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WALL STREET FEES, INVESTMENT RETURNS, MARYLAND AND 49 OTHER STATE PENSION FUNDS

BY JEFF HOOKE AND JOHN J. WALTERS
Maryland Public Policy Institute
Maryland Tax Education Foundation

IN THIS REPORT, the Maryland Public Policy Institute and the Maryland Tax Education Foundation examine the investment fees and investment performance of Maryland's state pension fund. We compare and contrast these items to those of other state pension funds. A similar report was prepared in 2012.

State pension funds, including Maryland, have succumbed for years to a popular Wall Street sales pitch: "active money management beats the market." As a result, almost all state pension funds use outside managers to select, buy and sell investments for the pension funds for a fee. The actual result—a typical Wall Street manager underperforms relative to passive indexing—is costly to both taxpayers and public sector employees.

For example, the top ten states—in terms of Wall Street fees—had a lower pension fund investment performance—over the last five fiscal

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years—than the bottom ten states. See Table 5 in the report and the following. Note that returns are expressed "net" of fees.

	MEDIAN WALL STREET FEE RATIO	ANNUALIZED FIVE YEAR RETURN
TOP TEN WALL STREET FEE RATIO STATES	0.61%	1.34%
BOTTOM TEN WALL STREET FEE RATIO STATES	0.22%	2.38%
DIFFERENCE	0.39%	(1.04)%

State pension funds should consider indexing. Indexing fees cost a state pension fund about 3 basis points yearly on invested capital vs. 39 basis points for active management fees (or 92% less). For the five years ended June 30, 2012, we selected public security indexes that were good proxies for state pension fund asset allocations. Indexing provided a higher investment return. See Table 9 in the report and the following.

	ANNUALIZED FIVE YEAR RETURN
INDEX PORTFOLIO	2.19%
MEDIAN STATE PENSION FUND	1.50%
DIFFERENCE	0.69%

By indexing most of their portfolios, we conclude the 46 state funds surveyed could save $6 billion in fees annually, while obtaining similar (or better) returns to those of active managers. This policy potentially reduces unfunded pension liabilities by $80 billion within a few months.

Indexing is easy for states to implement, as index firms respond to state requests for proposals (RFPs) just like active managers. A state can liquidate most of its active manager portfolios within a few months, and provide the cash to index firms, which can then invest the money in the underlying securities of an index within a few weeks. Many large corporate pension funds and many individuals already use indexing for equity portfolios, and equity indexing has perhaps a 15% market share of equity mutual funds.

PROCESS

The authors reviewed the Wall Street money management fees of all 50 states and the states' five-year annualized investment returns. The information was disclosed in the state pension funds' Comprehensive Annual Financial Reports (CAFR). CAFR's are usually released 5-6 months after the fiscal year ends, so June 30 data is usually available the following January. Pension investment consultants, such as Wilshire Associates and Callan Associates, compile return data, but access on individual state comparisons is limited to paying clients. The Wall Street fee data prepared by the authors is not commonly calculated by consultants in a comparative way

For comparing the money management fees, the analysis included 46 out of the 50 states. See Exhibit A. Three states—Hawaii, Nebraska and Rhode Island—were excluded because they hadn't published CAFRs for fiscal years ending December 31, 2011 or later. West Virginia was excluded because its June 30, 2012 CAFR lacked sufficient disclosure. When states' CAFR disclosure was inadequate (or unclear), the authors contacted the pension funds via telephone or email. In this report, money management fees are expressed as a percentage of the fiscal year's beginning assets.

For comparing five-year annualized investment returns, this analysis only used those pension funds (i) with a fiscal year end of June 30, 2012 (in order to facilitate an "apples to apples" comparison); and (ii) with the appropriate disclosure. Thirty-five states met these criteria. For those states that separate "state employee" and "state teacher" pension funds, we used the larger of the funds for comparison purposes in rates of return and fees. See Exhibits B and C.

When states have different year ends, it is not appropriate to make annualized investment return comparisons. The 'start' and 'end' dates are different for the portfolios.

STATE OF MARYLAND REVIEW

Asset Allocations On June 30, 2012, the Maryland State Retirement and Pension System ("the System") reported net assets of $37.1 billion. The assets were principally publicly traded stocks and bonds as indicated in Table 1.

At June 30, 2012, $5.1 billion (32%) of the $15.7 billion in publicly-traded equities was passively managed or "indexed," according to Maryland's CAFR (i.e., 14% of

TABLE 1: MARYLAND PENSION SYSTEM ASSET CLASS
by Market Value and Allocation at June 30, 2012 (in billions)

	MARKET VALUE	ALLOCATION
PUBLICLY-TRADED EQUITY:		
U.S.	$ 4.8	12.9%
INTERNATIONAL	5.6	15.1
GLOBAL	5.3	14.4
	15.7	**42.4**
PUBLICLY-TRADED FIXED INCOME:	7.1	19.2
CREDIT/DEBT STRATEGIES	2.9	7.8
ALTERNATIVE INVESTMENTS:		
REAL ESTATE	2.4	6.4
REAL RETURN	3.7	10.0
PRIVATE EQUITY	2.1	5.7
ABSOLUTE RETURN	2.5	6.8
CASH	0.7	1.7
	$ 37.1	100.0%

TABLE 2: MARYLAND PENSION SYSTEM VS. PEER GROUP
Fiscal 2012 Wall Street Management Fees vs. Median as a percent of beginning fiscal year assets

MARYLAND PENSION SYSTEM	**0.64%**
46 STATE MEDIAN	0.39%

(1) See Exhibit A.

the entire portfolio). Much of the fixed income, credit/debt strategies, real return and absolute return portfolios consisted of publicly-traded securities. Real estate and private equity, in contrast, principally represent unlisted securities or partnerships, where the System would have needed several months, or several years, to liquidate a position.

Like many states, Maryland seeks to enhance investment returns through supplementing publicly-traded securities with alternative investments, although there is no scientific evidence supporting the effectiveness of this approach.

Maryland Wall Street Money Management Fees For the fiscal 2012 year, the State of Maryland spent $241 million on Wall Street money management fees, or 0.64% of beginning assets of the period. These fees as a percent of assets were higher than the 46 state median. See Table 2.

Note that the Maryland legislature lacks the statutory authority to impose a budget for such fees. Such fees are at the discretion of the Board of Trustees, many of whom are appointed by the Governor.

Investment Returns For the five years ended June 30, 2012, the System's annualized rate of return was 0.78%, which was lower than the 1.50% median for the 35 states

TABLE 3: MARYLAND PENSION SYSTEM VS. PEER GROUP
Five-Year Annualized Investment Return, Ending June 30, 2012

MARYLAND PENSION SYSTEM	**0.78%**
35 STATE MEDIAN	1.50%

(1) See Exhibit C.

TABLE 4: MARYLAND PENSION SYSTEM VS. PEER GROUP
Annualized Investment Returns-Latest Quarter Reports One Year and Five Years Ending March 31, 2013

FIVE YEAR	
MARYLAND PENSION SYSTEM	3.90%
TUCS PUBLIC FUNDS > $5 BILLION–MEDIAN	4.62%
ONE YEAR	
MARYLAND PENSION SYSTEM	9.60%
TUCS PUBLIC FUNDS > $5 BILLION–MEDIAN	10.50%

with June 30 fiscal year ends. *Ironically, the System pays more in fees than most states, and gets lower performance, a situation it shares with a number of its peers. See Table 3.*

The Maryland Public Policy Institute and Maryland Tax Education Foundation have noted that the System has underperformed its peers, from an annualized rate-of-return perspective, over varying periods of time. This fact has been pointed out in written reports as well as in three instances of legislative testimony in fiscal years 2011, 2012 and 2013.

One, 3, 5 and 10 year periods are popular measurement periods in the investment business. Depending on which 10-year period is being measured, the opportunity cost of the System's underperformance ranges from $2 billion to $3 billion. The response of the System to these facts has been to "shoot the messenger" rather than to acknowledge the problem, admit a mistake, and institute reforms. The response of the Governor and legislature has been to do nothing. This "head in the sand" tactic is mirrored by Maryland's underperforming peers despite the huge dollars involved.

Latest Quarterly Performance The latest quarterly update for the System, as of March 31, 2013, indicates a five-year annualized return of 3.90% (Table 4), which is higher than the 0.78% for the five years ending June 30, 2012. See Table 3.

The difference between 3.90% and 0.78% reflects principally the rise in the U.S. stock market over the nine-month period (i.e., June 30, 2012 to March 31, 2013). It also reflects the March 31, 2013 five-year period starting at a lower stock-market-price base. However, other public pension funds benefited from the same factors, and Maryland's System was still an underperformer. See Table 4. TUCS is the Wilshire Trust Universe Comparison Service, which publishes aggregate data.

TABLE 5: CONTRASTING TEN TOP WALL STREET FEE RATIO STATES TO BOTTOM TEN
(35 State sample size) five years ending June 30, 2012

	MEDIAN WALL STREET EXPENSE RATIO	MEDIAN PENSION FUND ANNUALIZED FIVE YEAR RETURN
TOP TEN WALL STREET FEE RATIO STATES	0.61%	1.34%
BOTTOM TEN WALL STREET FEE RATIO STATES	0.22%	2.38%
DIFFERENCE	0.39%	(1.04)%

(1) Note: For largest of state funds, when state reports teachers/employees separately.
(2) See Exhibit D.

Accountability Neither System employees nor System money managers have much to fear in terms of accountability. There have been no wholesale System staff changes, and System money managers experience little turnover. In fiscal 2009, for example, the market crash caused the System to lose billions. None of the high-priced money managers saw the crash coming, yet they kept their System contracts. This non-accountability is not specific to Maryland, but endemic to the public pension fund sector.

NATIONWIDE REVIEW – 46 STATES

Maryland is hardly alone in spending large amounts on Wall Street money management. The 46 state sample collectively spent $9 billion on such fees over their latest fiscal years. See Exhibit A. The vast majority of the state public pension systems contract with Wall Street firms to select publicly traded stocks and bonds, which comprise the bulk of the systems' investment portfolios. The Wall Street firms' typical 'sales pitch' is that they can 'outperform' a given section of the stock or bond market; therefore, the system should pay them a fee for their stock (or bond) picking prowess. To varying degrees, pension system employees monitor the Wall Street firms, usually with moderate assistance from other Wall Street-type companies called 'investment consultants.'

Public Money Managers – Poor Investment Performance vs. Indices The preponderance of evidence suggests that managers who select publicly-traded securities (on behalf of clients) cannot beat benchmark indices.

According to S&P Dow Jones indices/SPIVA Scorecard Year-Ended 2012, over the five years ended December 31, 2012, 69% of domestic equity funds *failed* to beat the S&P benchmark. On the fixed income side, 13 out of 14 *benchmark indices outperformed* actively managed fixed-income funds over the five years; 60% (or more) of managed fixed-income funds typically failed to meet related indices. Morningstar, the leading mutual rating fund, reports similar results, as pointed out by Vanguard's "The Case of Index-Fund Investing," dated April 2013. Such underperformance has been a consistent problem over time for active managers.

If public pension fund assets were indexed to relevant markets rather than actively managed, the public pension systems in Maryland and across the United States would save enormous amounts of money on fees, without undue harm to investment performance. In fact, many Wall Street managers 'shadow' their target "public market" indexes with 70 to 80 percent of their investments in the same stocks (or bonds) as those in the target index. The pension funds are thus buying the same stocks (or bonds) in the index, but paying sizeable fees for the privilege.

Alternative Investments – No Proof They Beat the Market To try and compensate for the fact that "beating the market" is difficult with publicly-traded securities, many public pension funds have increased their exposure to alternative investment managers, who claim a "secret sauce" that allows them to beat the public markets consistently. However, there is no scientific evidence to support such a notion. Many alternative managers buy and sell publicly-traded securities (i.e., "hedge funds"), so this idea is simply "old wine in a new bottle."

Furthermore, the private equity industry has yet to offer proof that private equity (PE) consistently beats the relevant public equity market index, after fees. The industry association, the Private Equity Growth Capital Council, offers no "peer reviewed" scientific evidence on its own, and the most recent PE study (2012) touting above-average returns (Higdon-London Business School and Stucke-Oxford University), has "more holes than Swiss cheese," according to a review written by Jeff Hooke, one of this report's authors. He furnished his critique to a number of academic researchers in the field. See Maryland Tax Education Foundation website.

Complicating PE performance measures is the fact that many leveraged buyouts from the pre-crash period have yet to sell, and the state pension systems rely on the buyout funds' in-house valuation of such investments to determine the systems' own investment returns. The states exercise limited supervision over the buyout funds, and examination of buyout fund portfolio values by buyout fund independent certified public accountants is less than rigorous.

When questioned about the unproven return history of alternative assets, public pension funds' officials and investment consultants typically respond, "Mediocre performance may be true, but alternatives allow diversification

TABLE 6: STATE PENSION SYSTEMS (46 State sample) summary nationwide data

	NET ASSETS, FISCAL YEAR START (BILLIONS)	WALL STREET FEES (MILLIONS)	WALL STREET FEE RATIO
MARYLAND	$37.1	$241	0.64%
U.S. MEDIAN	27.0	81	0.39
TOTAL OF 46 STATE SAMPLE	**$2,448.1**	**$9,157**	**0.37%**

(1) See Exhibit A.

TABLE 7: FIVE STATES WITH HIGHEST WALL STREET FEE RATIOS, Out of 46 state sample

RANK	STATE	WALL STREET FEE RATIO	YEAR END
1	SOUTH CAROLINA	1.31%	JUNE 30
2	MISSOURI	0.94%	JUNE 30
3	PENNSYLVANIA	0.88%	DECEMBER 31
4	NORTH CAROLINA	0.71%	DECEMBER 31
5	MARYLAND	0.64%	JUNE 30

(1) Includes all state funds, not just largest fund or June 30 year end.
(2) See Exhibit A.

TABLE 8: STATE PENSION FUND COMPOSITES
Asset allocations and indexes (that mimic/benchmark the assets)

TYPICAL STATE PENSION FUND ASSET ALLOCATION CATEGORY	PUBLIC SECURITY INDEX THAT 'MIMICS' THE ASSET CATEGORY	TYPICAL STATE PENSION FUND ASSET ALLOCATION
U.S. STOCKS	RUSSELL 1000	30%
NON U.S. STOCKS	ACWI EX-U.S.	20
PRIVATE EQUITY	U.S. MICRO CAP[1]	10
U.S. FIXED INCOME	BAR CAP USAAG	20
NON U.S. FIXED INCOME	CITIGROUP WCBI EX-U.S.	10
REAL ESTATE	MSCI U.S. REIT[2]	10
		100%

(1) Proxy for private equity.
(2) Proxy for actual holding of real estate.
(3) See Exhibit E.

out of public equity and public fixed-income markets." This statement shows a lack of understanding about alternatives. Hedge funds, as noted, principally invest in publicly-traded securities. For example, Pershing Square hedge fund, run by Bill Ackman, has sizeable positions in J.C. Penney (long), Herbalife (short) and Proctor & Gamble (long). Private equity funds, in contrast, acquire mainly securities in privately-owned corporations. The underlying issuers of such private securities have economic attributes that are similar in many ways to their publicly-traded counterparts. That's hardly diversification.

No Connection Between High Fees and Performance

The 46 systems had total assets of over $2 trillion. In 2012, they spent over $9 billion in Wall Street fees, despite the lack of evidence that active management provides above-average investment returns. *For the five years ended June 30, 2012, we were unable to find a correlation between high fees and high returns.*

By way of illustration, for the 35 state sample with June 30, 2012 fiscal year ends, we contrasted (i) the top ten states in terms of Wall Street expense ratios; to (ii) the bottom ten. The bottom ten had better investment performance. See Table 5. This is not a "glowing endorsement" for Wall Street advice, and one is reminded of the classic investment exposé entitled "Where are the Customer's Yachts?"

The authors acknowledge more work needs to be done, and they hope the states and public sector employee unions will take note. This report examines a single five-year time period. This report will be expanded to cover multiple time periods, time and funding permitting.

Summary Data on State Pension Systems Table 6 above outlines summary data. The "Wall Street Fee ratio" refers to the Wall Street fees divided by the net assets at the start of the relevant fiscal year (i.e., the most recent year for which data were available). The ratio is expressed as a percentage.

Table 7 above shows the five states with the highest Wall Street fee ratios, based on the latest CAFR.

The Maryland System spends more on Wall Street fees, relative to its net assets, than 41 other state systems surveyed. Among systems with publicly available financial reports, Maryland comes in at 5th place.

PENSION SYSTEM PERFORMANCE VS. INDEX FUNDS THAT 'MIMIC' THE ACTIVE MANAGERS

As a point of intellectual inquiry, the Maryland Public Policy Institute and Maryland Tax Education Foundation asked a wealth management firm to calculate the returns a pension fund would realize by investing in the relevant indexes and allocations. The indexes and allocations 'mimic' the state pension fund composites. Sometimes, consultants 'benchmark' an asset allocation's performance by comparing it to an index. See Table 8.

Over the five years ending June 30, 2012, the index portfolio had an annualized return of 2.22%, or 2.19% net

TABLE 9: RETURNS OF INDEX PORTFOLIO
that 'mimics' state pension asset allocation vs. actual median pension performance

	FIVE YEAR ANNUALIZED INVESTMENT RETURN (JUNE 30, 2012)
INDEX PORTFOLIO	2.19%
MEDIAN 35 STATE PENSION FUNDS	1.50%
DIFFERENCE	0.69%

(1) See Exhibits C and E.

of assumed fees of 0.03% annually (2.22% minus 0.03% equals 2.19%). See Exhibit E. The index portfolio was 'rebalanced' every 12 months. The median return for the 35 state pension funds with the same five years was 1.50%, net of fees. The states earned 0.69% less than the composite index. Although 0.69% doesn't sound like much, on a $30 billion portfolio, it represents $207 million per year, or over $2 billion for ten years, when compounding is used. See Table 9.

Many states index a small portion of their portfolios to public stock and bond market indexes. Assuming the performance set forth in Table 9 holds over varying historical time periods, states may want to extend this indexing practice to 80 or 90 percent of their portfolios This policy would provide annual savings approximating $6 billion. Applying this annual savings, at a seven percent liability discount rate, reduces unfunded pension liability by $80 billion.

CONCLUSION

State pension systems represent the retirement security of millions of public employees across the nation. Confidence in the strength of that safety net is beginning to erode.

In these tumultuous economic times, the administrators of the state's pension systems would be wise to consider indexing the systems' portfolios to ensure average investment returns and to cut unnecessary fees. This would be a safer, more responsible use of system resources than paying Wall Street management firms billions of dollars each year to deliver sub-par results on public securities and risky alternative investments. Taxpayers and public sector employees suffer the results of subpar performance.

Many corporate pension funds and many individuals already use indexing for public equity portfolios, and indexing has perhaps a 15% market share of public equity mutual funds.

Implementing an indexing policy should be moderately problematic for state governments, relative to other money-saving measures. Wall Street fee reduction from indexing is not a "hot button" issue like local school funding. Also, the fee cuts will impact principally the incomes of public stock and bond money managers, hedge fund managers, and private equity fund managers, who are concentrated in just a few states. Encouraging more indexing for public pension funds should thus be an "easy vote" for most legislators. Nevertheless, the indexing education process for state legislators will be formidable.

Getting pension fund administrators to support the policy and to educate legislators about indexing will be an uphill battle. By agreeing to the policy, administrators essentially admit they made mistakes by betting heavily on active managers. Who wants to admit an error? Investment consultants and Wall Street money managers will vigorously oppose such a policy.

Mechanically, the switchover from 'active management' to 'passive management' (i.e., indexing) is simple. It shouldn't require more than a few months for most state pension funds.Index firms respond to RFPs just like active management firms. Once index firms are selected by a state, existing publicly-traded portfolios can be quickly liquidated. Then, the proceeds can be transferred to an index firm for investing. Alternatively, the pension fund can transfer a publicly-traded asset that fits into a relevant index to the index firm. Costs of the switchover should be minimal as a percent of assets. On the private alternative asset side, hedge funds can often be redeemed in six months. Private equity funds have a modest secondary market, and liquidation may entail several months to several years.

Exhibits The (i) excel exhibits with state-by-state data; and (ii) the index calculations are available on the following websites: www.marylandtaxeducation.org and www.mdpolicy.org

JEFF HOOKE *is the unpaid, volunteer chairman of the Maryland Tax Education Foundation. He is a managing director of a Washington, D.C. based investment bank and the author of four books on finance and investment. He has taught at several universities and was recently an adjunct instructor of finance at the Carey Business School of Johns Hopkins University.*

JOHN J. WALTERS *is a visiting fellow at the Maryland Public Policy Institute. He holds a degree in economics from Loyola College in Baltimore.*