private equity. Why? Because you're
15 making a case for internal resourcing. How else do you make
16 the case without incredible detail on carried interest from
17 private equity?

18 Last, but not least, you build networks. You
19 go out and you develop relationships. And the best
20 institutional investors in the world today -- Canada, New
21 Zealand, elsewhere -- are building proactive teams to foster
22 these relationships, relationship teams. It's the last
23 thing. The overseas offices that you hear about, it is
24 literally the last layer on the pyramid.

25 I wanted to share with you that research

1 output because it was the product of an enormous amount of
2 work. It's being utilized today by a number of pension
3 plans in their insourcing planning. And it is partly how I
4 would assess any pension plan that came to me to say, "Hey,
5 we have an idea and we want to internalize asset
6 management." I would say, "How's your governance? How's
7 your people? Tell me about your systems, your
8 administration, your compliance."

9 So with that in mind, we did a quick review
10 of some of the governance of the plans here today. It's
11 already been discussed, so I don't need to go into too much
12 detail.

13 Let me preface this slide and the next few
14 slides by saying, this wasn't necessarily part of our scope
15 and we weren't given an opportunity -- we didn't have an
16 opportunity to sit down with the board members from these
17 plans, which we would normally want to do if we were going
18 to do a true skill or gap analysis of the boards. But
19 there's enough public information to be able to make some
20 assessment of these boards and their governance.

21 If you look at PSERS, you have 15 members.
22 It's a wonderful administrative board. I would not describe
23 it as an investment board. It is representative. There is
24 some expertise on there, but I don't know if that is sheer
25 luck that that expertise arrived there or if it's part of

1 the nomination procedures to ensure it's always there.

2 There's a difference.

3 PSERS is running quite a complex and
4 innovative investment strategy with lots of illiquids, use
5 of derivatives, internal management, seeding new managers,
6 even looking to open foreign offices in places like China.
7 It appears to me that PSERS may need a new governance
8 structure to oversee the current complex strategies. The
9 current governance structure does not seem fit to oversee
10 the current complexity of the portfolio.

11 There's an overreliance by the board on
12 consultants. The investment staff seem to drive everything
13 forward. And while I have huge respect for everybody that's
14 working there, delegation to staff has to be accompanied by
15 adequate oversight, has to. That pyramid needs its pieces
16 in place to ensure you're not exposing the system to unknown
17 risks.

18 If I move on briefly to SERS, again, this is
19 publicly identified information. It's only an 11-member
20 representative board, which I'd acknowledge as better. But
21 it doesn't seem to be functioning as an investment board,
22 per se. Again, it feels more like an administrative board.

23 There are governance of people going on, and
24 some of this governance work seems to be on the right track,
25 which I congratulate them for. If you read the SERS

1 statement of investment policy, we just happened to notice
2 the following statement: "In order to administer the system
3 and carry out its investment obligation, the board relies
4 heavily on both staff and external contractors."

5 I think it's okay to rely on those. To rely
6 heavily implies to me that there has been a shift in the
7 principal/agent relationship. The principal in this
8 equation is the board. The agent is the staff. Capitalism
9 functions by principals holding agents accountable. Without
10 that you end up with principal-agent costs and all sorts of
11 distortions that are hard to predict. The board must hold
12 accountable the staff.

13 There was also a note that they end up
14 relying greatly on consultants. Just in our prior
15 experience here, we had Tim Jenkinson from Oxford, who has
16 written two papers that show the selection of investment
17 managers by consultants has shown that the value out of
18 investment consultants is questionable. So the academic
19 research would suggest that consultants are not a
20 replacement for a great board, an expert board.

21 The board is great. The board is
22 representing its interests. It just may not be expert, and
23 we need an expert board. I just want to clarify that.

24 Okay, so a brief comment on administrative
25 boards versus investment boards. I think it's interesting

1 to note that the U.S. public sector pension plans that have
2 been able to carry out the innovative strategies like
3 internal management successfully have a separate investment
4 board compared with their administrative representative
5 board. These include some of the funds that were here last
6 time. So good job in picking the right funds to show up
7 here. South Dakota, state of Wisconsin, and Florida state
8 all have separate entities.

9 And if you'll permit me a moment, I'd just
10 like to read from each of those states' foundational laws
11 and regulations around the plan. In South Dakota law, "The
12 members of the State Investment Council shall be qualified
13 by training and experience in the field of investment or
14 finance." And the state of Wisconsin board, five members,
15 at least 10 years' experience in making investments, 10
16 years. Florida has a separate Investment Advisory Council
17 appointed by the trustees consisting of nine members, so
18 dual board structure. The trustees of the board appoint an
19 Investment Advisory Council made up of experts.

20 In contrast, if we look at SERS, "Each member
21 of the board will be required to obtain eight hours of
22 mandatory training in investment strategies, actuarial cost
23 analysis, and retirement portfolio management on an annual
24 basis." To me that sounds like the definition of an
25 administrative board. Eight hours, as much as I applaud the

1 education efforts and always encourage pension plans to do
2 education with their board members, eight hours is not the
3 same as a ten-year career in finance.

4 On PSERS, the board consisting of 15 members,
5 is "an independent administrative board of the
6 Commonwealth." That's in, that's a direct quote. "The
7 members of the board of trustees of the fund have exclusive
8 control and management of the fund and full power to
9 invest." So it's an administrative board with full power to
10 invest.

11 Investment boards ultimately facilitate the
12 environment in which investment decisions are being made.
13 This needs to be a commercial environment. They need to
14 monitor and hold accountable the CIO. They need to maintain
15 a nonpolitical environment. They need to get on with the
16 business of generating investment returns.

17 In summary on my governance comments, it
18 appears the capacity, resourcing, and expertise of the
19 respective boards of the two Pennsylvania plans is not well
20 aligned with the complexity of the plans' portfolios. The
21 governance budget does not seem to match the risk budget,
22 which means the complexities and risks in the portfolio are
23 likely -- although I won't say definitely -- not fully
24 appreciated by the board. This is problematic.

25 I understand there is a lot of reporting that

1 goes on. One thousand two hundred pages may be delivered to
2 this lay board. I don't see that as best practice. You
3 should refine those 1200 pages into something that is
4 digestible, that the board can understand and have strategic
5 conversations about.

6 A lower governance budget would be suited to
7 lower levels of complexity and sophistication. And I think
8 the reason we've done all this is because we think this
9 should be taken into account when identifying cost savings.

10 Mr. Chairman, I just wanted to ask a
11 question. I have three slides on risk-adjusted returns,
12 which we've included. Would you like me to go and do those?
13 I realize we're already running behind. Or would you like
14 me to move to the recommendations?

15 CHAIRMAN TOBASH: I think in the spirit of
16 time and trying to keep on track, why don't we submit that
17 complex information into the record and move right on to
18 recommendations?

19 DR. MONK: We will definitely be putting it
20 all in the report, and that report will be sent to all the
21 commissioners.

22 And I'll simply note that when we were here
23 last time, we were uncomfortable presenting numbers that we
24 had not fully vetted. We've done the hard work. We hired
25 an extra adviser to come in, his name is David Goerz. He is

1 the chief investment officer of Strategic Frontier
2 Management, and he is a board member of a risk analytics
3 firm, Axioma, and he has vetted all of the data with us and
4 our team to make sure that we're presenting information that
5 is factual.

6 CHAIRMAN TOBASH: So we appreciate your deep
7 dive and your backing up your information with outside
8 sources. And it's going to be an important part of the
9 final product. And I think we move on to recommendations
10 for today. Thanks.

11 COMMISSIONER GALLAGHER: Sorry, I realize
12 that time is of the essence, and I'm sorry, Mr. Chair.

13 And I appreciate you submitting that. And I
14 was kind of hoping that we'd see, actually, the Nobel
15 laureates' work. I think we were promised that. But that's
16 okay, now I'm just giving you grief.

17 But I think the talk about risk-adjusted
18 returns is more within the scope of the statutory duties of
19 this commission than is governance. So us suppressing the
20 conversation about risk-adjusted returns at the expense of
21 governance seems a little bit like a stretch. So I just
22 want to say --

23 DR. MONK: I'd be happy to do that.

24 COMMISSIONER GALLAGHER: -- for the record
25 that I think governance is important, but not in the

1 statute.

2 CHAIRMAN TOBASH: Since a commissioner has
3 brought up the topic and would like to dive a little bit
4 deeper into it, then I'd appreciate it if you could comment
5 on it.

6 DR. MONK: Yeah, let's do it. I'm more
7 trying to respect the time of the commission than my own
8 time.

9 CHAIRMAN TOBASH: Understood, but if it's an
10 importance topic to all of us --

11 DR. MONK: Let's do it.

12 CHAIRMAN TOBASH: -- and we'll develop it
13 here, let's do it.

14 DR. MONK: So in our previous presentation,
15 we showed that on an absolute basis with all the different
16 peers we pulled together, the funds were performing below
17 the median, not only in the peer group, but in the PPD
18 universe. That was on an absolute basis, and we were
19 cognizant and acknowledged the challenges of doing an
20 absolute basis performance analysis.

21 Here (indicating) we have attempted to
22 highlight risk-adjusted performance measures for the two
23 plans. Risk-adjusted performance provides an effective
24 comparison of total active management for different
25 strategies and allocations. The two measures we calculated

1 for the plans are the Sharpe ratio measures risk-adjusted
2 performance against the risk-free rate, and the information
3 ratio measures risk-adjusted performance against the
4 benchmark.

5 We calculated Sharpe ratios and information
6 ratios for PSERS and SERS from publicly available data
7 beginning in 1988. We constructed multiasset benchmark
8 portfolios using total return indices for comparison to the
9 pension plan returns and to measure the information ratios.
10 The benchmarks compounded monthly data to provide annual
11 returns compatible with annual plan norms. No management
12 fee is included on the benchmark indices, but we could
13 assume that this might be a 10- to 15-basis point management
14 fee, so the benchmark returns could be, in our final paper,
15 discounted by this amount for comparison.

16 It must be noted that the data for doing
17 risk-adjusted performance analyses can be challenging to
18 obtain because of the insufficient frequency or shorter time
19 period of, especially of the private market investments and
20 the marks that they provide. They are infrequent and the
21 market-to-market pricing is limited. The limited frequency
22 of fair value pricing of private market funds also creates a
23 lower risk illusion for the fund. The greater the exposure
24 to private market funds, the more likely that observed total
25 fund return risk is understated.

1 So all that being said, this is the data on
2 PSERS. (Indicating.) The three benchmarks that we used to
3 measure the performance of the two funds against include a
4 U.S. based portfolio of 60 percent equity, 30 percent fixed
5 income, 5 percent real estate, 5 percent cash. We have a
6 global balanced 60/40 mix of equity and bonds optimized for
7 mean variance to the efficient frontier. The PSERS global
8 is a mixture of public indices that match the most recent
9 asset allocation policy of the plan. We also have an LDI
10 portfolio, as PSERS uses leveraged LDI portfolio, that has
11 longer duration assets on fixed income and higher allocation
12 to commodities in real estate.

13 From the table, we can see that the 30-year
14 Sharpe ratio for PSERS is slightly lower than all the
15 alternative balanced benchmarks. But the 10-year Sharpe
16 ratio is two-thirds of the global balanced portfolio,
17 reflecting more than a two-to-one ratio of risk to return
18 and excess of the risk-free rate, despite a higher than
19 average exposure to bonds.

20 The near zero information ratios over the
21 30-year period and negative values over the 10-year period
22 versus the 60/35/5 and the global balanced portfolios
23 reflects that PSERS has underperformed various simple
24 multiasset index portfolios. This confirms the performance
25 measures from our previous presentation, the absolute

1 numbers.

2 From the charts, we observe the Sharpe ratio
3 over the first half of the period was much higher than the
4 second half of the period, as total fund risk has nearly
5 doubled. The blue line is the fund's Sharpe ratio and risk
6 levels for the entire period up to that point; whereas, the
7 red line is a rolling 10-year value at any given point. It
8 is interesting to see that the fund risk of PSERS has stated
9 high levels over the last 10 years despite their allocation
10 to equities decreasing over the financial crisis.

11 On SERS, the 30-year Sharpe ratio is slightly
12 lower than the alternative balanced benchmarks constructed,
13 but the 10-year Sharpe ratio is two-thirds of the global
14 balanced portfolio, reflecting a two-to-one ratio of risk to
15 return in excess of the risk-free rate. The negative
16 10-year information ratio versus both the 60/35/5 and global
17 balanced benchmark portfolios reflects that SERS
18 underperformed other alternative policy mixes on a
19 risk-adjusted basis by more than the fees of using simple
20 liquid indices. We used a 15-basis-point discount to
21 returns.

22 Similarly to PSERS, the fund risk has
23 generally increased over the period and Sharpe ratios have
24 declined. However, we do see fund risk declining and Sharpe
25 ratio increasing at the end.

1 The context -- in summary, the analysis here
2 has shown that both plans, historically, have not performed
3 as well on a risk-adjusted basis against a simple balanced
4 public indices as indicated by their negative information
5 ratios over the 10- and 30-year period. The overall risk of
6 both funds has increased over the time period looked at
7 despite general market volatility increasing. The Sharpe
8 ratios of both plans over the 10-year and 30-year period are
9 very low. However, the values over the last five years
10 have, in fact, been better.

11 For PSERS, it would appear that the larger
12 allocations to illiquid asset classes away from public
13 equities and the use of leveraged and fixed income were
14 problematic. SERS allocation to private equity does not
15 seem to have benefited them very well, although we note that
16 their allocation to global public equity has meant that
17 their performance has been better than PSERS.

18 So with the context of the ingredients, the
19 governance, and the performance, it seems to me there is a
20 case to be made that we should do something. We do believe
21 there are certain cost-saving strategies that are not
22 appropriate for the PA plans because they do not appear to
23 have the governance required to adequately monitor them. We
24 do not think that increasing internal management or
25 innovation is advisable until such a time that the

1 governance of the plans can be brought into line with the
2 complexity of the portfolios that are currently being
3 managed.

4 You saw the power of internalizing earlier in
5 my ingredients slides, and the ability to dramatically cut
6 costs by doing things like seeding managers or launching
7 platform companies. I only hope those figures are enough to
8 give you the courage as a commission to take on the
9 governance challenge and move your funds into alignment with
10 your peers in South Dakota, Wisconsin, and Florida, to
11 establish an expert investment advisory council either
12 within or under the supervision of the existing boards.

13 In terms of cost-saving recommendations --

14 COMMISSIONER BLOOM: You know, I just have a
15 quick question on governance, and it is quick.

16 To get the kind of professionals that you're
17 talking about to serve on an investment board, okay, it's
18 obvious to me, you're talking about a paid board.

19 DR. MONK: It doesn't need to be. In the
20 state of Wisconsin, they're volunteer. They are volunteered
21 professionals that just want to give back.

22 COMMISSIONER BLOOM: That'd be terrific if we
23 could find that. I just, I have some concerns about that.

24 DR. MONK: You have concerns about a
25 volunteer board?

1 COMMISSIONER BLOOM: No, no, I just have
2 concerns that we could get the right people to volunteer to
3 do this. I guess out of 12,500,000 people we could probably
4 find a few.

5 DR. MONK: I think you'd be shocked at how
6 motivated people are to work and help this system. I think
7 everybody in this room would probably put their hand up.

8 Final recommendations, and then I'll turn it
9 over to Marcel. In summary, based on this analysis that
10 we've carried out, which I acknowledge has been a little bit
11 abbreviated and without the full information that we might
12 have liked to have had for a typical assessment of this
13 kind, here are the recommendations that I would put forward
14 to the commission for their assessment.

15 Recommendation number one is renegotiating
16 and monitoring of current mandates. Good news is, it sounds
17 like the funds are already taking this seriously and moving
18 in a strong direction.

19 Without changing the asset allocation and
20 risk levels of the current portfolio, renegotiations should
21 take place along best practice guidelines.

22 I'm not going to steal Marcel's thunder on
23 this. He will help you understand how you can get there and
24 even get beyond the 1.5 billion in savings per fund.

25 To me, that may be the most palatable pathway

1 to achieve the objectives of the commission. I'm not a
2 politician, so I don't understand the politics, but that is
3 something that I think everybody could probably get behind.

4 Second recommendation, which I will begin by
5 saying -- again, I would ask the commission to consider
6 recommending a governance overhaul. To do internal
7 management or add innovation or complexity to the plans
8 would require adding a governance budget to meet and align
9 with the risk budget. This might require legislation to
10 change the composition of the respective boards or install
11 underneath them an advisory board or an advisory committee
12 to compliment the existing board with the necessary
13 expertise. This is a path I would encourage, though I
14 recognize it is difficult to enact at this time.

15 So that leads me to the second formal
16 recommendation. Given the governance budget of the two
17 plans does not appear to be sufficient to take on more
18 complexity or innovation right now, we recommend
19 investigating simplifying the investment strategies of the
20 two funds. A move to simpler strategies, such as active to
21 passive or illiquid to public could be considered. This
22 could not only reduce costs, but also help bring the
23 governance budget of the plans in line with the level of
24 complexity already contained within it. Consideration would
25 have to be given to the active risks associated with these

1 changes, as well as the extra short-term volatility that
2 might come with moving to passive indices, for example.

3 There's a reason why absolute return tends to
4 have a role in a portfolio and it's to mitigate volatility.
5 If you remove all of that, be ready for more volatility.

6 This concludes my portion of the
7 presentation. I thank the commission for their attention.
8 I'll be taking questions, obviously, after Marcel.

9 And, Marcel, I'll get you set up.

10 DR. STAUB: Thank you all for having me.
11 Thank you for the microphone.

12 This is an unusual format for me, so I'm not
13 used to this kind of hearing. So apologies if I disrespect
14 a protocol in any way, I don't mean to.

15 As Ashby has previously mentioned, this is
16 not the typical work we would do. We see ourselves as
17 mediators, essentially, between financial service providers
18 and asset owners, such as pension funds, sovereign wealth
19 funds. And we're typically called in by asset owners, such
20 as you, who need advice on how to maybe restructure and
21 renegotiate the agreements that they have in place.

22 And every investment, if you want to look at
23 it that way, has a return, it has a risk, and it has a cost
24 that is associated to it. And the only thing we would do is
25 we would look at that cost component and essentially see

1 whether we believe that, from best practice perspectives or
2 from arbitrage perspectives, looking at the global market,
3 we think that there is opportunities to renegotiate those
4 fees with the existing managers. So we would never advise
5 someone to go from active to passive simply to save costs.
6 That is not in our line of business. We would look at the
7 existing contracts and try to help the asset owners to
8 improve those terms for the ultimate benefit of the
9 beneficiaries.

10 So everything we're going to be saying today,
11 please, should be heard and read as a constructive input to
12 help the plans and this commission to maybe position
13 themselves where we think they stand with their terms and
14 agreements, and where we see opportunities for the plans to
15 improve those terms. And we are more than happy to have a
16 conversation with either of the plans to give them more
17 detail and more in depth maybe feedback so that they can
18 take this to the conversations with their managers.

19 So -- do you mind flipping those slides?

20 DR. MONK: Okay.

21 DR. STAUB: I can see that this is very
22 small, so I also tried to be a bit quick in the
23 consideration of time. But essentially -- Ash, if you don't
24 mind, move to the executive summary slide.

25 So we were asked whether, from our experience

1 of negotiating many contracts the world over -- and we have
2 a little over 60 clients and they in total represent more
3 than \$2 trillion in assets. And we're essentially something
4 like a procurement office for them and they use us for the
5 mediation of their terms. So we have a bit of experience.

6 And all of our staff, we did go to these
7 Harvard classes of negotiation, so we would understand what
8 the counterparts, you know, potentially try to bring to the
9 table and anticipate that. And of course, we prepared for
10 those discussions.

11 And we were asked whether, from our
12 experience, looking at the information we were given, that
13 there is an opportunity for the two plans to save one and a
14 half billion each. And the good news is we think there is
15 an opportunity for both plan by renegotiating terms to
16 actually achieve those savings. And I will comment in
17 greater detail later to where we think those lie.

18 As I have previously said, our analysis is
19 really focused on, I would call that best practice
20 procurement. So we're not giving any kind of idea or advice
21 whether you should be with other managers or whether you
22 should have a different allocation. That's not what we do.
23 The only thing we do is we look at your allocation, your
24 existing managers, those terms, and we try to compare them
25 to terms we see elsewhere and best practice we see elsewhere

1 to identify whether there is opportunity to create some
2 savings.

3 We also believe that the target, being equal
4 for SERS and PSERS, although both plans are different in
5 size, is by definition a bit harder to achieve for SERS than
6 it is for PSERS. We also recognize that SERS already has a
7 high passive allocation, which of course, bears less room
8 for renegotiation than an active allocation.

9 One more thing just for the record, we have
10 not been granted full access or we have not received all the
11 data we would have needed to do a full deep dive analysis.
12 So we are very comfortable with the results represented
13 today, but they are also very limited to public equity
14 because we would have needed a lot more information to dive
15 clearer into the other asset classes. I will come back to
16 that later.

17 So maybe as an executive summary, on SERS, we
18 see there are a few mandates. We've anonymized them, but
19 I'm more than happy to share, of course, the details on
20 those managers with the two plans.

21 So we've identified essentially four mandates
22 that we believe should be and could be renegotiated. We
23 will later on also say to what levels we think they could be
24 renegotiated and based on what reason we think that should
25 be achievable. But there's essentially four mandates we

1 think that should be renegotiated.

2 We've also heard from SERS in the
3 questionnaire that we have shared with them, some sort of a
4 self-assessment.

5 We've heard that there are most favored
6 nation clauses in place. And we just wanted to make the
7 point that most favored nation clauses, from our experience,
8 don't guarantee best terms. And we see them, quite frankly,
9 circumvented, you know, all the time. So there's lots of
10 opportunities for managers and asset owners to actually find
11 ways around most favored nation clauses, even if they're in
12 place. And we realize that they've probably initially been
13 a good idea from an asset owner's perspective, but over the
14 time, they've actually turned out to help the asset managers
15 more than they helped the asset owners because asset
16 managers could now -- no matter what the market does -- they
17 could keep their fees artificially high, hiding behind most
18 favored nation clauses. And we see that happening all the
19 time. So it's just a word of caution here. Most favored
20 nation clauses don't mean that you actually have the best
21 terms.

22 And for PSERS, we think that all the mandates
23 in international equities small cap should be up for
24 renegotiation and we've identified three more mandates that
25 we also think bear the potential to be renegotiated. One of

1 them, funnily enough, is a mandate that SERS has, too, and
2 despite that SERS has a smaller investment with the very
3 same manager and the very same mandate, SERS pays lower fees
4 than PSERS. So we also think there is more opportunity for
5 what has already been done by the plans to communicate with
6 each other and bundle forces whenever that is opportunistic.

7 Another thing we have learned from the
8 self-assessment, and I've highlighted this here (indicating)
9 just briefly, is the fact that more expensive mandates do
10 not guarantee better returns. It is the same the other way
11 around. I mean, it's not because a mandate is cheap that it
12 will be a good mandate, right? So it's kind of like the
13 wrong measure to say a mandate is cheap or expensive, and
14 therefore, it is bad or it is good. But I think it's really
15 important to make sure that whatever mandate you choose to
16 be in or whatever asset class you choose to be in, you try
17 to pick the best terms that you can find with that manager
18 or in that asset class and you renegotiate hard as a plan to
19 find commercial terms that make sense for both parties. And
20 I think it's important not to forget that all of these
21 arrangements are ultimately commercial arrangements between
22 two parties and they should be seen as such.

23 So moving on to the next slide, Ash, if you
24 don't mind.

25 I mentioned that (indicating), no need to go

1 into that further.

2 We have not had all the data we would have
3 wished to have. We could have maybe made a few more
4 statements, but in broad, it wouldn't have changed much, the
5 view that we have.

6 Maybe -- to mention on SERS, we did not
7 receive unredacted contracts, meaning that we did not really
8 see the terms that are signed. The terms that we have taken
9 for our analysis are from a consultant report of SERS, but
10 they represent average fees paid and not necessarily the
11 actual terms signed, so it's difficult for us to say whether
12 those terms would include performance fees or carried
13 interest or whatsoever simply because we don't have the
14 access to that.

15 So I would like to share maybe a few slides
16 that are not notable to share.

17 On the self-assessment that we have asked the
18 plans to reply to us -- and this is just an excerpt, and I'm
19 kind of like pointing to a few deals that I think the plans
20 have an opportunity to improve. And of course, there have
21 been many questions that we have asked that have been
22 answered favorably, and therefore, you know, there is
23 nothing that we would want to highlight because the plans
24 are already doing it according to what we would be perceived
25 to be best practice. So if I'm highlighting here maybe the

1 more negative examples, that doesn't mean that the total
2 self-assessment has that much of a negative picture. It's
3 really the ones that we think are noticeable to discuss and
4 to bring the attention to the commission.

5 So we asked both plans on a scale from one to
6 10 whether -- one being the least competitive and ten being
7 the most competitive -- where they would put themselves.
8 And both plans have said, "Well, we would give ourselves a
9 ten," meaning that they are the most competitive in the
10 market or that they have the most competitive terms in the
11 market. And both plans have said that this self-ranking is
12 based on the fact that they have most favored nation clauses
13 in place. And I mentioned that previously, that those most
14 favored nation clauses actually are not a sign that you do
15 have the best terms that are available in the market.

16 And I'm just maybe opening up that bracket
17 quickly again. I've mentioned before that they help asset
18 managers more than they help asset owners. And in fact, we
19 actually think that most favored nation clauses are more a
20 bit a sign of weakness than they are a sign of strength, all
21 right? Because plans the size of SERS and PSERS, quite
22 frankly, should be fee makers and not fee takers. And
23 therefore, they should enter the market, we believe, with a
24 sign of strength, where really, what others pay is not
25 relevant. It's relevant what you're willing to pay for the

1 assets that you are giving to managers.

2 So the next point is we have asked both plans
3 about the average age of the fee schedules in the
4 portfolios, and both plans have said that they don't track
5 that. So we would highly recommend to track that, because
6 it is our strong belief that if a fee arrangement is older
7 than three years, it needs to be revisited, which is also
8 part of the reason why we would recommend those managers for
9 renegotiation that we said earlier, or we will point again
10 to later. Because some of those contracts are eight or nine
11 years old and the market has, of course, moved a lot since
12 and they should definitely be revisited.

13 So we would also recommend to the plans to
14 start tracking the age of those fee schedules and very
15 diligently, whenever those are two or three years old, take
16 it out of the drawer and bring it to negotiation.

17 Next slide.

18 So we have asked both plans what percentage
19 of their asset managers have confirmed in writing that they
20 don't receive commissions, rebates, retrocessions, or any
21 other incentives associated with their investments. And
22 PSERS has said that they do not maintain this information.
23 SERS has said that it's part of their regular due diligence
24 process. We would just like to highlight that this is an
25 area of potential conflict of interest. So we believe it is

1 very important to know whether the manager that you have
2 employed has any other compensations than the one that
3 you're actually paying to them. So we believe it is very
4 important to track that and to be aware of any potential
5 conflicts of interest that could be there because they might
6 have an incentive to earn money elsewhere.

7 We have also asked the worst question, that
8 managers would confirm if they are paying anyone commissions
9 or introduction fees and so on. And PSERS has again has
10 said they do not maintain this information. SERS has said
11 that it is again part of their due diligence process.

12 Again, we encourage both plans to really stay on top of this
13 because we believe it is very crucial to have full
14 transparency on whether out of the fees that you as a plan
15 are paying to the manager or the incentive fees that they
16 may be earning on top, whether any portion of that is going
17 to a third party that you may not be aware of. We believe
18 it's very important to have that information and we
19 therefore encourage the plans to regularly ask all of their
20 investment managers to confirm both of those points to them
21 in writing.

22 We have again asked the plans if their
23 brokers are allowed to use bundled brokerages. And to those
24 not knowing what it is, it is essentially an embedded
25 research compensation that brokers would get through the

1 transaction of an asset. So whenever they are charging a
2 brokerage fee, there might be an element which is
3 essentially for research. And the broker would charge that
4 based on transactions, and then allocate that research
5 budget to your asset manager. So this is essentially an
6 additional source of income -- although it's called soft
7 dollars because it doesn't typically flow as in hard
8 dollars -- an additional source of income for asset
9 managers, and therefore, again, a conflict of interest
10 because you believe as an asset owner that the full
11 compensation your asset manager receives from you is from
12 the management fees you pay to them, but that is often not
13 the case. They may have other sources of income, such as
14 research budgets that they do receive from bundled
15 brokerages.

16 And just as a side note, we realize that in
17 the U.S. and also in other markets, this is still very
18 common. In Europe, this has been completely abandoned. In
19 fact, since 2018, it has become illegal because there is a
20 big conflict of interest in that your manager might have an
21 incentive to churn your assets more than necessary in order
22 to create research budget for them, which pays for their
23 Bloomberg desks and what have you. And that, of course, is
24 a conflict of interest. Also because, as an asset owner,
25 you can never be sure whether the research budget that has

1 been generated from your assets is actually also used for
2 research for your assets or whether it's just used for
3 research for the firm, but maybe for different lines.

4 So it's a conflict of interest and --
5 although, we realize it's not banned or illegal in the
6 United States, we would highly encourage to discuss that
7 point with the asset managers and also find ways to go away
8 from model brokerages. And if the asset managers would
9 complain about the research budget that they would no longer
10 receive through that, then we think it is a lot healthier to
11 agree to such a budget and pay it directly to the asset
12 manager, other than to have it embedded in a transaction
13 where you just don't expect it to be.

14 So on the same note, we have asked whether
15 the plans are doing a transaction cost analysis and PSERS
16 has said "no." They have said that they would do it in the
17 past, but felt it was of not much use. We can understand
18 that.

19 These numbers are sometimes a bit cumbersome,
20 complex, sometimes not much you can derive from it.
21 However, there is, of course, also some indications that you
22 could see from these reports, such as, as an example, closet
23 indexing.

24 For those not being fully aware of the term,
25 that is when an asset manager has essentially more or less

1 replicated the index, but is charging you active fees for a
2 somewhat passive product. And you would see that kind of
3 behavior from a transaction cost analysis. So we would
4 again encourage both plans to do a transaction cost
5 analysis. And SERS has confirmed to do this on a quarterly
6 basis.

7 Next slide, Ash.

8 So we asked both plans on what they believe
9 is the single biggest hurdle, why the terms could not be
10 further improved. And both plans have mentioned capacity
11 issues with their managers is a concern. PSERS has
12 additionally mentioned that the overhead with their managers
13 is a concern.

14 I would maybe quickly go on to the capacity
15 side. We understand that some strategies are indeed
16 capacity constrained, but we would also like to warn that
17 capacity constraints is the single most used argument from
18 asset managers not to enter into fee negotiations. We would
19 also like to say that whenever we represent clients with
20 smaller assets, we typically hear, "The asset managers tell
21 us, 'Well, if you bring more assets, we can give you better
22 terms.'" And whenever we are speaking to larger plans, such
23 as SERS and PSERS, then typically asset managers would tell
24 them, "Well, we were at capacity constraint." So the answer
25 is often a capacity problem, either it's not enough or it's

1 too much. But it's really the single most argument and we
2 would just recommend the plans not to take their word for it
3 without questioning it.

4 And what PSERS has additionally said -- PSERS
5 has said that -- and I'm going to read this as a quote, not
6 to do any unfair judgment here, but -- "In traditional asset
7 classes, the two greatest impediments are the need for the
8 active asset manager to have a minimum amount of fees to
9 cover overhead of the business, especially during years
10 where performance may be more challenged."

11 And we would like to highlight that both of
12 these plans are very large. And both of the plans give
13 intendance, large allocations to asset managers. So we
14 don't think that overhead should be an issue for the
15 managers because they are making large fees. And even if it
16 was, we don't think it's the pension plan's problem, all
17 right? So if a manager says, "I need to make more money in
18 order to run my operation," then I would highly question
19 that.

20 Next slide -- I'm sorry. There was one more.

21 We have asked both plans if they have
22 procurement guidelines in place, and I believe I've heard in
23 previous statements today that those are actually being
24 built up. We believe those are very important and they
25 would allow for a structure and replicable process whenever

1 a mandate is agreed upon, but it would also help, from our
2 experience, the staff at both SERS and PSERS to actually
3 negotiate harder with the asset managers because whenever an
4 asset manager is pitching for a new mandate and is looking
5 for a new business relationship, that is the moment in time
6 where there is the most flexibility to discuss terms. And
7 if your procurement guidelines, essentially, don't allow you
8 full freedom on what you're going to be paying them, then
9 that will generally help the plan to negotiate at that
10 moment in time better terms.

11 Next slide.

12 So being aware of time, Mr. Chairman, I ask
13 you if we want to go manager by manager and give our
14 recommendations and why, or whether we should just, you
15 know, hand this over to the plans and be available for any
16 input we can give them?

17 CHAIRMAN TOBASH: So thank you for your
18 consideration of our time.

19 Here's what I'd like to do, and I take full
20 responsibility for allowing us to go over. I know you have
21 come a great distance. If we could condense your testimony
22 to what you believe is most important -- and certainly this
23 information will be disseminated and distributed in the
24 consultant's report -- if we can just try to wrap this up in
25 15 minutes. So whatever order you think is most important

1 for this commission to hear from you, I think we could
2 expedite by moving forward with your recommendation.

3 DR. STAUB: Okay. Thank you. We can do
4 that.

5 So I will be quick through those managers
6 there (indicating) anyway. You will see here (indicating)
7 in gold -- it's hard to read, it's a bit small -- but
8 essentially, the first manager, it's a nine year old
9 contract. We think the fee is almost double as high as it
10 should be. We think there's quite a lot of room here to
11 renegotiate that.

12 And then we have a passive mandate, we
13 believe it's priced fairly.

14 And in general, I have to say the SERS
15 mandates that are passive, the prices are quite attractive,
16 so well done on those negotiations.

17 We have another active mandate that we
18 believe should be renegotiated. Almost half of the gross
19 alpha has been, you know, paid through the manager. And
20 we've had that discussion before, how much of the alpha
21 could go to a manager or partner, and how much of that would
22 be justified. And there's a general understanding that
23 20 percent is acceptable. However, in this case, it's been
24 almost 50 percent, so we think that should be definitely
25 renegotiated.

1 There's two more passive mandates, both of
2 them priced fairly. Another passive mandate priced fairly.
3 Another active mandate which we believe is too high.

4 Again, on SERS, as a little side note, we
5 haven't had unredacted contracts, so we don't know exactly
6 what the terms are. We've only actually seen a number and
7 that number appears to be high. We would need to see the
8 real terms to be able to give more of a statement.

9 The next mandate is the same. We believe
10 that the rate being paid is too high. There's an
11 opportunity to renegotiate that mandate.

12 And again, for the record, for both plans, I
13 think they would have my contact details from the
14 presentation, I'm available at all times to give them more
15 background as to why we think and how we think they could
16 renegotiate those terms.

17 So I'm not --

18 COMMISSIONER BLOOM: Could you mention the
19 mandate numbers as you go through them? Because I'm lost
20 now.

21 DR. STAUB: Oh, sorry.

22 Do you mind going back one page?

23 So we have a lot of passive mandates on this
24 page. (Indicating.) Those would be mandate five and six
25 and seven -- sorry, five and seven. And those are priced

1 fairly, whereas mandate six, as an example, we have no
2 contract details. So on this mandate six, called SERS
3 mandate six, 99 million -- which we believe might actually
4 be in wind down, so it may not be that relevant. But we
5 haven't seen any contractual details to that manager, so
6 just simply cannot comment on the terms.

7 So I'm going to PSERS mandates. And I'm not
8 going to go into the details of this, but I would like to
9 mention something. We've previously heard that there is a
10 plan to reduce the base fees and introduce higher
11 performance fees or -- there's been a discussion about
12 whether it's carried interest or performance fees or
13 whatever, and we've looked at some of the arrangements that
14 seem to be, recently have been adjusted. And we believe
15 that those will actually turn out to be more expensive in
16 the future. So we would just like to raise a word of
17 caution. We'll come to that later.

18 Whenever performance fees are being
19 introduced, those need to be, from our perspective and
20 experience, they need to be negotiated very carefully
21 because they do carry a potential to actually increase the
22 total cost of such a mandate. And in one specific example,
23 if we look at data from the past, and clearly there's an
24 indication, it would have been more expensive in the past to
25 be in that new fee schedule. So if the assumption is the

1 manager is going to do equally well going forward, then that
2 adjustment of the fee schedule was not to the favor of the
3 plan, it was to the favor of the manager.

4 So in the interest of time, I will want to go
5 quick through this. On PSERS, we think that with various
6 mandates --

7 And, Commissioner Bloom, here (indicating),
8 these are the PSERS active mandate two, active mandate
9 three, and active mandate four.

10 We think that in all of those, there is
11 potential to renegotiate those. We have given approximately
12 where we think those tiers should be.

13 Active mandate three, as an example -- and
14 this is now the benefit of having contracts that are not
15 blacked out. So here we had, for PSERS, we actually had the
16 real contract. Thank you to PSERS for providing those.

17 We could see as an example with the active
18 mandate three, despite its over a billion dollars in size,
19 the top tier ends at 200 million. So the last fee
20 reduction, in a sense, that larger allocation would bring,
21 ends at 200 million. And this is probably some sort of a
22 legacy thing, right? When the contracts were negotiated,
23 the assets were probably not that big. It's an assumption
24 I'm making. And the terms were appropriate at the time and
25 now we think that having a last break point that's -- 200

1 million for a 1 billion investment is just not appropriate.
2 So we think there is room to renegotiate that, as there is
3 with mandate four.

4 So I've mentioned before that we believe all
5 the international equity small cap mandates bear room for
6 negotiation. And I've also mentioned at the beginning of
7 the presentation that a more expensive mandate doesn't
8 guarantee better returns. And in this asset class here
9 (indicating), we actually have that, the living proof of
10 that.

11 So the cheapest out of the five mandates has
12 actually been the best performing. So there's clearly room
13 with the others to negotiate the fees, also because their
14 performance has maybe been a bit disappointing, especially
15 also compared to this active mandate five, which is here
16 listed at the top. (Indicating.)

17 So I've said before that we believe contracts
18 should be renegotiated every two to three years. And in
19 PSERS, I think there is an opportunity here to renegotiate
20 the fees also because some of those mandates -- and in total
21 it's almost 30 percent -- are older than five years. So
22 there is definitely room here to renegotiate them.

23 There's another interesting component, and
24 I'd just like to highlight it for the benefit of PSERS to
25 really look into this. We think that the high yield

1 allocation is definitely different than we would typically
2 see it. We would typically not see allocation to this asset
3 class through a private market instrument like it has been
4 structured here.

5 So essentially, this originally liquid asset
6 class has been structured in an illiquid way. And from what
7 we can tell, it hasn't really worked out. A, of course, you
8 are locking yourself in. Of course, those terms -- it would
9 be shorter than it would be on private equity, but you're
10 still locking yourself in. So we believe there is also a
11 problem from an asset allocation perspective. So you're
12 also, by going private and by locking yourselves in, you're,
13 of course, also taking away flexibility to reallocate your
14 assets between different asset classes because certain of
15 those are locked in. And there's a certain amount that you
16 can't move.

17 And secondly, we think that the terms that
18 have been agreed here for this investment are just very much
19 in favor of the asset manager. We would definitely
20 recommend to PSERS that whenever this comes to expire, to
21 renegotiate those terms. And maybe just to give a few words
22 here, it really hasn't performed as well as I believe it was
23 maybe anticipated, and therefore, has really not justified
24 the fees.

25 And if we take into consideration -- on the

1 next slide, Ashby -- the carried interest on top of what has
2 been paid, then on the 10-year period ending -- when is that
3 ending? Give me a second -- so the 10-year period, I
4 believe, ending July this year or June this year, including
5 carried interest, 93 percent of the gross alpha has been
6 captured by the manager. So essentially almost all the
7 value add that has come from this asset class or this
8 investment has remained with that manager in total.

9 And if we look at the previous 10-year
10 period, and it's actually been over 100 percent, which means
11 that the managers made their money, but you didn't. So we
12 definitely think this asset class has a lot of potential to
13 restructure, renegotiate, whenever it comes to expiring.
14 And because the performance numbers haven't proven to be
15 what probably was anticipated, there's also a lot of room
16 here to save money, really.

17 Next. Yeah, go to the private equity.

18 So we've also been asked to give our view on
19 private equity and we didn't have contracts for private
20 equity, so we really can't give a very detailed view. But
21 we can, from our experience, of course, say that this is an
22 asset class that has high fees. And as fees are high, there
23 is a lot of room to save money. It is, in private equity,
24 as has been previously said, difficult to save money once
25 you're invested because you're locked in. So you need to

1 essentially wait for the moment until those come to
2 reinvestment, whether that is with the same firm or with a
3 different firm. And at this point in time, you need to
4 renegotiate your terms very carefully.

5 And we believe that in that asset class
6 alone, there is a potential to save a lot of money for both
7 plans by renegotiating hard at the time of reinvesting those
8 assets. And if we look at the total cost of private equity
9 and -- we did have more precise numbers for one plan, where
10 it was -- including carried interest, which for me, clearly
11 is a part of the cost, it was almost 701 basis points. We
12 also realize, however, that out of that number there is only
13 a certain number that can actually be renegotiated.

14 And from our experience in private equity --
15 that portion that is up for renegotiation is about 300 basis
16 points of total cost that has room for renegotiation. And
17 we believe that if both plans were to renegotiate in those
18 300 basis points -- which don't represent the full cost of
19 the asset class, but the portion of the cost which actually
20 has room for renegotiation. Then if both plans renegotiate
21 10 percent of savings in those 300 basis points -- and that
22 is definitely achievable -- and that will do a lot towards
23 your savings target. I will show two slides later how much
24 exactly.

25 We have also listed here a few ideas just as

1 some recommendations for the two plans of how they could
2 achieve those savings. I'm not going to go into detail here
3 in the interest of time, but there -- we could probably give
4 you 30 pages of guidelines of what to do and not to do when
5 you invest into private equity. But we've given you maybe
6 10 or 12 bullet points as an indication of where you could
7 start to actually get better terms. And again, we'd be more
8 than happy to support both plans in that process if they
9 wanted more input from us, and maybe share some of our
10 experience that we have had renegotiating those terms.

11 So if we come to the summary of savings
12 potential -- this is just to give you an idea of how the 1.5
13 -- 1 billion that we believe SERS can achieve, how that
14 comes about. We later on have the same slide for PSERS.
15 Again, this is what, from our experience, from having
16 renegotiated a lot of assets in the past, over the past 12
17 years, and from looking at the portfolio of both SERS and
18 PSERS, what do we think can be achieved through
19 renegotiation.

20 And these are the numbers. And essentially
21 for SERS, we do believe that the 1.5 billion over 30 years,
22 that could be achieved. I noticed before that, probably the
23 target should have started back in 2017. We didn't -- we
24 weren't aware of that, so we were actually considering that
25 it would start 30 years from now. So there's one year

1 missing, essentially.

2 Next slide.

3 For PSERS, we actually think that the savings
4 potential is quite a bit higher. And this is primarily due
5 to the fact that we believe the high yield allocation that
6 we have mentioned before, where, you know, the managers have
7 kept 93 percent of the gross alpha over the last 10-year
8 period. And we also believe that the asset class is simply
9 overpriced. You can achieve this asset class significantly
10 cheaper. And therefore, when these mandates come to expire,
11 we believe there is a lot of room to renegotiate that. We,
12 in fact, think there's almost 42 million of renegotiation
13 potential on an annual basis in that asset class alone. And
14 taking those various assumptions together, we believe that
15 PSERS has the potential of saving up to 4.96 billion over
16 the 30-year time horizon.

17 We had the discussion before, and I was
18 following it carefully on the amalgamating plans or
19 investments of the plans. And it is our view that there is
20 additional savings potentials if the two plans were to work
21 closer together on their investments. We also think because
22 both plans are already big, those additional benefits are
23 marginal, all right?

24 We have also, in our entire review, not
25 looked at the organizational costs of the two plans. We've

1 really just looked at the cost of their external managers.
2 So if there is a potential savings on the organizations, we
3 refrain from making any statements because we don't have any
4 information on that, we can't say. But if we look at the
5 external managers, because both plans are already big, we
6 think, yes, there is some savings potential, but we also
7 think it is not that big.

8 I mean, sorry, to correct that. Those
9 additional savings are still very meaningful, don't get me
10 wrong, but if the renegotiations are done properly, then
11 those are more meaningful than what would come from
12 consultation of the investments.

13 Thank you. That's it.

14 So I will turn it over back to the commission
15 for questions.

16 CHAIRMAN TOBASH: And we appreciate you
17 coming a long way. And you have developed large numbers
18 here and large numbers oftentimes become sound bites and we
19 appreciate your expertise in backing up that information.

20 I will forego any questions at this point in
21 time. And I will only ask my fellow commissioners, if they
22 do have a question, to keep it very brief, number one, and
23 number two, to not insert comments, really focus on
24 questions that are important to develop back from the
25 testifiers.

1 So Mr. Vice-Chairman.

2 VICE-CHAIRMAN TORSELLA: I'll also forego.

3 CHAIRMAN TOBASH: Thank you.

4 Commissioner Gallagher.

5 COMMISSIONER GALLAGHER: Thank you,

6 Mr. Chair.

7 Thank you, Dr. Monk and Dr. Staub, for being
8 here. I recognize the journeys that you both took to be
9 here today.

10 You know, again, I also thank you for the
11 recipe. Getting into the Thanksgiving season, it's good to
12 have a good cost-saving recipe to go into a family reunion
13 with.

14 So to that point, though, what I'm hearing --
15 and maybe I'm oversimplifying it -- is that if we just
16 renegotiate the contracts we have, our partnership
17 agreements with our private equity and hedge firms, we'll
18 achieve these savings over X amount of time. Now, how easy
19 is it to renegotiate?

20 And second, I know you started out talking
21 about how, you know, there's Harvard Business School grads
22 who are experts in negotiation. What jobs do you have, what
23 qualifications do you have that can match that? And then
24 second, how many managers, explicitly the ones that PSERS
25 and SERS has currently, have you renegotiated terms with

1 directly?

2 DR. STAUB: So the first question, it is, I
3 would think in private equity, achieving 10 percent savings
4 on those 300 basis points that are up for negotiation, up on
5 time of reinvesting by just being more aware maybe of the
6 terms that you could achieve. I think that is achievable.

7 Achieving the savings with the public equity
8 managers, there's a certain level of uncertainty, right?
9 It's not a guaranteed fee outcome that you will have. And
10 we have negotiated with some of the managers that both plans
11 have, and we actually also, from experience, we have had a
12 case where we had the same manager, the same allocation, but
13 different clients. And they wouldn't grant us the same
14 terms. Although we had the contract in hand and we could
15 show them, "You've granted these terms to someone else,"
16 they wouldn't grant it to that other client. So there's no
17 guarantee for that outcome, right?

18 We are, however, highly convinced that these
19 achievements can be made, and therefore, these savings are
20 also, they're possible. Negotiating them, it's more of an
21 odd kind of science.

22 CHAIRMAN TOBASH: Okay, thank you.

23 So with that, we're going to end the
24 testimony for the first half of the day, if that's fine.

25 But I will ask, number one, I want to

1 announce that there's lunch available for the commissioners
2 and testifiers. We want everyone to keep their strength up.
3 And if it's okay, we're just going to take one half hour for
4 lunch and try and catch up on some of our lost time here.

5 But also, if possible, and there's one or two
6 more questions, would you be available for questions after
7 we return?

8 DR. MONK: (Nods.)

9 DR. STAUB: Sure.

10 CHAIRMAN TOBASH: Excellent, so we will
11 reconvene at five minutes after two. Thank you.

12 (Recess.)

13 CHAIRMAN TOBASH: Okay. The hour of just
14 after two having arrived, we want to get back to business.

15 Before we broke for lunch, we asked if Marcel
16 and Ashby could stick around for potentially one or two
17 questions from the commissioners that they didn't have a
18 chance to develop and maybe thought about it a little bit
19 over break.

20 So Mr. Vice-Chairman.

21 VICE-CHAIRMAN TORSELLA: Thank you.

22 Dr. Monk --

23 DR. MONK: Yes.

24 VICE-CHAIRMAN TORSELLA: -- a quick question
25 which shouldn't stump you because I've asked it twice today.

1 DR. MONK: Oh, yeah.

2 VICE-CHAIRMAN TORSELLA: Is carried interest
3 an expense?

4 COMMISSIONER GALLAGHER: Yeah. That's a --
5 so I have strong views. To give a balanced perspective, I'd
6 say there's a lot of confusion around this topic. This is
7 confusion in part because we see the gap not really giving
8 us clarity, but I think when it comes to the plans not
9 reporting carried interest as a fee or expense and calling
10 it a profit share, I wouldn't say that's conspiracy, I'd say
11 that's confusion.

12 I think on this topic, I'd have kind of two
13 points to make. One, carried interest in the public realm
14 is thought of as private equity and hedge funds. And we
15 think of the hedge funds of having a loophole, of using the
16 private equity carried interest, but when it's reported in
17 the media, the media talks about carried interest as hedge
18 funds and private equity.

19 In the PSERS reporting, they report the hedge
20 fund carry, the absolute return carry, but they don't report
21 the private equity carry. So I think that creates a lot of
22 confusion as to why you would be reporting one form of
23 carried interest, the hedge fund carried interest, which
24 uses the same tax rule as the private equity carried
25 interest, and not the other. So in like the court of public

1 opinion, that's confusing.

2 The second thing is, we heard about this
3 being profit sharing and alignment of interests. Look, the
4 example was given, we made four dollars, the GP gets one
5 dollar. It's not a complete context-rich scenario. Four
6 dollars gets earned by the plan, one dollar gets earned by
7 the GP, and there are base fees. That's on the upside. On
8 the downside, if you lose the four dollars, the GP loses
9 zero dollars and makes the base fee.

10 So this is not about alignment, this is not a
11 joint venture in the traditional sense of the word, where
12 there is commensurate gains and losses on both sides of the
13 trade. And frankly, most of the consultants in private
14 equity would tell you that this should be counted among the
15 performance fees that you're calculating. The idea that
16 it's a profit share to me is based purely on confusion, and
17 we just need to resolve that confusion. It should be
18 reported as a performance fee.

19 CHAIRMAN TOBASH: Commissioner Bloom.

20 COMMISSIONER BLOOM: I have no questions.

21 CHAIRMAN TOBASH: Commissioner Torbert.

22 COMMISSIONER TORBERT: I have none.

23 CHAIRMAN TOBASH: Commissioner Gallagher.

24 COMMISSIONER GALLAGHER: Just a continuation
25 of that conversation. And I'm sorry, I felt my eyebrows

1 kind of pivoting inwards there because I was a little
2 confused about the mathematics there, because that four
3 dollars never got earned. So if you lose money on it, there
4 isn't a gain to lose, right? So if the underlying asset
5 doesn't produce --

6 DR. MONK: In a partnership, a true
7 partnership, there is a loss share, as well as a profit
8 share.

9 COMMISSIONER GALLAGHER: Is there?

10 DR. MONK: Yeah.

11 COMMISSIONER GALLAGHER: Okay. That's news
12 to me because -- actually, I do understand that. I
13 understand the liquidation process. But what I don't
14 understand is when we talk about the profit share not being
15 a fee or just kind of waffling about that, and that it's
16 indicative of how it's reported, private equity does get
17 reported in our CAFR. It's just all included into a line
18 item. It's just not broken out the way --

19 DR. MONK: Absolute return is.

20 COMMISSIONER GALLAGHER: -- the way that
21 analysts like yourself would like to see it. We're getting
22 there. We're developing that, right, over time, but there
23 is no standard for that right now. As soon as there are
24 standards in every state and every system starts complying
25 with that, then you'll have that apples to apples

1 comparisons between systems. Is that not correct?

2 DR. MONK: I think I'd love apples to apples.
3 In the absence of apples to apples, I would refer to how
4 the, you know, IRS treats carried interest and they treat
5 private equity carried interest the same as hedge fund
6 carried interest.

7 COMMISSIONER BLOOM: I'm still confused, why
8 hasn't GASB recognized what you recognize?

9 DR. MONK: I'm not on GASB. I don't know.

10 Marcel, do you have a view on whether or not
11 carried interest is a fee?

12 DR. STAUB: So yes, I do have a view.

13 I mean, carried interest, in everything I've
14 experienced, is a form of a performance fee, and therefore,
15 it's a fee. So I'm of the clear opinion that carried
16 interest is a fee.

17 CHAIRMAN TOBASH: Okay, great. Thank you,
18 again. Thank you so much for traveling a great distance and
19 your expertise and your continued assistance if we develop
20 more questions coming down the stretch.

21 DR. MONK: It's been an honor. Thank you.

22 CHAIRMAN TOBASH: Okay, our next testifier,
23 Steve Nesbitt. Thank you so much and thank you for
24 accommodating us getting behind schedule a little bit.

25 Mr. Nesbitt is the chief executive officer at

1 Cliffwater, LLC, an overseas all investment research -- I
2 apologize. He oversees all investment research as the
3 firm's chief investment officer. As well, Cliffwater
4 assists globally in the allocations of alternative
5 investments. He has been with Cliffwater and actually
6 started the firm in 2004. He was a senior managing director
7 at Wilshire Associates, started his career at Wells Fargo
8 Investment Advisers, and he was an early pioneer in index
9 funds. His articles have been published in *Financial*
10 *Analyst Journal*, the *Journal of Portfolio Management*, and
11 the *Journal of Applied Corporate Finance*.

12 We appreciate you being here today,
13 Mr. Nesbitt.

14 MR. NESBITT: Thank you, Mr. Chairman, Mr.
15 Vice-Chairman, Commissioners. Thank you for having me
16 today. I really appreciate it.

17 I was asked to come to share my thoughts on
18 issues of performance, transparency, and fees in the context
19 of a state pension system.

20 I am here as an experienced institutional
21 investment adviser, having worked with literally hundreds of
22 public pension systems over the last 40 years. I have
23 advised some of the largest U.S. state and federal pensions
24 through my career. I've advised -- given advice to, as a
25 consultant, to CalPERS, CalSTRS, Connecticut Retirement

1 System, DC Retirement System, Federal Retirement Thrift,
2 Iowa PERS, MainePERS, Massachusetts PRIM, Nebraska defined
3 benefit plan, New Mexico, Ohio PERS and STRS, Ohio Police
4 and Fire, Oregon PERS, Pension Benefit Guarantee
5 Corporation, Pennsylvania SERS, and Pennsylvania PSERS, New
6 Jersey, Rhode Island, Texas County District Retirement
7 System, the state of Virginia, and Wisconsin SWIB.

8 You can see that my credentials come really
9 from the school of hard knocks.

10 As an investment consultant, I have
11 introduced and helped guide the use of both low-cost index
12 funds and higher cost private equity, seeing an important
13 role for both. I've been intimately involved in virtually
14 all aspects of pension investing, as an adviser to both
15 pension boards and staffs.

16 My objective in the next 15 to 20 minutes is
17 to share what insight I have into these issues with the
18 commission, okay, providing perhaps a different perspective
19 from several of the outsiders you have already heard from.

20 Let me start with slide one, which I call the
21 inconvenient truth in state pensions. You have already
22 heard this narrative in prior meetings, okay? Actuarial
23 rates have been too high for too long compared to the
24 returns pensions earned. The high actuarial rates cause
25 contributions to be too low, eroding pension funding rates

1 from near unity, 100 percent in 2000 to roughly 70 percent
2 today. Justifiably, all stakeholders in public pensions
3 understand that this is a problem and want to fix it.

4 I understand that one important commission
5 task is reviewing the state's investment strategies. No
6 investment strategy is more important than asset allocation,
7 adopted as policy by individual pension boards. Studies
8 show that the choice in waiting to get individual asset
9 classes have the greatest impact on long-term pension return
10 and risk.

11 So the first question is whether the problem
12 is with the investment strategy or the actuarial rate or
13 both, okay? Are pension boards making asset allocation
14 decisions that offer the best chance of achieving pension
15 security or not?

16 You have already heard testimony on long-term
17 asset allocation trends, which I won't repeat here.
18 Instead, I want to impress on you that public pension
19 systems cluster in almost all their investment decisions,
20 and no more so than in asset allocation covered in slide
21 two.

22 Foremost is the role of the prudent person in
23 fiduciary law. Investment decisions by board members are
24 heavily influenced by what other pensions are doing, a proxy
25 for prudent person. And in the small community of public

1 pensions, everybody knows what everybody else is doing.
2 This is reinforced by the handful of investment consultants
3 that guide asset allocation decision-making using mostly the
4 same models and inputs. Importantly, this all leads to
5 similar asset allocation policies groomed by the collective
6 wisdom of boards and investment professionals, and producing
7 more returns than the financial markets will allow them to
8 earn, not what actuaries assume they will achieve.

9 As fiduciaries, boards are continually
10 balancing the pull of high actuarial rates against the push
11 of higher risk that achieving these high rates would entail.
12 Most pensions end up roughly in the same place, as slide
13 three shows, where return and risk for state pensions
14 cluster tightly between a commonly used low-risk bond index
15 and a higher risk stock index. State pensions fail in asset
16 allocation when they give up too soon on their existing
17 asset mix, for example. Moving from lower to higher risk
18 strategies near the top of the market, or moving from higher
19 to lower risk strategies after a market downturn, and
20 particularly, that latter case. Sticking with the existing
21 asset allocation strategy has proven as important to
22 long-term performance as which strategy you choose.

23 Let me also add that statistically, state
24 pension asset allocation has been independent of funding
25 ratio. This means that state pensions generally ignore or

1 act as if they ignore funding ratios in setting asset
2 allocation. Anecdotally, that has also been my experience
3 and is not necessarily a bad thing.

4 Boards have generally viewed pension funding
5 as an actuarial issue, not an investment issue, seeing
6 themselves as setting prudent investment policies with
7 expected returns that actuaries should then use to set
8 funding amounts. An unfortunate post-Global Financial
9 Crisis perversion has been to pressure boards to change
10 investment policies to be consistent with high actuarial
11 rates and their low funding schedules rather than fiduciary
12 standards. In summary, my opinion is that the health of
13 state pension systems has not been compromised by current or
14 past asset allocation policies.

15 Staying on the topic of investment strategy
16 is the question of active versus passive management. Let me
17 first say that public pension systems were some of the
18 earliest and largest investors in index funds. Because of
19 their low fees, good performance, and ability to get moneys
20 invested and divested quickly. None of that has changed.
21 Index funds now represent close to 70 percent of U.S. equity
22 allocations and 20 percent of total state pension
23 allocations.

24 The attraction of index funds, though, is not
25 all consuming, okay? First, there are asset classes where

1 indexing is not possible, like private equity and private
2 real estate. Second, there is a concern with trade
3 execution and price dislocation for index funds that track
4 securities that are not traded on exchanges, such as high
5 yield bonds and leveraged loans. Third, there are some
6 asset classes that are viewed as price inefficient where
7 investors believe active management can add value, net of
8 higher fees. These include small cap stocks, high yield
9 bonds, and non-U.S. stocks. Most state funds use a
10 combination of active and passive management for these asset
11 classes with very few 100 percent active or 100 percent
12 passive.

13 Slides four and five illustrate some of the
14 thinking behind active and passive investing. Both slides
15 report 10-year performance for state pensions by asset
16 class. Slide five provides asset class returns for
17 individual state pension systems, while slide six
18 consolidates asset class performance into a single asset
19 class average. Also shown are the most common asset class
20 benchmarks, which can be viewed as proxies for passive
21 management.

22 U.S. equity allocations generally trail index
23 funds -- excuse me, U.S. equity returns generally trail
24 index funds, represented by the Russell 3000 Index,
25 suggesting that perhaps more or all of that asset class

1 should be indexed. However, for fixed income and non-U.S.
2 equity, state pension returns have generally outperformed
3 index funds. State pension boards regularly weigh past
4 performance and fees in deciding how much of every asset
5 class to allocate to index funds.

6 Key to the well functioning of a market
7 system is the reallocation of capital from bad performing
8 companies to good performing companies. This function was
9 largely broken in the 1970s, as companies grew to become
10 large underperforming conglomerates without outside forces
11 that could change market behavior to the corporate
12 governance issues mentioned earlier. Terms like entrenched
13 management, enriched management, conglomerate discount came
14 to unhappily describe corporate America. At the same time,
15 corporate pensions dominated the institutional landscape and
16 their proxy policies were strictly to vote with management
17 and not to rock the boat.

18 This capital dysfunction was corrected when
19 large state pensions began using private equity, proxy
20 voting, and high yield bonds to dislodge bad management and
21 capital from poor performing companies. Private equity and
22 high yield bonds not only directly benefited state pensions
23 through higher returns, but also indirectly benefited index
24 funds through merger and acquisition premiums, a form of
25 economic externality that bequeaths a part of the wealth

1 creation of private equity to index investors.

2 Slide six reports net of fee performance for
3 private equity for individual state pensions and the
4 composite return for 16 years ending fiscal 2017. Without
5 exception, state pension, private equity returns, net of
6 fee, all fees, exceeded an equivalent public equity return
7 with the average private equity return exceeding
8 10.7 percent compared to 6.6 percent for the public equity
9 markets. The difference of 3.1 percent per year, if
10 repeated over the next 10 years, would produce a cumulative
11 87 percent in additional return compared to the index fund
12 alternative. Considering past performance, it is surprising
13 that the average state pension allocation to private equity
14 is less than 10 percent of total assets.

15 Previous testimony has suggested that private
16 equity has lost its performance edge versus public equity.
17 And it is true that post-Global Financial Crisis, state
18 pension private equity returns have exceeded public equities
19 by a smaller one percent compared to the three percent
20 long-term average. However, drawing forward-looking
21 conclusions from this data is premature. Historical return
22 patterns show that most of the outperformance in private
23 equity occurs when public markets turned bearish because
24 private equity valuations get a chance to catch up to public
25 valuations, and two, the value-driven strategies of most

1 private equity is most effective during stock market
2 downturns.

3 If I may briefly go back to the subject of
4 asset allocation and speak to the issue of private equity
5 and liquidity management, which has generally been
6 overlooked in asset allocation. Trustees learn from the
7 Global Financial Crisis that asset allocation targets to
8 private equity and private assets more generally need to
9 take account of cash flow needs of the pension system and
10 the potential for large variances in actual versus target
11 allocations during downturns. Prior to the Global Financial
12 Crisis, many endowments, including large endowments like
13 Princeton and Stanford, had outsized allocations and
14 unfunded commitments to private assets well exceeding
15 50 percent of their total assets. The crisis forced these
16 and other endowments into potential distress sales of their
17 illiquid assets and unfunded commitments to meet then
18 current spending needs.

19 Fortunately, distressed sales were largely
20 averted as capital markets rebounded and private asset
21 managers delayed calling on committed capital. But the
22 experience was a lesson learned, and today, state pensions
23 routinely incorporate liquidity management when stress
24 testing their asset allocation policies.

25 My own experience working with pensions and

1 endowments is that allocations to private assets above
2 40 percent of total assets requires a detailed liquidity
3 plan as part of overall asset allocation. Currently, the
4 average allocation to private assets among state pensions
5 equals 25 percent, well below that 40 percent threshold.

6 Let's turn now to manager fees, because
7 despite strong historical returns produced by private
8 equity, it is also where state pensions spend the most in
9 fees. One of the challenges in understanding private equity
10 fees is that they can't be expressed as a fixed percent of
11 the assets. In addition, there are several fee components
12 and each component can vary depending upon performance and
13 time. Fee components and levels are spelled out in a
14 private equity partnership agreement. These are negotiated
15 between managers and investors before the partnership is
16 activated.

17 So again, there is an active negotiation of
18 fees, it happens when the partnership is originated. Large
19 state pensions have historically played an active role in
20 negotiating private equity partnership fees and terms and
21 are not simply price-takers.

22 Slide seven provides total fee estimates for
23 a typical private equity partnership for different levels of
24 gross of fee partnership return. Note on the right-hand
25 side of slide seven, the fee components and fee rates for a

1 typical partnership. Collectively, these fee components and
2 rates produce different fees as a percent of invested
3 assets, the common measure of expressing fee rates for
4 different levels of gross partnership return. There's
5 simply not one number. This uncertainty in combined private
6 equity fee rates is frustrating when trying to answer the
7 simple question, "What am I paying for private equity?" But
8 as slide seven shows, paying more in combined fees is
9 probably a good thing because your net of fee performance is
10 better.

11 Our fee analysis, using simulation to capture
12 different possible return outcomes, yields a combined
13 private equity fee equal to 3.73 percent of invested assets,
14 which represents approximately 25 percent of gross profits.
15 How might investment professionals pass judgment on these
16 fees? Well, the 25 percent of the profits would likely seem
17 very reasonable to investors in private assets. On the
18 other hand, the 3.73 percent combined fee as a percent of
19 invested assets might strike some investors accustomed to
20 more traditional fee structures as extraordinary.

21 Fee fairness is difficult to assess. But in
22 the allocations to private equity, these fees are
23 aggressively negotiated by state pensions against the
24 backdrop of performance expectations and competitive
25 pressures to access top performing funds.

1 My intent is to impress upon the commission
2 that by no means is there an attitude of acceptance by state
3 pensions when it comes to fees. In addition to pressing for
4 best practices when it comes to partnership fees, state
5 pensions are aggressively moving in two additional
6 directions to lower fees.

7 The first is co-investments, which allow
8 state pensions to potentially invest directly in the same
9 deals as the manager puts in their fund, but at a much lower
10 or no fee. The second is called strategic partnerships.
11 These are bespoke agreements between state pensions and a
12 highly valued manager, where state pension commits
13 significant long-term capital to the manager across multiple
14 years and strategies in return for lower management fees and
15 the netting of performance fees. These are important tools
16 that state pensions can use to significantly reduce overall
17 private equity, and also, these are tools that they
18 originated.

19 In my final remarks, I would like to first
20 compliment all the presenters that preceded me. Their
21 analyses, opinions, recommendations deserve serious
22 attention, but I do take exception to a narrative that a
23 couple of presenters put forward, and that is the claim that
24 state pension staff are hiding fees from the public for fear
25 of losing their jobs. I can tell you from personal

1 experience over many years that nothing is further from the
2 truth. I have found staff across pension systems to be well
3 qualified, hard working, ethical, and thinking first of the
4 beneficiaries that the assets support. In fact, today, one
5 of the most serious issues facing state pensions is keeping
6 staff, particularly in the nation's state capitals where
7 professional opportunities in public policy far outweigh the
8 opportunities in investment policy.

9 Most likely, outsider distrust of pension
10 staff comes from the lack of understanding that transparency
11 itself is negotiated as part of the legal agreements
12 underlying private equity and other private investments.
13 Part of the agreed upon terms of these investments is
14 confidentiality on the part of the investor subject to legal
15 redress. Pension staffs are not turning over data to
16 outside parties because they are bidding by these agreements,
17 not because they are afraid of their jobs.

18 Yes, state pensions could change these
19 agreements and require transparency by their private equity
20 managers as a condition of investment. Perhaps public
21 policy overrides investment policy in this instance. But
22 make no mistake, such action will likely result in lower
23 returns of some unknown magnitude from adverse selection,
24 particularly in today's favorable fundraising environment.

25 With that, I conclude my testimony.

1 Thank you, Mr. Chairman, for the opportunity
2 to share my thoughts, and I would welcome any questions you
3 might have.

4 Thank you.

5 CHAIRMAN TOBASH: Mr. Nesbitt, thank you so
6 much for traveling here. Thank you for your work and
7 testimony and expertise. And I just have one or two brief
8 questions.

9 You mentioned at the beginning of your
10 testimony your long résumé. You've worked with so many
11 different pension organizations, but you've also done some
12 work with SERS and PSERS. Can you tell us what work you've
13 done with the systems in Pennsylvania?

14 MR. NESBITT: It's dated now. So one of my
15 first clients was Pennsylvania State Employees' Retirement
16 System. And I think I was 28 at the time. But this was
17 during the 80s and we did really some great things.

18 We introduced performance fees. So the first
19 performance fee for a long-only strategy, a traditional
20 long-only strategy, was done by Pennsylvania State
21 Employees' Retirement System. We also introduced index
22 funds for the first time to that state system, and actually
23 created a Pennsylvania index fund. At the time, if you
24 remember the Governor, Thornburgh, was very interested in
25 in-state investing and so we created a Pennsylvania index

1 fund, which did pretty well.

2 So it was cost savings, fee reduction was a
3 headline event back in the 1980s and I thought we did good
4 work there.

5 A previous speaker talked about brokerage,
6 which basically, here in the U.S., we know it as soft
7 dollars. And so soft dollars were very high and basically
8 we insisted on eliminating soft dollars and monitoring
9 brokerage costs and transaction costs at that time.

10 It was during the 1990s I worked with
11 Pennsylvania School Employees' Retirement System. I built
12 an office. They wanted local representatives, so I built an
13 office in Pittsburgh at my prior firm. I took the puddle
14 hopper from Pittsburgh here. But it was there that we
15 introduced private equity, which became, you know, a very
16 performing, good performing asset class for them, and did
17 other good work for them, introduced index funds, et cetera.

18 So I'm sorry for that long-winded answer.

19 CHAIRMAN TOBASH: No, no, great. No.

20 MR. NESBITT: It's kind of memory lane.

21 CHAIRMAN TOBASH: Yeah. So it's important
22 for us to know your past work and commitment, continued
23 commitment to the Commonwealth of Pennsylvania. So I really
24 thank you.

25 So some of the people that you worked with in

1 the organizations you worked with -- I'll get back to the
2 transparency question. In this balancing act between
3 confidentiality and transparency, there's -- right -- they
4 don't work congruently. So some of the other systems you
5 worked with have been leaders in transparency. And I think
6 you mentioned Rhode Island. I think they've come back and
7 said something that's maybe contrary to your testimony,
8 saying that they haven't seen that being more transparent
9 has caused them to erode their ability to enter into
10 investment contracts. Can you comment on that a little bit
11 and particularly how you see Pennsylvania with the
12 opportunity to become more transparent or where do you think
13 we're at right now?

14 MR. NESBITT: Well, if -- I don't know who
15 was here from Rhode Island, but if they said that, I agree
16 with it.

17 But I do know specific cases where GPs have
18 said, you know, "We really don't want you -- given your
19 policies of transparency, we don't want you as an investor."
20 And different states make different judgments on that. The
21 Treasurer, very abled Treasurer, in Rhode Island has decided
22 to be very, very transparent. And the board went along with
23 him, and that's their decision.

24 CHAIRMAN TOBASH: So ILPA is kind of setting
25 the standard now trying to get on a national level, trying

1 to get more people on board with a blueprint for
2 transparency. Do you have any comments about their model
3 and how that might assist other states in the endeavor that
4 we're also working on?

5 MR. NESBITT: We're a big supporter of ILPA.
6 So, you know, our hope is that, basically all public pension
7 systems adopt ILPA and that all managers get on board in
8 that type of disclosure. And so I think that's a very
9 positive thing that's happening in the industry.

10 CHAIRMAN TOBASH: Great. Thank you again.

11 Do you have any questions, Mr. Vice-Chairman?

12 VICE-CHAIRMAN TORSELLA: Thank you, Chairman.

13 Thank you for being here. Thank you for your
14 past work for Pennsylvania.

15 You said that large state pensions have
16 historically played an active role in negotiating prices and
17 haven't just been price-takers, which is encouraging to
18 hear. So is it your belief that systems as large as ours
19 can negotiate good prices?

20 MR. NESBITT: Yes, but as a collective. So
21 basically, it's the large systems that negotiate price with
22 the GP. And so it's not individual negotiations. It's
23 basically, the GP and the large LPs know who's going into
24 the fund, and basically they call each other and say, "Hey,
25 what do you think of this? Do you agree with that?" And

1 basically they put pressure collectively on the GP to change
2 terms or to change fees. So it's basically --

3 VICE-CHAIRMAN TORSELLA: So larger and more
4 is better than smaller and less, in most things?

5 MR. NESBITT: Yeah. At the margin, big is
6 beautiful, but I will say there are some more medium-sized,
7 really well-respected state pensions that carry as big a
8 stick as the larger ones.

9 VICE-CHAIRMAN TORSELLA: And a question on
10 the liquidity, which I thought was an important point you
11 were making. You said that in the great financial crisis,
12 some funds found themselves with illiquid investments,
13 including their allocations and unfunded commitments of
14 greater than 50 percent. You said, I thought, that you
15 thought 40 percent was where yellow lights flash.

16 Is that in your practice, your view, that the
17 appropriate yardstick is when allocations and unfunded
18 commitments are more than 40 percent, there needs to be a
19 very careful analysis?

20 MR. NESBITT: It all depends on individual
21 circumstance. Generally, boards are willing to tolerate
22 plus or minus 10 percent at the outside vis-à-vis their
23 target allocations. If you have more than 40 percent in
24 private equity and you stress test that allocation amount in
25 2008, 2009, that 40 percent becomes basically something

1 closer to 60 percent, between 55 and 60 percent. And that
2 causes a variation from policy that's really outside the
3 typical bounds.

4 VICE-CHAIRMAN TORSELLA: And would that be,
5 the better funded the plan, the easier it is to tolerate,
6 correct, with liquidity?

7 MR. NESBITT: No. That protocol, if you
8 will, to stay within your asset allocation range is
9 really -- in the first order, it's independent of your
10 liability. In the second order, you know, if you have a
11 large unfunded liability, generally you have more negative
12 cash flow. You have more benefits going out than you have
13 contributions come in. And that situation would suggest
14 something more conservative.

15 VICE-CHAIRMAN TORSELLA: Okay. Thank you.

16 CHAIRMAN TOBASH: Commissioner Gallagher.

17 COMMISSIONER GALLAGHER: Thank you,
18 Mr. Chair.

19 And I think the Treasurer just touched on my
20 question. It's just, you know, how does a fund that's
21 60 percent funded navigate as compared to a 90 percent
22 funded plan? In terms of the liquidity needs and cash flow
23 negative, we've got a very mature -- both of our plans are
24 very mature. One more is more than the other. The State
25 Employees' System is much more mature.

1 Given those contexts of demographics and
2 presently the asset allocations that both systems deploy,
3 which are different, and that brings about contrast that
4 kind of elucidates a way to think about things differently.
5 But can you layer in about, just relatively speaking, within
6 the framework of the logic of your piece here, how is it a
7 fund at 60 percent must navigate on a moving forward basis
8 relative to a 90 percent funded plan?

9 MR. NESBITT: That's a very challenging
10 question without one answer. So let me explain myself here.

11 This is really the view -- in my experience,
12 I've had pension funds that were exceedingly low funded,
13 that took the long-term view and stayed aggressive. And
14 I've had those that were really underfunded and basically
15 were worried about running out of money and they became very
16 conservative. So what's the difference in the vision of
17 those two boards? It really has to do with how they view
18 the sponsor of the pension system, in other words, the
19 state.

20 One of my early clients was the state of
21 Massachusetts. And this was 1985 when they first set up
22 PRIM, when they took all the local pension systems and put
23 them together and had one board, one policy. Their funded
24 ratio was 25 percent. If you think about the 80s in
25 Massachusetts, it's like, gee, the logic would suggest,

1 "Gee, let's stay conservative because we may run out of
2 money in the next five years," okay? With a five percent
3 spend rate, that was a possibility. Basically, they came to
4 the opposite conclusion. The Governor, the legislature, all
5 the stakeholders said, "We're going to have a commitment to
6 funding. We're going to have a 30-year funding schedule,
7 where we expect to pay for this unfunded liability and we're
8 all bought in on that."

9 So the pension board at that time, which had
10 a diversity of stakeholders, said, "Okay, given that we have
11 assurance in that obligation to provide state contributions,
12 given that we have that assurance, we can go for the
13 long-term and we can invest aggressively with the idea that
14 we're going to lower the long-term costs of the pension
15 system." At the same time, I've had pension systems that
16 are currently at 40, 50 percent funded, that -- "Gee, I'm
17 not so sure about my sponsor, my state," whether -- their
18 commitment, either the legislature or the Governor or
19 whatever, "I've got to worry about running out of money. So
20 I'm going -- I see my duty as maximizing whatever money is
21 left for those shorter term benefits." So they adopt a more
22 conservative policy.

23 So I apologize, but there is no one answer.

24 COMMISSIONER GALLAGHER: That's helpful.

25 CHAIRMAN TOBASH: Commissioner Bloom.

1 COMMISSIONER BLOOM: Yeah. I just am reading
2 this one piece of your testimony that I just wanted to
3 clarify and I'm sure you'll understand.

4 You said that a couple of the presenters put
5 forward there's a claim that state pension staff are hiding
6 fees from the public for the fear of losing their jobs. I
7 don't remember anybody actually using those kinds of words.

8 There has been a debate, there's been a
9 pretty healthy debate for the past six months, as long as
10 the commission has been here, as to private equity and
11 carried interest. And I don't think anybody has said that
12 people are hiding numbers or hiding -- it's a matter of how
13 they report the fees. I think everybody has tried to be
14 accurate and I think our staff are, as you put it,
15 qualified, hard working, ethical, and thinking first of the
16 pensioners, at least the ones that I've spoken to.

17 I just wanted to clarify because it looks a
18 little bad when, if we were listening to folks who were
19 telling us that people might lose their jobs for hiding
20 fees. I don't believe that's a, you know, any of that's
21 true. I just wanted to let you know.

22 MR. NESBITT: Thank you. Maybe those words
23 are strong. But I heard it twice in testimony listening to
24 the audio and video. So I just wanted to make it clear to
25 anybody else who was listening.

1 CHAIRMAN TOBASH: Okay. Great. We thank
2 you. We thank you once again for being here.

3 MR. NESBITT: Thank you.

4 CHAIRMAN TOBASH: We thank you for your past
5 assistance to the state and your current assistance to the
6 Commonwealth, and we would look forward to being in contact
7 with you as we work to close out this document.

8 MR. NESBITT: Thank you very much, Mr.
9 Chairman.

10 CHAIRMAN TOBASH: Thank you.

11 So we have passed the seventh inning stretch
12 and we're here, I think, with our final testimony of these
13 hearings. And we've got a distinguished gentleman with us,
14 Dr. Charles D. Ellis, extensive résumé, graduate of Exeter
15 and Yale College with an MBA from Harvard Business School,
16 Ph.D. from New York University, has served on the Board of
17 Trustees of Yale Investment Committee, Stern School of
18 Business at New York University, the Brown Foundation, and
19 CalPERS. As I mentioned, his résumé is extensive. We
20 appreciate him being here.

21 Here's what I think I know, he likes to be
22 called Charley. So with this résumé, humility is one of his
23 best characteristics, I think. And I think you hail from
24 Boston, is that -- Charley, are you a Boston native, a
25 Boston native?

1 DR. ELLIS: Roxbury, part of Boston as Boston
2 would define it. Fiercely independent, as people living in
3 Roxbury.

4 CHAIRMAN TOBASH: Okay, good. But that means
5 that you appreciate the fact that the left fielder,
6 Benintendi, last night made a terrific catch at the track
7 and that he hung in there in the fifth inning. My daughter
8 is living in Boston right now. That's her favorite player,
9 and I know that that made you happy, that the Red Sox won,
10 so we're happy that you're here and we're happy that you're
11 happy because of that.

12 DR. ELLIS: I think that's a very nice thing
13 to say.

14 CHAIRMAN TOBASH: We look forward to your
15 testimony. Thank you.

16 DR. ELLIS: I think we all ought to recognize
17 that it's late in the day and I'm sure I won't be as
18 articulate as I could have been earlier. And I'm sorry
19 about imposing on you for more time.

20 CHAIRMAN TOBASH: We're happy you're here and
21 you are the cleanup batter, so...

22 DR. ELLIS: I was given complete freedom,
23 which I'm going to take, because for the first time in my
24 life I'm not accepting a fee for doing any work for anybody
25 in the investment management world. And the reason I'm here

1 is that a man I have a high regard for has a very, very high
2 regard for your Treasurer. And we had a delightful
3 conversation and I realized, if he's going to be working on
4 the kinds of questions I think are really important, I would
5 like to help with him.

6 My deepest concern personally is that
7 retirement security is, in this country, increasingly at
8 risk, perhaps even a myth. And it shows up in a variety of
9 different ways, but it does show up in the public pension
10 sector, it shows up for sure in the private sector. And we
11 as a nation can see that a nightmare is headed our way
12 unless we start doing something about it. But since it's
13 not an immediate crisis, most people are putting it off.
14 "I'll worry about that later."

15 At my age, I can't put things off for very
16 long. So my focus and interest on that had me deeply
17 attracted to coming and spending a little time. And I would
18 love it if I could be truly helpful to you.

19 I am going to rehearse, or go over a decision
20 you've already made and just encourage you to keep on going
21 until you've got it completed. And that is the movement to
22 indexing and away from active management.

23 If you go back to 1965, when I was first
24 getting interested in investment management, active
25 investing was the only way to go. But every factor that

1 made that the only way to go then has been reversed 180
2 degrees and it no longer applies. Let me just give you some
3 of the characteristics, and they are, when you get down to
4 it, truly profound.

5 Back in 1965, trading on the New York Stock
6 Exchange by professionals -- and that's a guarded term --
7 was a little bit under 10 percent. Let's call it nine
8 percent. The rest was done by individuals who averaged one
9 trade every year or two. Half of their trades were in AT&T
10 because it was the most widely known stock. They had no
11 access to any research or information on companies at all
12 except the Standard & Poor's so-called tear sheet. It was a
13 five-by-seven-inch double-sided, and it looked only at the
14 past, it had nothing in the way of forecasting or what you
15 could expect. They had no reason to know what was going on.
16 And they might have read *Business Week* or *Forbes* or one of
17 the other business magazines, but they really relied on a
18 retail stockbroker. They were not hard competition.

19 The nine percent that were quote, unquote,
20 professional were dominated by regional bank trust
21 departments. You may remember, back then, banks were
22 limited to state lines or less. And so there were, in my
23 hometown now of New Haven, there were four trust companies.
24 And they bought laddered maturity bonds and they bought blue
25 chip stocks and they met once a month at investment

1 committee and had an approved list. And it was not a tough
2 group of competitors.

3 Today, 99 percent of the trading, not 9, but
4 99 percent of trading every day is done by machines driven
5 by artificial intelligence and by professionals, half of the
6 trading by professionals done by the 50 largest, toughest
7 traders. That is a very dangerous, aggressive, competitive
8 environment. And all of us need to recognize that that is a
9 really different world.

10 Let's talk about some of the other things.
11 Back in '65, Goldman Sachs had no analysts that served a
12 public purpose. They had 12 analysts that served the
13 partnership looking for small cap stocks. Today, Goldman
14 Sachs and every other major firm in offices all around the
15 world have about 600 industry analysts, company analysts,
16 GNP analysts, commodity analysts, and all kinds of other
17 people trying to find bits and pieces that could be helpful
18 to investors, the same terrifically aggressive professional
19 group of investors, to earn some commission business for
20 their activities. That is an unbelievable flood of
21 information and it's because of the internet. Everyone has
22 24-hour access to all of that information anytime they want
23 it.

24 The federal government has added to that
25 regulation FD through the SEC. It is required that any

1 public company that gives any investor any useful
2 information for investment purposes must make a diligent
3 effort to get that same information simultaneously to all
4 investors. So the secret sauce of acting investing, which
5 is to do more homework than the other people, get to know
6 the company better than other people, get more data, do more
7 careful analysis, that has been obliterated or commoditized
8 and everybody's got it.

9 Mike Bloomberg was still in school. There
10 are now 240,000 Bloomberg Terminals all over the world. And
11 if you look at how many people you have to have to justify
12 one of those terminals, it would confirm my best estimate,
13 that the number of people who are involved in active
14 investing has gone from less than 5,000, most of whom would
15 have been located on the Eastern Seaboard or in the United
16 Kingdom, to comfortably over 1 million people, all of whom
17 have had the same objective, find a pricing error, find an
18 imperfection and take advantage of it. And as a
19 consequence, the markets have become more and more and more
20 and more impossible to beat on anything like a systematic
21 basis.

22 There are two ways you can approach a
23 concept. One is to start with the theory, and the other,
24 start with the data. Einstein is famous for theory. So the
25 theory of efficient markets has been around for quite a

1 time. Darwin's get the data, the kinds of data I've just
2 been sharing with you, and there's half a dozen more
3 specific elements -- that I'd be glad to share, if you
4 wished it -- lead to the same conclusion. Bottom up, top
5 down. It's not going to be a good place to take on the cost
6 of operation.

7 An active manager costs about 100 basis
8 points a year in expenses that he incurs and trading
9 imperfections. Add to that fees of maybe 50 basis points,
10 you've got to pick up 150 basis points in a market where the
11 people that I think of as being the most knowledgeable
12 estimate total returns of six or seven percent in equities.
13 We're talking about 20, 25, or 30 percent better than the
14 competition who have exactly the same information you have,
15 exactly the same time you have, with just the same computing
16 power you have. They're just on different floors in the
17 elevator bank. And it doesn't make any sense for someone to
18 say, "I am going to pay the fees that are being charged and
19 I'm going to put up all the capital for a very unlikely rate
20 of return."

21 If you think mutual funds are a reasonable
22 proxy, people are trying hard. Now we have data that in the
23 last 10 years, 84 percent of mutual funds have failed to
24 keep up with the benchmark they chose to beat, the benchmark
25 they had the freedom to choose how to organize to do it,

1 this benchmark they are specializing in. That's a dreadful
2 consequence. Has it been addressed and exposed and talked
3 about a great deal? Certainly not, but it is a reality.

4 You say, "Well, what if you had made it
5 longer, 15 years?" It goes up from 84 percent to 86. Then
6 say, "Well, how about other markets?" In the United Kingdom
7 it's 87 percent.

8 So the whole concept of active investing was
9 right, but the world changed and changed and changed and
10 changed, and just as the kind of clothing that we would wear
11 on the weekend during the last couple of months is not the
12 kind of clothing we wear on a weekend in the next couple of
13 months, the world has changed and everybody should be
14 recognizing it. The fact that you have recognized it, I
15 think, is terrific. And I would urge you to go right on
16 ahead and complete the task. So that's the main part of
17 what I really wanted to say to you.

18 There are several specific things that, if
19 you would tolerate, I'd like to make gratuitous suggestions
20 for consideration in the future.

21 What has happened in active equity management
22 is candidly just the tip of the iceberg. The same thing has
23 been reproduced in fixed income investment management for
24 high grade or medium grade securities. It's going to be
25 picked up and carried through to all the other types of

1 investment because there's a huge money flow that's looking
2 for higher rates of return. Some of it is sophisticated;
3 candidly, some of it is not sufficiently sophisticated or
4 sufficiently aware of the difficulties to recognize how hard
5 it's going to be to compete with all that other money that's
6 coming in to compete for access to the very best investment
7 managers.

8 You probably know that in venture capital, if
9 you're not in the top 10 by number, not 10 percent, top 10
10 managers, you are going to underperform the public market if
11 you go into venture capital, because the top 10 gets all the
12 superior rates of return. It's not unlike that in private
13 equity. The very best firms that do the best work already
14 have a superb clientele that they are serving on a regular
15 basis. And they are not competing for or looking for new
16 money.

17 By the time you get to the second quartile,
18 that would be open for business and interested in adding
19 more money, you're running the risk of drifting down towards
20 normal public market rates of return. By the time you get
21 below the median, you're really in serious difficulty. And
22 I think all of us ought to recognize how difficult it is
23 now, and it's going to get more and more and more difficult
24 because the amount of money is piling in at a terrific rate.

25 If I can make a suggestion, this commission

1 would be wise to stay focused on the passive or indexing
2 versus active, complete that task, illustrate how wise you
3 have been, and go back with a recommendation for further
4 study by other groups or yourselves of a blue chip, blue
5 ribbon commission to study other questions of real moment.
6 But I would urge you, don't try to factor them in with the
7 kind of a report that you have been mandated to achieve, as
8 I understand it, and which you're very close to having
9 terrific documentation for and a very strong case to be
10 made.

11 Let me pick up on some of the things that
12 might be of caution.

13 Could we get a really great blue ribbon
14 commission? I think the answer is yes.

15 I'm from Connecticut. I do not know
16 Pennsylvania well. But if you took Pennsylvania and just
17 said the 10 largest endowments, could you find really
18 talented people? I think so. If you took the 20 largest
19 investment managers, could you find substantial numbers of
20 people? I know so.

21 I spent -- for 10 years, I was the director
22 of Vanguard. They are filled with extraordinarily talented,
23 public servant-oriented, caring, boy scout types of people.
24 You've got at least 100 corporations that's got, for their
25 pension staff, very capable people. And then you have all

1 the people that retired in the last five to ten years who
2 are still very knowledgable about what the issues are, very
3 well connected, and have a substantial amount of experience.
4 It would be easy, in my view, for this extraordinary
5 Commonwealth to put together a first rate group of people to
6 do serious study of other questions that I would urge you as
7 a particular commission not to get involved.

8 The returns in public equity are going down
9 because the volume of money that is chasing after public
10 equity will be taken in by firms, and will therefore be
11 competitive in the market for opportunities to buy things
12 that could be taken private. The competition will raise the
13 prices, and when the price level going in has been raised,
14 the rate of return at the end -- I'm sorry, the price level
15 at the end does not get changed, but the rate of return in
16 the space in between does get changed and the rate of return
17 is clearly going down. It will go down for the top firms,
18 but it will go down more for the next tier firms and go down
19 even more for the next tier of firms. So it would be a
20 very, very difficult period.

21 If I can be just blunt spoken, when somebody
22 says "fee and carried interest are different," I agree with
23 that mechanically, legally, and so on. But everybody I know
24 in Wall Street and everybody I know in investment outside of
25 Wall Street is absolutely clear, they are part of the same

1 thing. That's what we get paid. And the cost and risk gets
2 absorbed by the clients. This is worth paying close
3 attention to. You put up 100 percent of the money, you take
4 100 percent of the risk, you have 100 percent of the
5 liquidity, and then the managers claim a 20 percent carried
6 interest. If that isn't part of their compensation or the
7 reason they're in business, it would be news to me, and
8 candidly, it would be news to them.

9 You heard twice today or three times today
10 that steady contributions into the system would be very,
11 very valuable. Yes, full stop.

12 It would be really worthwhile having careful
13 study done of the actuarial assumptions as to rates of
14 return. They do appear to me to be seriously high. And I
15 recognize that if you look back over the last 30 years,
16 there have been some truly wonderful times in rates of
17 return.

18 Almost no one who is active today was around
19 when Paul Volcker drove interest rates on 10-year treasuries
20 to 13 percent in order to break the back of inflation,
21 wonderful public service. Footnote, during that entire
22 period, with all the abuse he was taking in public and from
23 politicians, he was, every weekend, going back to New York
24 to take care of his infirm wife and cook her meals for
25 Saturday and Sunday, and leave in the refrigerator, Monday,

1 Tuesday, Wednesday, Thursday, Friday meals. Wonderful human
2 being, devoted to the American interest and did this nation
3 a world of good.

4 But the market went down in that period by
5 more than it went down in 1929, if you include inflation.
6 We really got hurt. And that drove the market to such a low
7 level that anything coming back should have recognized where
8 it came from. Sure, the returns were high, but they were
9 nominal returns. If you recalibrated and took 1968 as your
10 base, you wouldn't have seen those returns as being all that
11 great. Be careful how people take old data and apply it to
12 a new situation.

13 I have difficulty understanding why you have
14 two difficult plans from the point of view of investing and
15 what I would call the back office operations. I can
16 understand why you have two different plans in terms of
17 representation of the teachers and representation of all
18 other employees, but why they ought to be operationally
19 separated doesn't sound like anything that would be chosen
20 by a rational observer.

21 The best managers are capacity constrained in
22 private equity. If you have, your organization has managers
23 who are not private capacity constrained, they are not the
24 best managers because the best managers attract the best
25 clients and they seek out the best clients and they have

1 already cleared the table before the rest of us get there.
2 So if you accept that there's capacity constraint, it's only
3 with those who are earning the right to be capacity
4 constrained through the excellence of their work. And I
5 would be very, very careful of the way the terminology gets
6 moved around.

7 I would urge you to consider the possibility
8 of developing a consortium of the major state funds to deal
9 together on resetting the terms. Doing it one at a time
10 can't work because you'll be played off against each other.
11 But if you had a consortium, you might very well be able to
12 make a real change, and there's plenty of room for real
13 change.

14 I'd like to just stop with an invitation for
15 any questions, particularly tough questions, and a thank
16 you.

17 I've had a wonderful experience being able to
18 come and to sit in on the testimony that you heard before.
19 I've learned a lot. I haven't been pleased by some of the
20 things that I've learned. But I've had the privilege of
21 getting to know some of the members on this commission and
22 I've been deeply impressed by the caliber of their
23 commitment and the quality of their intention to serve the
24 Commonwealth. And it makes it, from my point of view, worth
25 the trip and I can't tell you how much I appreciate it.

1 Thanks.

2 CHAIRMAN TOBASH: Mr. Ellis, we're --
3 Dr. Ellis, we're honored that you're here.

4 DR. ELLIS: Charley will do.

5 CHAIRMAN TOBASH: Again, we appreciate it.
6 So you heard some conversation today about
7 governance and you've dealt with many different pension
8 systems and you're taking a look at the system right here
9 that has got two boards that are not the same, but in some
10 essence they are. They are political appointees, appointees
11 from different stakeholder groups. What's your perspective
12 on how an organization, a pension organization, can be most
13 effectively directed by a board that is capable and lacks
14 influence to the extent that they can make the difficult
15 decisions to win a loser's game?

16 DR. ELLIS: For the representation of the
17 beneficiaries and the representation of the Commonwealth, I
18 think you've got a fine board, because they are
19 representative and hopefully they're well chosen.

20 For investment management, a highly
21 specialized, rapidly changing, increasingly competitive, and
22 increasingly difficult field, to ask people who are not
23 deeply immersed virtually full-time in that work is unfair
24 to them and unfair to the people who will be dependent upon
25 the results of their work. You should be developing an

1 independent board, a separate group, who are directly
2 responsible for the investment management.

3 Yale University has got a wonderful group of
4 trustees. They serve with distinction for years. They have
5 wonderful characteristics, but we very deliberately choose a
6 small group of people to do the investment management, all
7 of whom are investment experts, otherwise it can't be done.

8 CHAIRMAN TOBASH: Thank you.

9 Mr. Vice-Chairman, questions?

10 VICE-CHAIRMAN TORSELLA: Thank you.

11 And thank you so much for being here and for
12 doing a great public service to a state that's not your own.
13 But I'm not sure -- this isn't in my charter as Treasurer,
14 but I think I hereby declare you an honorary Pennsylvanian.

15 DR. ELLIS: I'd be honored to accept if it's
16 your jurisdiction.

17 VICE-CHAIRMAN TORSELLA: Can I get away with
18 that? I'm asking the legislator.

19 DR. ELLIS: You know, if you go outside and
20 come in again, this truly beautiful building, it's got all
21 kinds of very nice decorations. One of them is a citation
22 from William Penn, who's talking about what he really had in
23 mind for Pennsylvania, that it would set an example for
24 others. And candidly, that's why I'm here and that's why
25 I'm so pleased that I'm here because you are setting an

1 example for all those others who haven't done what you've
2 done, which is identify the need for some specific service
3 on indexing versus active. Nice home run. And then I hope
4 that you will find a way to get the legislature, the
5 Governor, or both, to recognize there's a real opportunity
6 to do many other component parts of the total complexity of
7 the system of investment management.

8 VICE-CHAIRMAN TORSELLA: If we succeed in
9 that, it will be in part due to your doing us the courtesy
10 and the service of coming, so thank you.

11 On indexing, you know, we do hear from time
12 to time two things. One, you hear the assertion that, well,
13 that makes sense for large cap stocks, large cap U.S.
14 stocks, but for other places where there are, you know, less
15 efficient markets, it doesn't make so much sense. Even
16 though my reading, at least, of the SPIVA data is that the
17 same numbers obtain -- and I wanted to ask you for your
18 views on that or why you think that there's still this
19 persistent view that in things other than large cap U.S.,
20 active management makes sense.

21 The second thing we sometimes hear is, going
22 to your top down, bottom up, people will say, "Well, the
23 theory of it is plausible, but my managers have
24 outperformed. You know, we've had five years of
25 outperformance, so shouldn't we keep sticking with that?"

1 If you can comment on those two things,
2 that'd be great.

3 DR. ELLIS: Sure.

4 I've probably had more opportunity to study
5 investment managers than anyone else in the world. I spent
6 30 years as a managing partner of Greenwich Associates and
7 our principal line of work that I was involved with was
8 investment managers. And we had clients in every major
9 market around the world. And we worked with the investment
10 managers in every one of those markets, usually the top
11 three or four people in the firm and usually the top four or
12 five managers in each market -- sorry, usually the top ten
13 or a dozen managers in each market and the top four or five
14 people within each of those managers.

15 And one of the things that is a dreadful
16 reality is that they come and they go. And I first
17 recognized that after we had been doing this kind of work
18 for 10 years. Isn't it astonishing, some of the people who
19 were at the top are no longer included in the top 10, no
20 longer included in the top 20. Then I started paying
21 attention to that. And as the years went by, it got worse
22 and worse and worse, because it's a hugely competitive
23 business and the data that people are making decisions on is
24 statistically interesting, but it is not statistically valid
25 because it's a way too complex process of investment

1 management and comparative. It makes it a doubly way too
2 complex process and small differences do show up and cause
3 people to make major moves, clients to make major moves,
4 which is, over time, notoriously a mistake.

5 Best estimate that I have is that the error
6 rate on changing managers for major corporate and public
7 funds runs somewhere between 100 and 150 basis points per
8 year on average. That's a serious penalty.

9 Do people recognize it? No. Because the
10 decision-makers change and change and change. We don't
11 examine the study data of what's happened to us in the past.
12 It's only when SPIVA came in with the data on the mutual
13 funds that anybody had any recognition. "My Lord, look at
14 what an enormous failure rate is taking place." And these
15 are wonderfully talented, hugely carefully chosen people who
16 are given mandates that are really responsible, not just to
17 the clients, but to the managers of the firm. And still
18 you've got over 80 percent failing in such a short period of
19 time. And that confirms the experience that I had.

20 And that was not in any other country where
21 it really changed. It's a dreadful irony that all the firms
22 will recognize that they've gotten better. This is a major
23 point that I'd like to have made earlier.

24 Every firm that I talk to knows that they're
25 better. They've got better computers, they've got more

1 capably, more carefully trained staff, they've got much
2 better models on their computers. They learned a lot and
3 they are raring to go because they know they're better than
4 they were 10 years ago. What they don't recognize, but only
5 an outsider might be able to recognize, is that they're
6 actually getting closer and closer and closer and closer to
7 being equal in their capabilities because they all have
8 Bloomberg, they all have the internet, they all have SEC
9 regulation fair disclosure, they all have 600 analysts at
10 every major security firm pumping stuff into them all the
11 time. They all have everything you could dream of having.
12 And they're, therefore, more and more and more equal. Then
13 when they get more and more equal, it's harder for them to
14 beat the other guys enough to cover the costs or the fees
15 and get back to even again, so they fall short. It's real
16 short. And it's not going to change.

17 People ask me, "Oh, Charley, indexing has
18 been doing so well, I'm sure it can't continue to do that
19 well. There's going to come a time when it's time to go
20 back into active investing." Candidly, I look at all the
21 different ways people have come up with and they all sound
22 like prune juice to me, but there's one that I think is
23 sure. If we could get the million people who are actively
24 involved in active investing right now to drop down to
25 50,000, 25,000 -- gee, wouldn't it be great if it went down

1 to 10,000? And we're talking about almost everybody saying,
2 "The hell with it, I'm giving up on investment management.
3 I know it's the highest paying line of work in the world. I
4 know it's the most fun line of work in the world. I know
5 it's the most traveling and other activities that are just
6 terrific. I don't want to do that anymore.

7 I want to go be a middle manager at some
8 middle-sized industrial company. And I'm going to have to
9 learn a lot in order to be able to do that, but I'm going to
10 get rid of all this." That's not going to happen. We
11 graduate enough people every year from business schools all
12 over the country and around the world to fill up any empty
13 spaces that are created.

14 Until you can get a large number of people to
15 say, "It's been a" -- and I say, "The hell with it," or
16 something equivalent to that and quit the business, you're
17 going to have too many people with too much talent with too
18 much information to be able to say, "I can go out there and
19 beat them." It ain't going to happen.

20 CHAIRMAN TOBASH: Thank you.

21 Commissioner Gallagher.

22 COMMISSIONER GALLAGHER: Dr. Ellis, I --

23 DR. ELLIS: Charley will do fine.

24 COMMISSIONER GALLAGHER: I hear that, but you
25 are of an exalted status, so I appreciate you being here and

1 sharing your insight so that we can make informed decisions
2 that will be generational in nature.

3 My question, I'm going to pose to you that I
4 posed to a former CIO of a very large Canadian system, who
5 is now working at a very large private equity firm in the
6 U.S. Same question, I said to him, "What's the difference
7 between your organization and a high school student with a
8 computer in California?" And he recognized, you know, the
9 uniformity of information that's available now to a lot of
10 people, to your point about, you know, how information is
11 getting flat. And his response was that, "Fair question,
12 I'll give you one example." His was that his organization
13 has a fleet of drones and they are able to fly over and
14 encase areas and measure car movements whether or not to
15 invest in real estate, right, or like retail real estate.
16 And I thought it was an interesting question to give them an
17 information advantage.

18 That's going to evolve over time, right? I
19 understand that. But it seems like that is an information
20 advantage that could be taken advantage of. What are your
21 thoughts about that?

22 DR. ELLIS: I'm going to give you a
23 reciprocal story and then I'd be glad to try to answer, if
24 that's not sufficient.

25 I am working with a small investment

1 management firm in New York that has, I think, designed a
2 very interesting system. They have seven analysts who are
3 in their mid-30s to mid-40s, who have made enough money so
4 that they put their money in the pot that they all are
5 managing. They're led by a man who made a very substantial
6 success and his money, entirely, in the pot. And they are
7 taking a small number of clients.

8 One of their lines of work is retail. They
9 are the only organization I know that calls a different
10 group of 30 different retail outlets every month to get
11 seven questions answered with regard to inventories in those
12 outlets. They know more about that company's inventory
13 realities, that retail, than the management of the company
14 knows because they've tested it out. That's the degree at
15 which skill levels are going.

16 We've all heard about drones and satellites
17 checking to see how many automobiles are in various parking
18 lots. That's sort of standard stuff now. The degree of
19 specificity of over-the-top information gathering is simply
20 astonishing. And that extraordinarily gifted firm also has
21 made the sensible view, they're not going to do anything
22 with the thousand largest companies, which of course, as we
23 all know is where almost all of us have almost all of our
24 money invested, whether we like it or not. So they stay
25 away from all the big ones. They're looking for small

1 companies that nobody else is following. If they knew there
2 were two analysts from Wall Street following them, they'd
3 stop. It's one of their checks.

4 And for all the work that they put into it --
5 and boy, are they price sensitive and marvelous people and
6 gifted -- they're just barely lagging behind the market
7 average. I think that's tremendously compelling
8 information.

9 I think it's compelling information when
10 Warren Buffet says, "For my wife, I would like her to
11 index." He's the best investor any of us know of or will
12 ever meet.

13 I have the privilege of having a friendship
14 with Warren that goes back a long, long way. And when I was
15 teaching a course on business ethics, I thought, "What a
16 terrific thrill this would be." I had the head of insider
17 trading litigation at Davis Polk come for one class. I had
18 the *Consumer Reports* head for a class on credit card
19 manipulation and things like that. "Now, if I could get
20 Warren to come, that would just be over-the-top wonderful."

21 So I invited him to come to Yale and sit in
22 with the students. He said, "Charley, I can't do that, but
23 I'll tell you what I will do. If you bring the students out
24 to Omaha, I'll spend two hours with them." Done deal? Not
25 yet, got to find out how we're going to cover the cost

1 because a lot of these students at Yale, as you probably
2 know, about half of them are on scholarship. So I checked
3 in with the family that sponsors this particular course, and
4 they said, "We'd be thrilled. We'll pay for all the
5 students to go. We'll pay for the rooms and we'll pay for
6 the meals." So we went out free of charge. Two hours with
7 Warren Buffet. What a thrilling experience.

8 I asked the students, "Do me a favor, let's
9 have a competition for who's got the best question to ask
10 the smartest person in any room we're going to go to the
11 rest of our lives." Because that is how good Warren is at
12 this sort of stuff.

13 So we had a really interesting -- and it was,
14 you have to write out the question and you have to have two
15 follow-up questions, and then we as a class of 27 will
16 decide which of the questions in which order. We only got
17 to the fourth question because Warren gave such complete
18 answers to every question that was put up, pros, cons,
19 complexities, what to think about the past, how to think
20 about the future. When he says, "I'd like my wife to invest
21 in index funds," I don't need to know a hell of a lot more.

22 My friend, David Swensen, who is the chief
23 investment officer of Yale's -- probably has the best record
24 that anybody in institutional investing has ever had --
25 said, "Indexing is the only sensible way for almost

1 everyone."

2 And then if you want to ask a rude and blunt
3 question, "What are you doing with your own money?" My
4 family and I are indexers, with one exception. Back in the
5 early 1970s, I lucked into Berkshire Hathaway, and that's
6 close enough to an index fund. And I don't want to meet
7 Warren some day and have him say, "Charley, I hear you sold
8 out on my investing." No, I'm not going to do that. So
9 I've left it for old time's sake. Other than that, index.

10 COMMISSIONER GALLAGHER: Thank you.

11 CHAIRMAN TOBASH: Commissioner Torbert.
12 Thank you.

13 COMMISSIONER TORBERT: My turn, Charley.

14 DR. ELLIS: Great.

15 COMMISSIONER TORBERT: One of the things that
16 you mentioned was about the back office operations of the
17 two systems. So if I understood that correctly, your
18 thinking would be, maybe consolidate back office, but yet
19 have your two investment teams.

20 DR. ELLIS: Yep.

21 COMMISSIONER TORBERT: Am I thinking that
22 way?

23 DR. ELLIS: I'm comfortable if you said, "We
24 would be uncomfortable having to integrate the two
25 investment decision-making units," but I'll bet a lot of

1 other parts can be integrated and a reasonable cost saving,
2 but an upgrade in terms of the capability set that you would
3 have to work with.

4 Personally, I would integrate the investing,
5 but that's a personal thing. And I don't know anywhere near
6 enough to think my opinion has any valid, any throw-weight
7 here.

8 COMMISSIONER TORBERT: Another question is,
9 in the business of investments, you see a lot of volatility.
10 A great example is the past week -- by the way, the market
11 seems to be doing really good today. And part of the reason
12 for the dramatic change up and down is because of all the
13 indexing. I mean, they go in in mass numbers and they pull
14 out in mass numbers.

15 DR. ELLIS: Okay, we're going to disagree on
16 this subject. I'll just prewarn you.

17 COMMISSIONER TORBERT: Well, your quick
18 thoughts on that.

19 DR. ELLIS: I happened to have gotten
20 interested in indexing back in the early 1970s. And in the
21 mid-1970s, I did my Ph.D. dissertation on why corporate
22 pension funds -- because that's where I had data access.
23 Clearly, given the criteria, they said, "We want reasonable
24 fees, we want regular returns, we want reliability." They
25 would, serious, be wonderful opportunity for them to use

1 indexing, so that's surely the way they're going to go. And
2 item by item by item, I proved it wasn't true. They didn't
3 care about the fees, they didn't care about volatility. No,
4 they didn't care about diversification and they certainly
5 didn't care about indexing.

6 So as time has gone by, it's been really
7 quite pleasing for me to see, well, I may have been wrong
8 when I turned in my dissertation and had to defend it before
9 the faculty. But it's coming right and coming right and
10 coming right. And then the data that's being collected
11 today, there would be a wide acceptance that indexing is a
12 very sensible and realistic way to go. It's a little bit
13 of -- well, it's working out so far.

14 One of the questions people have about
15 indexing is, "Isn't it true that index funds are banal, and
16 just have to do whatever the index does and isn't there
17 enough money following a banal process that's going to slosh
18 into the market and be highly predictable? Besides, we know
19 exactly what it's going to do and if I know what my
20 competitor is going to do, that makes it easier for me to do
21 something that is different." And none of those things
22 appear, by looking at the data hard, appear to hold up.

23 One dimension that I particularly put focus
24 on is, there's got to be an impact on trading. Yes, but if
25 you were an index fund manager, you would look at that as a

1 problem that you need to deal with. And sure enough, the
2 major index fund managers have figured out ways that they
3 can lead and lag on indexing, changes in the index. And
4 they're able to use derivatives a lot for that purpose so
5 that they're basically invisible and also no waves being
6 created.

7 And they say to you, you know, "We hear this
8 and we hear this and we hear this, but we can't find it in
9 our own operations. We don't see any difficulty." And then
10 they start laughing, "But you should see what the active
11 managers are struggling with, it must be driving them
12 crazy." But we've got problems that we've identified and
13 we've figured out ways to manage those problems so they're,
14 honestly, just no problem. And I'm -- you know, we're just
15 talking candidly together, just as you and I are, Mike.

16 COMMISSIONER TORBERT: Oh, I'm not saying I
17 disagree with you. I'm just asking the question.

18 DR. ELLIS: Yeah. Thank you.

19 COMMISSIONER TORBERT: Two quick comments.

20 Back in '84 when I was a broker trying to buy
21 Pennsylvania municipal bonds for my clients and hearing that
22 I couldn't get any because Vanguard was buying them all.
23 They almost take down the whole, you know, debt group. And
24 then years later, when I was a portfolio manager with PNC,
25 that owned 80 percent of Blackrock at the time, I was in New

1 York City on the bond trading floor at Blackrock. And it
2 was big as the cafeteria with people in Bloombergs and
3 yelling to each other, buying bonds all over the world, and
4 I thought, "No wonder, you know, that's probably the way to
5 go in the future." Obviously, it was.

6 I'm not against indexing at all. As a matter
7 of fact, I manage my own portfolio, which is index funds and
8 some good dividend producing stocks. But I see that as a
9 value added for sure when it comes to passive versus active,
10 but I think there's room for both. And especially when it
11 comes to private equity because you can't really do indexing
12 on a private equity.

13 DR. ELLIS: Agreed, on private equity.

14 COMMISSIONER TORBERT: But you have got to,
15 you know, really be careful with private equity and really
16 do a lot of study and research on that.

17 Thank you very much for your...

18 DR. ELLIS: Thanks for the hospitality last
19 evening, too. That was very nice.

20 CHAIRMAN TOBASH: Okay, that --

21 COMMISSIONER BLOOM: I'm sorry, Dr. Ellis is
22 looking at me waiting for a question.

23 CHAIRMAN TOBASH: That's all right. I'm
24 sorry.

25 COMMISSIONER BLOOM: Did you go to Roxbury

1 Latin?

2 DR. ELLIS: I did not. I went to Elbridge
3 Gerry School and then I went to the junior high school of
4 Marblehead, Massachusetts, and then I went to Phillips
5 Exeter Academy.

6 COMMISSIONER BLOOM: I'm just checking.

7 DR. ELLIS: I have to tell you, if I could
8 have gone, if I had known about Roxbury Latin, or better, if
9 my parents had known about Roxbury Latin, I suspect that's
10 where I would have been sent, if I could get in.

11 COMMISSIONER BLOOM: I got you.

12 Thank you very much, Doctor.

13 CHAIRMAN TOBASH: Okay, Dr. Ellis, thank you
14 very much. We appreciate you very much being here today.

15 And I just want to thank -- that concludes
16 our testimony. I just want to thank the entire staff, the
17 Joint State Government, the House staff, the Treasurer's
18 staff, everyone that's been involved in the process so far.

19 I want to thank the commissioners. We
20 certainly have got a lot of information to consolidate and
21 get into a report that we will deliver to the administration
22 and the general assembly.

23 I just want to applaud all of the testifiers.
24 As I have mentioned on a number of occasions, we have a lot
25 of work to do and I think that we can do outstanding work.

1 And the Commonwealth of Pennsylvania has an opportunity to,
2 only an opportunity, to implement some of the
3 recommendations that we have heard from the testifiers and
4 from the document that we will put together.

5 So with that said, our next official meeting
6 will be December 12th, at a location to be determined here
7 in the Capitol. At that point in time, we expect to have a
8 final product that we will vote upon.

9 As I mentioned at the beginning of the
10 meeting, any additional comments or amendments, addendums,
11 additions, or changes to the document that we handed out
12 today should go through Joint State Government and that will
13 bring our hearing today to a close.

14 Thank you.

15 (The hearing concluded at 3:34 p.m.)
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C E R T I F I C A T I O N

I hereby certify that the proceedings are contained fully and accurately in the notes taken by me on the within proceedings, and that this copy is a correct transcript of the same.

Summer A Miller

Summer A. Miller, Court Reporter
Notary Public