PSERS seeks to generate the highest risk-adjusted net-of-fee returns over time. To fulfill this objective, PSERS employs External Portfolio Managers in areas where it does not have the in-house expertise and/or where PSERS believes the manager can reliably outperform its peers and a net-of-fee benchmark. One component of whether to hire, retain, or terminate an External Portfolio Manager is the investment management fee charged by that manager for its services. In recognition of the importance of investment management fees, Investment Office Professionals (IOP) have developed this External Portfolio Manager Fee Policy.

**Purpose**

The purpose of the policy is:

* To define the different variables of an investment management fee structure
* To describe the elements of a good investment management fee structure
* To describe the approval process for an investment management fee structure with an External Portfolio Manager
* To establish a process for the reporting, disclosure, and review of investment management fees.

**Scope**

This policy applies to External Portfolio Managers in both Traditional Investments and Non-Traditional Investments.

**Roles and Responsibilities**

* Allocation Implementation Committee (AIC)(Staff Level) – (1) Develops overall fee goals and objectives for PSERS. (2) Reviews the annual investment management fee report (described below in the *Reporting, Disclosure, and Review*section). (3) Approves the investment management fee structure for a new External Portfolio Manager mandate as part of its overall approval of that manager or mandate. The AIC’s approval is referred to the CIO, who may forward to the Investment Committee for review and then the Board for approval. (4) Approves changes to the investment management fee structures of current External Portfolio Manager mandates. These changes may be desired as IOP re-underwrites a manager, establishes additional mandates with a manager, increases the mandate, or some other reason. The Board does not require that these changes be approved by them. However, material changes are disclosed to the Investment Committee in the annual investment management fee report.
* Investment Consultants – Provide guidance to the AIC as to how fee structures are evolving in general, and in particular whether a specific structure for a manager is consistent with prevailing market standards.
* Investment Committee (Board Level) – Reviews the fee structure for a new External Portfolio Manager mandate through its overall review of that mandate. The Committee also receives the annual investment management fee report from IOP.
* The Board – Approves the fee structure for a new External Portfolio Manager mandate through its overall approval of that mandate.

**Variables of an Investment Management Fee Structure**

* Base Fee – Provides the External Portfolio Manager sufficient revenue to cover the cost of its operations. It is typically calculated as a percentage of assets under management (AUM) for Traditional Investments and as a percentage of either invested capital or committed capital for Non-Traditional Investments. The Base Fee (also known as a management fee or a fixed fee) is often tiered, where incremental additional investments are charged a progressively lower amount.
* Profit Share – Compensation earned by the External Portfolio Manager for outperforming the benchmark established by PSERS for that manager; it is the reward for skilled outperformance and appropriate risk management. It is typically defined as a percentage of the outperformance. Also known as performance fee, incentive fee, carry, and carried interest.
* Hurdle Rate – The minimum return, net of the Base Fee, needed before an External Portfolio Manager can earn a Profit Share. The Hurdle Rate can be 0%, a fixed rate also known as a preferred return (e.g., 8%), or a variable rate such as the return of a benchmark (e.g., the S&P 500). The Hurdle Rate may be coupled with a Catch-up provision.
* Catch-up – The period of time during which the External Portfolio Manager receives the majority or all of the profits until the Profit Share is reached. Catch-up provisions can range from 0% to 100%.
* Crystallization Frequency – How often the Profit Share is paid out to the External Portfolio Manager. In Non-Traditional Investments asset classes, the Profit Share is paid either on an American basis (deal-by-deal) or a European basis (at the end of the fund’s life). In other asset classes, it is paid typically on a calendar year basis (e.g., paid out every year).
* High Water Mark – If an External Portfolio Manager has underperformed the Hurdle Rate in a previous period (as provided in an applicable agreement), the manager must first recover this amount before it is eligible to earn a Profit Share in the subsequent period. In effect, previous underperformance creates a loss carryforward. High water marks may be standard or modified. Under a standard high water mark, Profit Share is not received until all underperformance has been recovered. Under a modified structure, Profit Share is paid at a reduced rate until all previous underperformance has been recovered.
* Fee Cap – The maximum fee payable to an External Portfolio Manager. Most agreements do not contain Fee Caps. A Fee Cap typically applies to the sum of the Base Fee and Profit Share and is designed to curb excessive risk-taking.
* Lock Up – The time period during which PSERS is not permitted to redeem or reduce its investment with that External Portfolio Manager. Generally, the longer the Lock Up, the lower the Base Fee and/or Profit Share. Other agreement terms such as gates, notice periods, and side pockets are also sometimes used to regulate or limit the ability of investors to redeem or reduce their investment.
* Netting – In cases where PSERS has more than one mandate with a management firm and each of those mandates has a Profit Share, PSERS will seek to pay a Profit Share only on the net Profit Share across all the mandates PSERS has with that management firm.
* Clawback – In cases where PSERS has paid a Profit Share that subsequent poor performance renders excessive, PSERS can “claw back” the excess. In some cases, a Profit Share is deposited into an escrow account in order to make a future Clawback more secure.
* MFN (Most Favored Nation) – A stipulation that no investor in a similar strategy will receive a better fee structure than any other investor of comparable or lesser commitment amount.
* Other Variables – In general, fees payable to an External Portfolio Manager with large remaining capacity or in a strategy with large capacity are lower than otherwise. Also, in cases where PSERS makes a large allocation to the manager (relative to the fund’s size or relative to other investors), makes that commitment early in the manager’s capital raising cycle, or has a previous relationship with that manager (from other mandates or other funds), fees are lower than otherwise. Finally, PSERS can often obtain an Advisory Board Seat with an External Portfolio Manager, which, while not directly providing any fee savings to PSERS, provides value to PSERS in the form of better governance oversight over the manager.

**Elements of a Good Investment Management Fee Structure**

Because we cannot know future returns with certainty, the optimal fee structure is one that leaves PSERS with a higher *expected* risk-adjusted net-of-fee return than any reasonable alternative. Significantly, this might mean that the total amount of fees (i.e., Base Fee plus Profit Share) paid to one External Portfolio Manager is higher than would be paid to another manager if the chosen manager’s expected risk-adjusted net-of-fee return is higher than that of the other manager. Consequently, a good investment fee structure does not seek simply to minimize fees paid to the manager but instead seeks to maximize the expected risk-adjusted net-of-fee return of that manager. In other words, it is fee-efficient.

It is important to recognize that there is no single fee structure, or range of settings for each of the variables, that will do this in all cases. However, a good fee structure has many or even all of these elements:

1. Is simple
2. Aligns the interests of the manager and PSERS
3. Promotes a focus on outperformance and idea generation by the manager
4. Rewards outstanding long-term performance by the manager
5. Splits any outperformance fairly between the manager and PSERS
6. Provides relatively more of the outperformance to PSERS when absolute returns are low and relatively less of it when absolute returns are high (in other words, PSERS is willing to give up outsized positive absolute returns in return for earning higher absolute returns when absolute returns generally available in the markets are low, in order to more consistently and reliably achieve its actuarial required return)
7. Helps cover the reasonable overhead costs of the manager
8. Promotes an entrepreneurial mindset at the manager
9. Allows the manager to attract and retain skilled talent
10. Discourages asset gathering by the manager
11. Discourages excessive risk-taking by the manager
12. Is not game-able by the manager
13. Encourages the manager to interact with PSERS’ Internal Portfolio Managers and provide them ideas and/or co-investment opportunities.

The final element above relates specifically to PSERS and the fact that it manages a significant portion of its assets internally. External Portfolio Managers, in addition to providing asset management services for PSERS, are a source of insights and co-investment opportunities that PSERS should exploit for its internally managed portfolios. In return for the fees PSERS pays them, these managers must be willing to provide these insights and co-investments opportunities to Internal Portfolio Managers. It should be PSERS goal to align and incentivize Internal Portfolio Managers with appropriate Profit Share structures similar to those provided to External Portfolio Managers in order to attract, retain, and promote internal alpha generation.

A fee structure that relies solely on Base Fees does not contain all of these elements and is not optimal. Such structures encourage asset gathering and alpha dilution.

A fee structure that relies solely on Profit Share also does not contain all of these elements and is also not optimal. Such structures do not cover the overhead costs of the manager and can encourage excessive risk-taking. (Note: If only a portion of the manager’s assets under management is Profit Share only and the rest has a Base Fee component, then the overall fee structure for the manager is more balanced and therefore far closer to optimal.)

In general, in a fee negotiation with an External Portfolio Manager, PSERS will begin with the manager’s standard fee schedule and structure and end with a fee schedule and structure that contain the above elements in a way that maximizes the expected risk-adjusted net-of-fee return. The optimal fee structure negotiated will typically have both a Base Fee component and a Profit Share component, and be analyzed using a variety of different potential return outcomes.

**Approval Process**

When introducing a new External Portfolio Manager mandate, prior to commitment, IOP will, in accordance with this policy, negotiate a fee structure with the manager and present that structure to the AIC as part of the overall approval process for that mandate. Once that mandate is approved by AIC, it is referred to the CIO, who then may submit it to the Investment Committee for review and then to the Board for approval.

For a current External Portfolio Manager mandate, where IOP believes a better fee structure is warranted, IOP will negotiate a new structure with the manager and present that structure to the AIC for approval.

All documentation regarding fee negotiations, including notes and votes, shall be stored in Tamale.

**Reporting, Disclosure, and Review**

There exists no uniform standard for asset owners or public pension funds for the reporting and disclosure of investment management fees. The Governmental Accounting Standards Board (GASB) and [Government Finance Officers Association](http://www.gfoa.org/) (GFOA) have not taken a stance on a reporting structure for investment management fees, nor have any federal or state regulatory agency issued any guidelines or standards. Where possible, IOP will work with accounting, regulatory, and other external bodies to assist in the development of such a uniform standard. It is important to highlight that PSERS’ manner of reporting and disclosure may be different from those of its peers until uniform standards are adopted. One implication of this is that it may be difficult, if not impossible, to fairly compare the fees paid by PSERS to the fees paid by other public pension funds. Another implication is that there is no accepted benchmark for the appropriate level of investment fees paid by public pension funds, and therefore no basis for determining if a particular public pension fund’s fees are high or low.

PSERS does not report a gross-of-fee return for the fund as a whole, whether historically, currently, or prospectively, as to do so would be expensive and time-consuming for no discernable benefit. Calculating a gross-of-fee return for the fund as a whole is difficult since some assets are held in limited partnerships for which there is no standard or precedent for reporting a gross-of-fee net asset value, much less what expense items belong or do not belong in a gross-of-fee net asset value or even what items count as expenses and fees.

The Institutional Limited Partners Association (ILPA) has developed a template for standardized fee reporting of limited partnership-type investments such as private equity. It is currently promoting these guidelines to encourage pension plans and investment managers across the U.S. to adopt them as the best practice for investment fee reporting. However, fees reported in the ILPA template are not required to be reported or disclosed in a public pension plan’s financial statements. PSERS will generally require its Non-Traditional External Portfolio Managers to submit information to PSERS using the ILPA template. (Note: The ILPA template also has a standardized breakout of other expenses (e.g., legal costs, audit costs, taxes). These other expenses are in all funds, whether mutual funds, limited partnerships, ETF’s, etc. These costs should be audited by a third party, so that they can be deemed reasonable fund level expenses. PSERS does not view these expenses as investment management fees, because such fees are not paid by the fund to the manager.)

Once per year following the end of the fiscal year, IOP will submit to the AIC an investment management fee report that aggregates fees paid to all External Portfolio Managers. Total fees paid will be shown in dollars, in basis points of PSERS net asset value, and in basis points of PSERS gross exposure. This report will also provide a breakdown between Traditional Investments and Non-Traditional Investments, between Base Fee and Profit Share, and asset class by asset class. For fund-of-fund managers or managers-of-managers, PSERS will make a good faith effort to obtain and report the Base Fee and Profit Share of the underlying funds or managers. This report will also show how these figures compare to previous years, identify any significant trends, and list action items to be taken for the coming year with respect to investment management fees (e.g., identify those managers where fees should be re-negotiated).

Once per year following the end of the fiscal year, AIC will refer this report to the CIO, who may submit this same report to the Investment Committee.

**Review and Revision**

IOP will review and revise, if necessary, this policy at least bi-annually as part of its investment program. Any changes to the policy must be approved by the AIC and CIO.

**Approval**

Approved by AIC: \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ Date: \_\_\_\_\_\_\_\_\_\_

Approved by CIO: \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ Date: \_\_\_\_\_\_\_\_\_\_