MARYLAND PENSION FUND’S WALL STREET FEES TOP HALF-BILLION DOLLARS IN FISCAL 2015, EVEN AS INVESTMENTS CONTINUE TO UNDERPERFORM

The Maryland Public Policy Institute Estimates Undisclosed Fees

BY JEFF HOOKE AND MARCO ORSIMARSI

OVERVIEW

THE MARYLAND PENSION FUND SPENT OVER A HALF-BILLION DOLLARS on Wall Street fees in fiscal 2015, according to this analysis by the Maryland Public Policy Institute. Those fees canceled out the revenue that the state collected from the lottery and casino industry in taxes.¹

In 2015, for every $1 in investment income (net of fees) in 2015, the Fund spent 50 cents on fees. Over the last five years, the fee-to-return ratio is better, but only marginally. We estimate the Fund’s fees represented about 11 percent of its investment income (see Figure 2).

Ironically, despite the fees, the Fund’s investment performance was below the median of its peer group in 2015, and for the last five and 10 years (see Figure 3). Undisclosed hedge fund and private equity fund “performance fees” were $251 million in 2015, according to our estimates.

In conducting the estimate, we match the performance fee percentage of a similar state’s fund (with near full disclosure) to that of Maryland, which has less than full
private equity (PE), hedge funds, and real estate, than most other U.S. public funds. The Fund’s alternative allocation is 48 percent of the total portfolio.

In the past, the Maryland Public Policy Institute has questioned this allocation strategy for two reasons:

1. The Fund has underperformed the average state pension fund over the last one-, five-, and 10-year periods.
2. A properly designed passive index portfolio can provide similar risk-return attributes for the Fund, at lower cost.3

Our research (and that of CEM Benchmarking) suggests that most states do not know the extent of their performance fees, and would have difficulty supplying such information. As such, this report is not an attack on the Maryland Pension Fund’s reporting practices, but an attempt to provide the legislature with a better indicator of fees than is currently available. By way of example, public union employee pension funds in California and New York recently attempted to estimate performance fees over and above fixed fees.

Indeed, consider the following revelations by New York City Comptroller Scott Stringer, who administers the New York City Retirement System: “Since we started the hard work of reforming the investment environment 22 months ago, we’ve uncovered layer after layer of Wall Street fees…In our review of this year’s financial reports, we’ve found more charges—millions of dollars in ‘incentive fees’—that had gone largely unreported in previous reports.”2

BACKGROUND
The Maryland State Retirement and Pension System (the Fund) invests more in alternative investments, such as disclosure. The Maryland Pension Fund, like other state pension funds, is not obligated to disclose total performance fees to the public, and most state funds choose less than full disclosure.

FIGURE 1 MD PENSION FUND, 2015

FIGURE 3 MARYLAND VS. MEDIAN LARGE PUBLIC FUND
ANNUALIZED INVESTMENT RETURNS

FIGURE 2 MD PENSION FUND, LAST 5 FISCAL YEARS

FIGURE 4 MD PENSION FUND ALTERNATIVE
INVESTMENT FEES, 2015

FIGURE 5 MD PENSION FUND, ALTERNATIVE
INVESTMENT FEES, 2015

No 2016-02  |  May 24, 2016
For typical alternative investments, the performance fees payable to the manager are 20 percent of profits above the hurdle rate, once the hurdle rate, if any, has been achieved. Some performance fee calculations are cumulative, where “profit” years can be cancelled by “loss” years, but others are not. Many hedge fund managers can lose 20 percent in one year, and then gain 10 percent in the second. A performance fee is due, even though the investor has lost money over the two years (see Figure 6).

**ALTERNATIVE ASSET FEES HIGHER THAN CONVENTIONAL ASSET FEES**

As a percent of assets under management, the manager fees for alternative investments are 5–15 times the fees charged by the active managers of conventional investments, like publicly traded stock and bonds, who supposedly analyze different securities and then make selections. Alternatives are 50–80 times more costly than indexing, which involves the manager just copying a well-known benchmark, like the S&P 500. Alternative asset managers often claim that their investments have a better “risk-return” profile than conventional investments.

**ALTERNATIVE ASSET PERFORMANCE IS BELOW CONVENTIONAL ASSET PERFORMANCE**

Private Equity Funds: With respect to returns, for example, a recent study by five finance professors indicates that
leveraged buy-out PE funds originating after 2005 (i.e., 10 years ago) have not outperformed the broad public market, despite the higher fees.

Maryland’s own PE funds have underperformed U.S. public equities by over 2 percent per year over the last five years, according to the latest Comprehensive Annual Financial Report (CAFR) (i.e., 17.5 percent vs. 15.1 percent). Little extra diversification is obtained, since most Maryland PE funds invest in U.S.-based private companies, which are similar to their publicly traded counterparts (Figure 8).

Hedge Funds: The Maryland hedge fund portfolio has a mix of strategies, some that defy easy comparators. Over the last five years, most hedge fund strategies have underperformed the U.S. stock market or a 60 U.S. stocks/40 U.S. bonds mix. Holding more bonds than stocks is considered a “hedge” against a stock market drop, and many use this 60/40 measure as a comparator of hedge funds, although more static measures, such as a 6 percent annual return each year, through good and bad equity markets, are also considered. Figure 9, using data from Prequin, shows the recent hedge fund performance is lacking.

FEE TRANSPARENCY IS IMPORTANT
We believe that one duty of the Fund is to provide complete fee transparency, so policy makers can understand the true cost of alternative assets to state taxpayers and public employees. Like most state funds, the Fund does not disclose the bulk of its performance fees.

To assess those fees, we filed a Freedom of Information Act (FOIA) request for that information from Fund officials. The information we received in return for fiscal 2014 indicated a very low level of 2014 fees ($85 million) compared to the few state funds offering complete data—so low, in fact, that we believe the Maryland data are incomplete. Maryland has no record of total performance fees, as yet, for fiscal 2015, according to the FOIA response.

We say this not to challenge the integrity of Maryland pension fund officials; we believe they complied with our FOIA request in good faith. Rather, we believe the Fund, like many state pension funds, lacks the appropriate record keeping to appreciate the full extent of performance fees charged to the Fund. Several states have launched inquiries in this regard and have discovered assessments far larger than was expected.

Given our skepticism of the Maryland information obtained under FOIA, we have constructed our own fee estimates using fee data from the State of New Jersey pension fund, which has alternative assets with a similar size and composition to Maryland.

Other funds with near full disclosure were Massachusetts in 2014 and Arizona’s Public Safety Personnel Retirement Fund in 2015. A similar analysis was conducted by CEM Benchmarking for South Carolina in April 2015.

CALCULATION OF 2015 PERFORMANCE FEES
Table 1 is a summary of the Fund’s alternative investments. Table 2 outlines “disclosed” alternative asset fees in the CAFRs for the last two fiscal years.

Again, to facilitate our estimation, we use the New Jersey pension fund as a comparator. (See Table 3 for New Jersey’s alternative asset fees.) Again, CEM Benchmarking completed similar analysis for South Carolina in 2015.

As Table 2 and Table 3 illustrate, New Jersey had just 15 percent more alternative assets than Maryland in fiscal 2015, yet New Jersey’s fully disclosed alternative asset fees were 198 percent higher than Maryland’s partially disclosed
fees. This suggests that Maryland has not disclosed most of such fees (see Figure 11).

Since the alternative asset mix was reasonably similar between the two states, we apply New Jersey's percent performance fees (1.30 percent) to Maryland's alternative asset total ($22,080.0 million). The resultant estimate of Maryland's performance fees is $287.0 million for 2015

Thus, the true 2015 total of Wall Street private equity fund and hedge fund management fees was $484.3 million, not the $233.5 million disclosed in the 2015 CAFR (and set forth in Table 2) (see Table 5).

Considering that $250.8 million in fees are undisclosed for fiscal 2015, a logical inference is that fees of similar magnitude are missing from the Maryland CAFRs of prior years. We estimate that undisclosed Wall Street fees over the last five fiscal years approximate $926 million (see Table 6 and Figure 13). Maryland's Wall Street fixed fees and performance fees have topped $2.2 billion (in our estimation) over the last five years, while the Fund has underperformed its peer group.

**DISCLOSURE REGULATIONS**

We asked the Fund's auditor, SB & Company, and the Fund's executive director, Dean Kenderdine, about undisclosed performance fees in October 2015. We submitted a FOIA request on February 1, 2016 and received a response on February 17, 2016 indicating estimated fiscal
2014 performance fees of $85 million, although these data have not been independently verified by the Fund’s staff or its auditors. We also checked with the Municipal Securities Rulemaking Board. The public pension accounting authorities do not require state pension funds to disclose performance fees, leaving such disclosure to the funds’ discretion.

**REVIEW OF MARYLAND FUND PERFORMANCE**

Given that U.S. public equity has outperformed private equity over the last 15 years, and that an equity/fixed income blend beats most hedge funds, we believe an expansion of public stock and bond indexing is preferable for the Fund, which performs below its peer group (see Table 7).

The diversification and hedging benefits of private equity and hedge funds are often touted, but they seem illusory in Maryland’s case. To date, Nevada is the only state pension fund to fully index its portfolio to public securities, and Maryland may want to look at Nevada’s experience. The Maryland Public Policy Institute has advanced this notion for several years in previous studies and testimony.

**POINTS OF INTEREST**

Had the Fund matched its peer group and had it indexed with a blend of stocks and bonds (over the last 10 years), we estimate the unfunded liability of the Fund would be $5 billion less. Expressed differently, the Fund’s assets would be $5 billion more. Our assumption is that (i) indexing would enhance annual returns by 60 basis points to meet peer group; (ii) indexing would save 60 basis points in
annual fees; (iii) the annual 120 basis points savings is reinvested at 6.6 percent annual return; and (iv) there would be an average portfolio of $30 billion over 10 years.

We express no opinion on the possible changes in the standard deviation of returns between the actual portfolio and the hypothetical index portfolio, and their correlations with standard benchmarks. We believe this matter requires in-depth study by concerned parties, and our research suggests no major change to portfolio risk.

POLICY IMPORTANCE

We view this paper as a helpful public policy tool for the Fund Board, the legislature, the executive branch, and the state employees’ union. The paper may help them consider whether the Fund is getting its money’s worth.

JEFF HOOKE is a senior fellow at the Maryland Public Policy Institute. 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.

MARCO ORSIMARSI is a research associate at the Maryland Public Policy Institute. He holds a B.A. in economics and political science from Loyola University in Maryland.

1. The Pension Fund comprises the Teachers Retirement System, the State Employees Retirement System, and small retirement systems for state police, judges, and law enforcement officers.
3. See the Maryland Public Policy Institute previous studies on 33 state pension funds in 2014 and 2015.

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.