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MARYLAND'S PENSION FUND RETURNS TREND WORSE THAN PEER GROUP

Nearly 3% Deficit Means Loss of $1.16 Billion in Investment Income

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MARYLAND'S STATE PENSION FUND had another sub-par investment performance for the year ending June 30, 2014, costing the state $1.16 billion. The fund's percentage increase lagged behind the median state pension fund by 2.91 percentage points. This 2.91 percentage point difference on a $40 billion portfolio (at the start of the fiscal year) resulted in $1.16 billion in lost income for the state (i.e., 2.91 percent × $40 billion = $1.16 billion).

Taxpayers make up the difference between sub-par returns and median returns by paying more money into the pension fund. Alternatively, the government may ask state employees to accept less in pension benefits.

The table on page 2 illustrates the widening gap between the Maryland state pension fund and the Wilshire Trust Universe Comparison Service (TUCS), a well-known and widely used tool for measuring the comparative performance of large state pension funds.

As the table shows, the underperformance trend is not only continuing but worsening as the percentage divide widens. Part of problem may be due to the fund's large exposure to alternative investments, such as hedge funds and private equity funds, that have tended to perform worse in recent years than traditional investments such as publicly traded stocks and bonds.

	WILSHIRE TUCS[1]	MD PENSION PLAN[2]	PERCENT DIFFERENCE	LOST INCOME (BILLIONS)[3]
1 YEAR	17.28%	14.37%	2.91%	$1.164
3 YEARS	10.24%	8.26%	1.98%	$2.079
5 YEARS	12.91%	11.67%	1.24%	$2.170
10 YEARS	7.37%	6.45%	0.92%	$3.220

THE FUND'S MONEY MANAGEMENT FEES GO UP, BUT PERFORMANCE GOES DOWN

Ironically, as the fund's relative performance (i.e., compared to other states) has declined, its Wall Street money management fees have risen. In fiscal year 2014 alone, the Maryland state pension fund paid out roughly $300 million in fees to Wall Street money managers. Over the past 10 years, these money management fees amounted to over $1.5 billion, according to the fund's annual financial reports. Nevertheless this high-priced advice resulted in 10-year returns that were $3.22 billion (net of fees) below the median, as indicated in the table.

That is a serious deficit, and in a private sector environment it would require some explanation. Most underperforming states, in contrast, take little heed of the problem. There are logical reasons why the principal actors, such as state employee unions, elected officials, and pension fund employees, pay minor attention to the issue.

PROBLEMS $3.22 BILLION COULD SOLVE

If the Maryland pension fund had matched the median state fund performance, Maryland would not have needed money from the Transportation Infrastructure Investment Act of 2013 (better known as the "Gas Tax"). This tax is expected to raise $2.9 billion through 2019.[4]

Alternatively, the state could have awarded 80,000 poor children with $40,000 four-year college scholarships ($10,000 state university/community college tuition per year × 4 years × 80,000 children = $3.22 billion).

THE INDEXING SOLUTION

Like most states, the Maryland state pension fund indexes only a small part of its total investment portfolio, preferring to "roll the dice" on active money managers (of public bonds and stocks) and alternative investment managers. Eliminating active managers, selling alternative investments, and adopting indexing for 90 percent of the state's portfolio would ensure median performance. These actions would also save the state huge amounts in money management fees.

This report's co-author, Jeff Hooke, has testified in this regard three times before the state legislature. He has urged legislators to index the entire fund and described the process as reasonably quick and uncomplicated. The State of California pension fund has announced a policy of greater indexing, and Montgomery County, Pa. has indicated it will index its entire pension portfolio.

The Maryland Public Policy Institute recognizes that "being first in indexing" in the state pension fund business is not easy. And, conveying indexing's benefits to legislators is a tough education process. The goal of savings billions of dollars makes such undertakings worthwhile.

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1 Wilshire Trust Universe Comparison Service for state pension plans, median fund investment performance for periods ending June 30, 2014, net of fees.
2 Maryland State Pension Fund, net of fees.
3 The Fund had a $40 billion portfolio as of June 30, 2013 and assumes a $35 billion portfolio over 3, 5, and 10 years. The portfolio was $45 billion as of June 30, 2014, according to the Maryland State Retirement and Pension Administration. Lost income is (a) the percent difference × (b) the amount in portfolio × (c) the number of years. Compounding is excluded.
4. The 90 Day Report: A Review of the 2013 Legislative Session, page G-1 http://mgaleg.maryland.gov/Pubs/LegisLegal/2013rs-90-day-report.pdf