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Study: Higher Wall Street Fees Equal Lower Returns for State Pensions

Study Shows Indexing Could Save States $5 Billion

ROCKVILLE, MD (July 28, 2015) – A new study released today shows that state pension systems that pay the highest Wall Street money management fees get poor investment returns relative to their peers. The study, conducted by the Maryland Public Policy Institute (MPPI), contradicts the assumption that Wall Street advice helps state pension systems achieve superior returns.

The study shows that higher Wall Street fees equal lower returns for state pensions. Specifically, the ten states paying the highest median Wall Street fee ratio of 0.66 percent earned annualized five-year returns of 12.44 percent, but the ten states paying a much lower fee ratio of 0.26 percent enjoyed a higher annualized return of 12.77 percent. The five states paying the highest fee ratios were Missouri, South Carolina, New Jersey, Maryland and Oregon.

“The findings are troubling,” said Jeff Hooke, a senior fellow at MPPI and one of the report’s authors. “The investment policies suggest either a lack of numeracy or a decision process not driven by the best interests of the pensioners and taxpayers.”

The full study, which updates calculations completed for a similar study in 2013, can be viewed at mdpolicy.org.

The study also shows that a passive index that mimics the investment allocation of the typical state pension fund outperformed the peer group median by 1.62 percent per year over a five-year period. By indexing most of their portfolios, the study concludes the 33 state funds surveyed could save $5 billion in fees annually, while obtaining similar (or better) returns to those of active managers. Enacting this policy potentially reduces unfunded pension liabilities by $70 billion within two years.

“Given that indexing has superior returns and lower cost attributes relative to active management, pension fund managers may have problems resisting a Tibble-type legal challenge from a union pensioner,” added Mr. Hooke.

“Private equity and hedge fund investments have been disasters for the states,” indicated John Walters, an MPPI fellow and report co-author. “Their underperformance was a surprising 5 percent per year, compared to relevant benchmarks, and it cost the states tens of billions in lost income.”

“The key conclusion—high priced advice provides lower returns—contradicts the efficient market teachings of our professors,” pointed out Steven Hee (Yale ’17) and Shahzeb Mirza (George Washington ’17), two project researchers. “It would be interesting to hear the pension funds’ side of the story.”

State public pension systems contract with investment firms to select publicly traded stocks and bonds that 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 market; therefore, the system should pay them a fee for their investing prowess.

State pension funds can ill afford questionable costs. The Pew Center on the States estimated in July 2015 that the nation’s state-run retirement systems had a $968 billion shortfall in 2013 – a $54 billion increase from the previous year.

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. The Institute’s mission is to formulate and promote public policies at all levels of government based on principles of free enterprise, limited government, and civil society. Learn more at mdpolicy.org.

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