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WALL STREET FEES AND THE MARYLAND PUBLIC PENSION FUND

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ON JUNE 30, 2011, the Maryland State Retirement and Pension System (“the System”) reported net assets of \$37.6 billion. The assets were principally publicly traded stocks and bonds. During the fiscal year ending June 30, 2011, the System spent \$221 million on Wall Street money management fees,¹ though fund management appears to have yielded subpar results. There is substantial evidence that Wall Street managers are unable to beat passive equity index funds that cost much less in fees.

Indeed, during calendar year 2011, 84 percent of actively managed U.S. equity funds underperformed their benchmarks, according to S&P Dow Jones Indices, a division of McGraw Hill. Morningstar, the leading mutual fund rating firm, reported similar results for its equity fund universe for 2011. Such underperformance is a consistent problem over time, according to both companies. A 2011 study from Vanguard shows similar underperformance results from actively managed fixed-income mutual funds versus the 2010 Barclays Capital Aggregate U.S. Bond Index.²

The ratio of the System’s Wall Street fees equaled 0.693 percent in FY 2011, above the 0.409 percent of similar state systems nationwide.

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 indexes with 70 to 80 percent of their investments in the same stocks (or bonds) as those in the index.

STATE RETIREMENT SYSTEMS

Public pension systems administer retirement benefits for millions of public employees across the nation. According to a 2010 Census Bureau survey, there were over 3,400 state and local public employee retirement systems in the United States, comprised of over 14.6 million active contributing members.³

The vast majority of public pension systems in the United States contract with Wall Street firms to select the publicly traded stocks and bonds that comprise the bulk of the systems’ investment portfolios. The 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.”

In Maryland, as in most states, a Board of Trustees supervises the State Retirement and Pension System. In Maryland, the Trustees are led by Chairman Nancy Kopp, the Treasurer of Maryland, and Vice-Chairman Peter Franchot, the State Comptroller.

EXHIBIT 1: SUMMARY DATA (IN MILLIONS)

	NET ASSETS, FISCAL YEAR START	WALL STREET FEES	WALL STREET FEE RATIO
MARYLAND	\$31,923	\$221	0.693
U.S. AVERAGE	\$43,803	\$160	0.409
U.S. MEDIAN	\$22,85	\$69	0.359
TOTAL OF 50 STATES SURVEYED	\$2,190,152	\$7,863	0.359

Source: Maryland Public Policy Institute and Maryland Tax Education Foundation; State Retirement and Pension System public data.

For many state pension funds, investment results over the last 10 years have failed to hit target returns of 7 to 8 percent annually. This has prompted Maryland’s System and other state systems to make large commitments to “alternative investments,” like leveraged buyout funds and hedge funds, with the hope of obtaining higher returns than conventional public stocks and bonds. In fiscal 2011, 25 percent of the Maryland System’s investment portfolio was in alternative investments, including private equity and real estate.⁴

Alternative investments are less liquid, less transparent, and more volatile than conventional public stocks and bonds. It is also questionable whether these investments provide higher returns than a similar risk-adjusted portfolio of public equities. Buyout fund promoters claim higher returns, for example, but many of their leveraged buyouts from the pre-crash period have yet to sell, and the state pension systems rely on the buyout funds’ in-house valua-

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tion of such investments to determine pension investment returns. The states exercise limited supervision over the buyout funds, and the examination of buyout fund portfolio values by fund auditors is typically inadequate.

NATIONWIDE DATA AND COMPARISONS

For this report, The Maryland Public Policy Institute and the Maryland Tax Education Foundation reviewed the comprehensive annual financial reports of major statewide retirement systems from all 50 states. The goal was to determine the ratio of state pension system Wall Street fees to their net assets, and compare those ratios to Maryland and other states.

Data were taken from the most recently published financial reports from each relevant system. For states that

EXHIBIT 2: STATES WITH HIGHEST WALL STREET FEE RATIOS

RANK	STATE	WALL STREET FEE RATIO
1	MISSOURI	1.385
2	PENNSYLVANIA*	1.117
3	HAWAII*	0.742
4	OREGON	0.705
5	MARYLAND	0.693
6	VIRGINIA	0.672
7	NORTH DAKOTA	0.664
8	LOUISIANA	0.662
9	ALASKA	0.653
10	INDIANA	0.705

Source: Maryland Public Policy Institute and Maryland Tax Education Foundation; State Retirement and Pension Systems public data.

*Note: Pennsylvania data from FY 2010, Hawaii data from FY 2009.

administered more than one major statewide pension system (for example, a public employees retirement system as well as a teachers retirement system), figures were combined from multiple reports published by selected major systems. All reports used are publicly available.

The 50 systems had total assets of over \$2 trillion. In 2011, they spent over \$7.8 billion in Wall Street fees, despite the lack of evidence that active management provides higher investment returns.

Exhibit 1 outlines summary figures. Dollar amounts are in millions. 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 for which data were available) and is expressed as a percentage.

As a percent of assets, Maryland’s System paid more in Wall Street fees than other states on average.

Many states index a small portion of their portfolios to public indexes. Extending this practice to 80 or 90 percent of their portfolios would provide annual savings in excess of \$6 billion.

Exhibit 2 shows the states with the highest Wall Street fee ratios.

The Maryland System spends more on Wall Street fees, relative to its net assets, than 45 other state systems. Among systems with publicly available financial reports from fiscal 2011, Maryland comes in at 3rd place behind Missouri and Oregon.

THE MARYLAND SYSTEM’S PERFORMANCE

Above-average Wall Street fees may be justified by above-average returns. However, Maryland’s System has lagged behind other state systems in this regard. In early 2012, MTEF presented testimony before the State Senate Finance

EXHIBIT 3: COMPOUND ANNUAL RETURNS — STATE PENSION SYSTEMS

	2011	5 YEARS	10 YEARS
MARYLAND	20.0%	4.0%	5.0%
DELAWARE	24.3%	6.6%	6.7
VIRGINIA	19.1%	4.3%	5.7%
NORTH CAROLINA	18.5%	5.1%	5.7%
NEW JERSEY	18.0%	5.2%	5.2%
KENTUCKY	19.0%	4.7%	5.5%
WEST VIRGINIA	20.7%	5.4%	6.3%
AVERAGE (EXCLUDING MARYLAND)	19.9%	5.2%	5.9%
ALL LARGE PUBLIC FUNDS	21.7%	4.7%	5.9%

Source: Maryland Tax Education Foundation; state retirement system reports; state pension fund administrators; pension fund data services.

Committee regarding the System’s investment performance compared to that of nearby states with June 30 fiscal years, see Exhibit 3. Maryland’s System underperforms others by about 1 percent each year.

This shortfall is significant and translates into about \$3 billion in lost income over the last 10 years.

CONCLUSION

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

In these tumultuous economic times, the administrators of Maryland’s pension systems would be wise to index the systems’ portfolios to ensure average investment returns. This would be a safer, more responsible use of system resources than paying Wall Street management firms millions of dollars each year to deliver sub-par results on public stocks and bonds and risky private alternative investments.

By the objective measure of fees to assets, Maryland spends significantly more on Wall Street management fees

than almost every other state, and its investment performance is substandard. This situation has cost the state billions of dollars and should be addressed immediately.

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- 1 Wall Street fees include money management fees, custodian fees, and currency exchange and hedging fees. The vast majority of fees are for stock or bond selection services.
- 2 Vanguard Research, “The Case for Indexing,” February 2011, <http://institutional.vanguard.com/iwe/pdf/ICRPI.pdf>.
- 3 U.S. Census Bureau, 2010 Annual Survey of Public Employee Retirement Systems, <http://www.census.gov/govs/retire/>.
- 4 Maryland State Retirement and Pension System, 2011 Comprehensive Annual Financial Report, <http://sra.maryland.gov/Agency/Downloads/CAFR/>.

NOTES FOR APPENDIX

- 1 Summed from Public Employees Retirement System and Teachers Retirement System reports
- 2 Summed from Public Employees Retirement System and Teachers Retirement System reports
- 3 Summed from Public Employees Retirement System and Teachers Retirement System reports
- 4 Active member total as of June 30, 2010 (www.census.gov/govs/retire/)
- 5 Summed from Employee Retirement System and Teachers Retirement System reports
- 6 Summed from State Retirement System, Teachers Retirement System, and Chicago Public School Pension and Retirement Fund reports
- 7 Summed from Public Employees’ and Teachers retirement system reports
- 8 Summed from Kentucky Retirement Systems and Kentucky Teachers Retirement System reports
- 9 Summed from State Employees’ Retirement System and Teachers’ Retirement System reports
- 10 Summed from Public School Employees, State Employees, State Police, and Judges Retirement Systems reports
- 11 Summed from State Retirement System, Public Employees Retirement System, and Teachers Retirement Association reports
- 12 Summed from State Employees Retirement System, Public Schools Retirement System, and Local Government Employees Retirement System reports
- 13 Summed from Public Employees Retirement System and Teachers Retirement System reports
- 14 Investment Expense figures expressed in percentages at: npers.ne.gov/whalecomfb0318c-98356c776ad65/whalecom0/SelfService/public/howto/handbooks/InvestmentReport.pdf
- 15 Summed from Public Employees’ Retirement System and Educational Retirement Board reports
- 16 Summed from New York State and Local Retirement System, the New York City Teachers Retirement System, the New York State Teachers Retirement System, and New York City Employees Retirement System reports.
- 17 Summed from State Employees Retirement System and Teachers Fund For Retirement reports
- 18 Summed from Public Employees Retirement System, School Employment Retirement System, State Teachers Retirement System, and Police & Fire Fund reports.
- 19 Summed from Public Employees Retirement Plan and Teachers Retirement System reports
- 20 Summed from Public School Employees Retirement System and State Employees Retirement System reports
- 21 Summed from Employees Retirement System and Teachers Retirement System reports

NET ASSETS & INVESTMENT EXPENSES OF SELECTED MAJOR STATE-FUNDED RETIREMENT/PENSION SYSTEMS

STATE	FISCAL YEAR OF REPORT(S) ANALYZED	TOTAL NET ASSETS, YEAR BEGINNING (\$ in millions)	TOTAL NET ASSETS, YEAR END (\$ in millions)	WALL ST. MONEY MGMT FEES* (\$ in millions)	REPORT(S) URL	INVESTMENT EXPENSES (Percentage of Beginning Net Assets)
Alabama	2011	25,435.65	25,092.79	14.234	www.rsa-al.gov/About%20RSA/Pubs%20and%20forms/RSA%20Pubs/CAFR/2011%20CAFR.pdf	0.056
Alaska ¹	2011	13,807.67	16,489.64	90.162	doa.alaska.gov/dr/pd/trs/cafr/2011_TRS_CAFR.pdf ; doa.alaska.gov/dr/pd/pers/cafr/2011_PERS_CAFR.pdf	0.653
Arizona	2011	27,978.79	33,531.45	150.121	www.azasrs.gov/content/pdf/financials/2011_CAFR.pdf	0.537
Arkansas ²	2010	13,152.80	14,612.07	51.912	www.apers.org/annualreports/APERS_FR2010.pdf ; artrs.gov/Forms/ATRS_2010_Annual_Report.pdf	0.395
California ³	2011	334,495.65	401,194.34	858.942	www.calpers.ca.gov/eip-docs/about/pubs/comprehensive-annual-fina-report-2011.pdf ; www.calstrs.com/Help/forms_publications/printed/CurrentCAFR/cafr_2011.pdf	0.257
Colorado	2010	35,036.94	41,135.785	153.924	www.copera.org/pdf/5/5-20-10.pdf	0.439
Connecticut ⁴	2011	21,869.59	25,183.665	89.625	www.state.ct.us/ott/PDFs/2011CIF_CAFR.pdf	0.410
Delaware	2011	6,372.537	7,648.78	22.302	www.delawarepensions.com/financials/fy11cafr.pdf	0.350
Florida	2011	107,179.99	126,579.72	354.999	www.rol.frs.state.fl.us/forms/2010-11_Annual_Report.pdf	0.331
Georgia ⁵	2011	59,604.126	69,563.89	35.08	www.ers.ga.gov/formspubs/formspubs/CAFR2011.pdf ; www.trsga.com/media/405081/cafr%20final%20for%20web-12-20-11.pdf	0.059
Hawaii	2009	10,846.789	8,815.285	80.504	ers.ehawaii.gov/wp-content/uploads/2012/02/CAFR-2009rev2.pdf	0.742
Idaho	2011	10,410.58	12,377.597	41.851	www.persi.idaho.gov/documents/investments/FY11/AR-FY2011.pdf	0.402
Illinois ⁶	2011	50,085.91	59,452.462	297.667	www.state.il.us/srs/ ; www.ctpf.org/AnnualReports/cafr2011.pdf ; trs.illinois.gov/subsections/pubs/cafr/fy11/financial.pdf	0.594
Indiana ⁷	2011	22,182.164	25,755.673	137.421	www.in.gov/inprs/annualreports.htm	0.620
Iowa	2011	19,878.08	23,082.133	41.933	www.ipers.org/publications/misc/pdf/financial/cafr/cafr.pdf	0.211
Kansas	2011	11,369.737	13,468.853	47.586	www.kpers.org/annualreport2011.pdf	0.419
Kentucky ⁸	2011	25,753.161	30,292.273	92.432	kyret.ky.gov/investments/cafr/2011-cafr.pdf ; ktrs.ky.gov/05_publications/reports/financial/CAFR%202011/3-%20Financial%20Section%2013-50.pdf	0.359
Louisiana ⁹	2011	20,076.11	24,280.708	132.86	www.lasersonline.org/uploads/2011_CAFR_web_version.pdf ; trsl.org/uploads/File/Annual%20Reports/CAFR11Web.pdf	0.662
Maine	2011	92,25.964	11,051.693	19.705	www.maineopers.org/PDFs/other%20publications/11CAFR.pdf	0.214
Maryland	2011	31,923.7	37,592.8	221.243	sra.maryland.gov/Agency/Downloads/CAFR/CAFR-2011-Financial.pdf	0.693
Massachusetts	2011	41,284.31	50,245.766	69.218	www.mapension.com/publications/	0.168
Michigan ¹⁰	2011	47,132.255	46,106.072	186.661	michigan.gov/documents/orsschools/Public_Schools-2011_CAFR_375806_7.pdf ; michigan.gov/documents/orstatedb/State_Employees-2011_CAFR_375807_7.pdf ; michigan.gov/documents/ormsmp/State_Police_2011_CAFR_375804_7.pdf ; michigan.gov/documents/orjudgesdb/Judges_-2011_CAFR_375803_7.pdf	0.396
Minnesota ¹¹	2011	44852.43	53,075.449	66.928	www.msrs.state.mn.us/pdf/2011CAFR.pdf ; http://www.mnpera.org/vertical/Sites/%7BCB6D4845-437C-4F52-969E-51305385F40B%7D/uploads/CAFR_11_financial_web.pdf ; minnesotatra.org/IMAGES/PDF/11-Financial.pdf	0.149
Mississippi	2011	18,274.112	22,133.851	42.765	www.pers.state.ms.us/pdf/financials/2011AR/Financial.pdf	0.234
Missouri ¹²	2011	36,661.684	43,421.121	507.662	www.mosers.org/About-MOSERS/~media/Files/Adobe_PDF/About_MOSERS/Annual_Report/2011_AR/Financial.ashx ; www.molagers.org/ ; www.psrns-trs.org/Investments/2011-CAFR/CAFR2011-FINANCIAL.pdf	1.385
Montana ¹³	2011	6,994.384	8,305.942	42.819	mpera.mt.gov/docs/2011CAFR.pdf ; www.trns.mt.gov/Publications/AnnualReports/FinancialReport2010-2011.pdf	0.612

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Nebraska ¹⁴	2011	8,200	9,600	(omitted)	npers.ne.gov/whalecomfb0318c98356c776ad65/whale-com0/SelfService/public/howto/publications/LegisReports/AnnualReport2012.pdf	(omitted)
Nevada	2010	18,770.137	20,906.283	23.899	transparentnevada.com/static/state-financial-documents/Public%20Employees%20Retirement%20System/PERS_CAFR_FY2010.pdf	0.127
New Hampshire	2011	4,898.339	5,891.179	18.446	www.nhrs.org/documents/NHRS_CAFR_FY2011.pdf	0.377
New Jersey	2011	74,648.168	81,067.61	13.417	www.nj.gov/treasury/pensions/annrpt2011/financial.pdf	0.018
New Mexico ¹⁵	2011	18,712.602	22,131.216	52.487	www.nmerb.org/pdfs/nmerb2011cafr.pdf ; www.pera.state.nm.us/pdf/PERAFinancialArticles/PERA_NM_CAFR_2011.pdf	0.280
New York ¹⁶	2011	272,878.873	315,448.871	821.513	www.osc.state.ny.us/retire/word_and_pdf_documents/publications/cafr/cafr_11.pdf ; www.trsnyc.org/WebContent/publications/cafr.pdf ; www.nystros.org/main/library/AnnualReport/2011CAFR.pdf ; www.nycers.org/(S(4klblunxhqdmgknc5rsmdqzw))/Pdf/cafr/2011/2011_FINAL.pdf	0.301
North Carolina	2011	65,300	74,900	295.1	www.nctreasurer.com/inside-the-department/Reports/AnnualReport-FY11.pdf	0.452
North Dakota ¹⁷	2011	3,127.743	3,743.377	20.759	www.nd.gov/ndpers/forms-and-publications/publications/2011-annual-report.pdf ; www.nd.gov/rio/SIB/Publications/CAFR/2011AnnualReport.pdf	0.664
Ohio ¹⁸	2010	140,766.21	153,981.873	296.142	www.op-f.org/Files/cafr10sm.pdf ; www.strsoh.org/about/CAFR10.html ; www.opers.org/pubs-archive/investments/cafr/2010_CAFR.pdf ; www.ohsers.org/publications	0.210
Oklahoma ¹⁹	2011	14,341.302	17,220.81	43.4	www.opers.ok.gov/Websites/opers/Images/pdfs/11OPERS3.pdf ; www.ok.gov/TRS/documents/CAFR%202011%20Final.pdf	0.303
Oregon	2011	51,739.652	61,189.775	364.687	www.oregon.gov/PERS/docs/financial_reports/2011_cafir.pdf	0.705
Pennsylvania ²⁰	2010	67,868.989	71,723.629	758.141	www.portal.state.pa.us/portal/serverpt?open=514&objID=701628&mode=2 , http://www.psers.state.pa.us/content/publications/financial/cafr/cafr10/fin.pdf	1.117
Rhode Island	2010	6,069.026	6,577.137	13.052	www.ersri.org/public/documentation/AR2010.pdf	0.215
South Carolina	2011	2,2691.66	25,891.849	71.05	www.retirement.sc.gov/financial/CAFR2011.pdf	0.313
South Dakota	2011	6,496.634	7,936.269	37.852	www.sdrs.sd.gov/publications/documents/CAFR2011_003.pdf	0.583
Tennessee	2011	28,574.195	33,663.308	32.213	www.treasury.state.tn.us/TCRS-AnnualReport-2011.pdf	0.113
Texas ²¹	2011	116,983.285	130,518.444	246.957	www.trsnyc.org/About/Reports/2011_CAFR/ ; www.ers.state.tx.us/About/Reports/2011_CAFR/	0.211
Utah	2011	23,012.754	23,218.742	50.105	www.urs.org/pdf/AnnualReport/2011/annualReport.pdf	0.218
Vermont	2011	2,956.971	3,470.318	13.993	auditor.vermont.gov/sites/auditor/files/2011_CAFR_FINAL.pdf	0.473
Virginia	2011	47,651.23	54,562.257	320.03	www.varetire.org/Pdf/Publications/2011-annual-report.pdf	0.672
Washington	2011	57,630.138	68,311.83	227.902	www.drs.wa.gov/administration/annual-report/cafr/cafr-financial.pdf	0.395
West Virginia	2011	8,946	10,750.84	28.167	www.wvretirement.com/Forms/2011FinSt.pdf ; www.wimb.org/wimb/files/annual-reports/annual-report-2011.pdf	0.315
Wisconsin	2010	69,996.296	75,872.072	245.806	etf.wi.gov/about/2010_cafir.pdf	0.351
Wyoming	2010	6,006.533	6,665.574	17.28	retirement.state.wy.us/publications/index.html	0.288
U.S. Total:		2,190,152.16	2,515,733.08	7862.954		0.359
Average:		43,803.04	50,314.66	160.468		0.409
Median:		22,852.21	25,469.67	69.218		0.359

*Wall Street money management fees are principally fees paid to Wall Street firms to select publicly traded stocks, publicly traded bonds and private equity commitments for the pension fund investment portfolios. A small percent of these fees include custodial costs and foreign exchange costs.

ABOUT THE MARYLAND PUBLIC POLICY INSTITUTE Founded in 2001, the Maryland Public Policy Institute is a nonpartisan public policy research and education organization that focuses on state policy issues. Our goal is to provide accurate and timely research analysis of Maryland policy issues and market these findings to key primary audiences. ■ The mission of the Maryland Public Policy Institute is to formulate and promote public policies at all levels of government based on principles of free enterprise, limited government, and civil society. ■ In order to maintain objectivity and independence, the Institute accepts no government funding and does not perform contract research. The Maryland Public Policy Institute is recognized as a 501 (C) (3) research and education organization under the Internal Revenue Code.