FTfm **Private equity**

The great Maryland pension fees gap

State fund claims it spent $86m on private equity managers but critics say it is $172m

Maryland's state pension portfolio has, over the past decade, underperformed a 60/40 passive portfolio made up of US stocks and bonds

Chris Flood YESTERDAY

Maryland's state pension scheme has furiously defended hidden fees worth $87m that it paid to private equity managers following criticism published by a think-tank last month. The feud has reignited debate over whether US public pension schemes receive value for money from Wall Street investment managers at a time when the outlook for returns from private equity strategies is deteriorating.

Maryland's $49bn state pension scheme pays out about $300m a month in retirement benefits to 156,000 pension beneficiaries. It has invested in 187 private equity funds since 2005, building a portfolio with more than $5bn in assets. It admitted last week that it paid $87.4m in previously undisclosed performance fees to its private equity managers for the year ended December 2016, the most recent period for which the information is available.

Maryland's historic reporting period, however, is a financial year to the end of June. Its report for the year to June 30 2017 shows that about $86m was paid in management fees to private equity managers, along with $47,000 for performance fees, an implausibly low figure. Just $37,000 was disclosed in performance fees for its 2015-16 financial year.

The estimates were challenged by Jeff Hooke, a senior finance lecturer at Johns Hopkins University's Carey business school, and Carol Park, a senior analyst at Maryland Public Policy

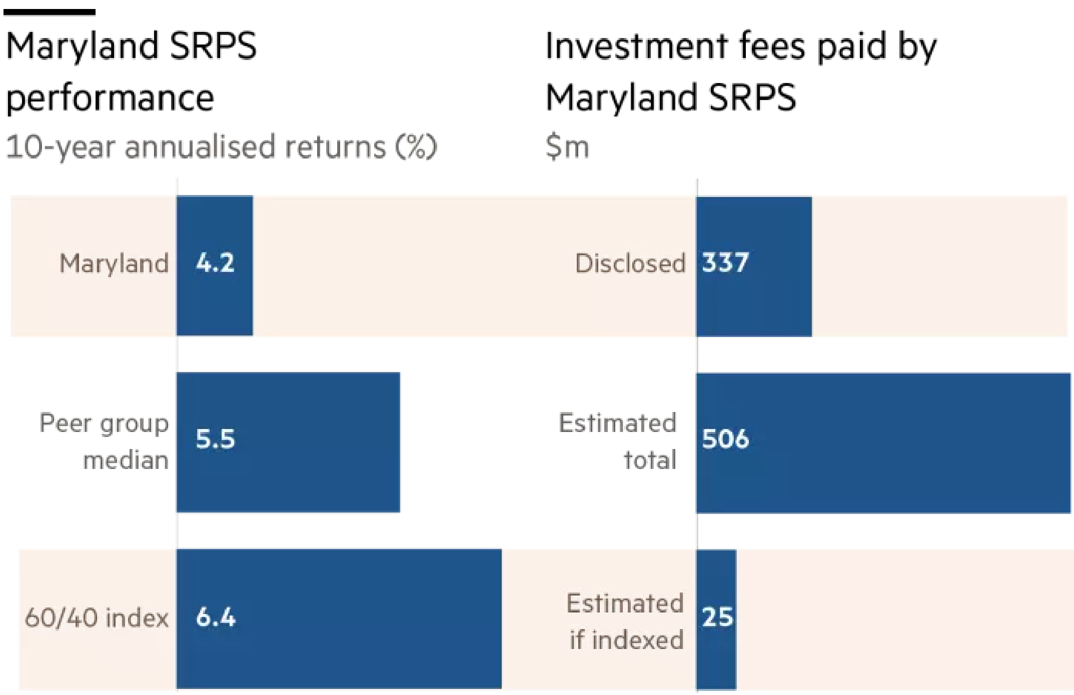
Institute (MPPI), a think-tank.

They estimated that Maryland paid about $172m in undisclosed performance fees in 2016-17 to all its alternative investment managers, including hedge fund and commodity managers as well as private equity.

In spite of a relatively high allocation to alternative investment managers, the state pension fund has only delivered a 10-year annualised return of 4.3 per cent, below the 6.4 per cent return of a basic 60/40 index-tracking portfolio made up of US stocks and bonds.

Mr Hooke estimated that Maryland could save about $481m a year in fees if it adopted a low-cost index-tracking strategy.

"This would be a safer and more responsible way to run a public employees' retirement fund than to pay huge sums to investment managers on Wall Street to deliver mediocre results," said Mr Hooke.



Source: Maryland Public Policy Institute
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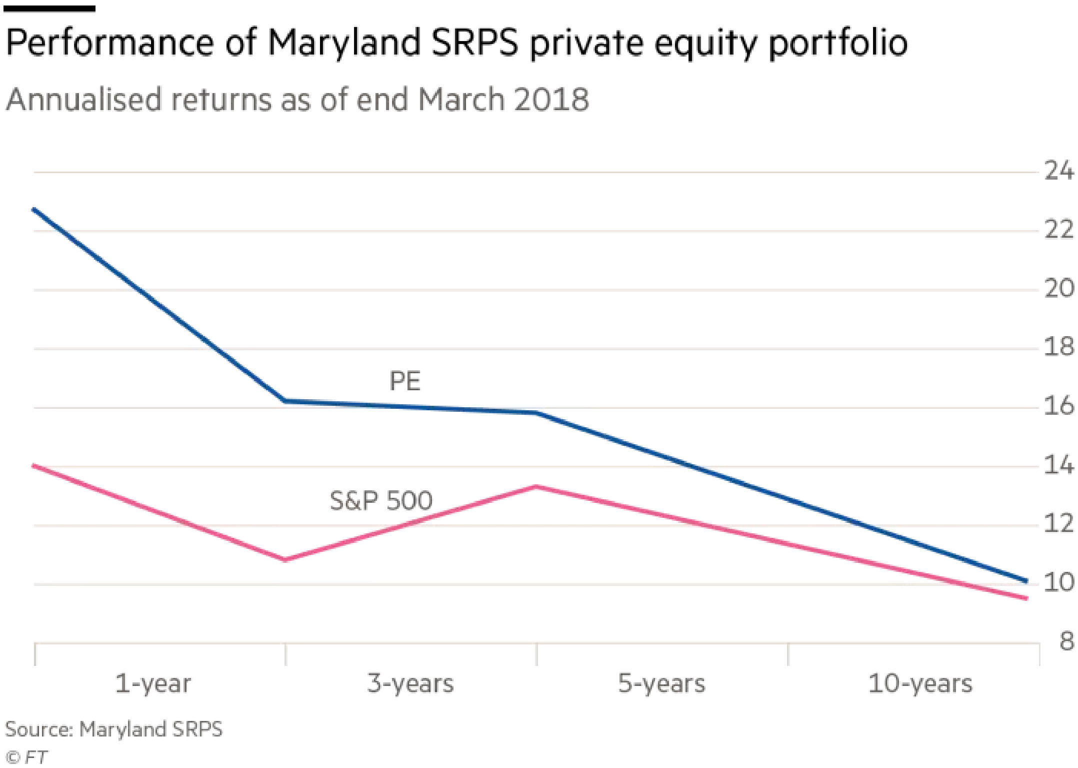
Andrew Palmer, chief investment officer of the pension scheme, said the think-tank analysis was "fraught with inconsistencies and inaccuracies".

"Maryland pays careful attention to ensure that it is compensated for the higher fees it pays to active managers," he said, in a response published on the pension scheme's website.

Mr Palmer, who declined a Financial Times request for an interview, admitted, however, that Maryland's portfolio had underperformed the 60/40 passive portfolio over the past decade. He said this was due partly to an under-allocation to private equity.

Maryland's private-equity portfolio has delivered annualised returns of 10.1 per cent (net of fees) over the 10 years to March 2018 compared with a 9.5 per cent return for the S&P 500.



"A larger exposure to private equity would have had a positive impact on [pension scheme] performance," said Mr Palmer.

Eileen Appelbaum, co-director of the Center for Economic and Policy Research, the Washington think-tank, said Maryland should disclose all fees paid since its private equity programme started in 2005.

"For Maryland to admit that it has paid tens of millions of dollars in performance fees to private equity managers when it had previously claimed to have paid only tens of thousands of dollars shows that disclosure standards are inadequate," Ms Appelbaum said.

The report should include details of all expenses paid to private equity managers, including the opaque monitoring fees imposed on portfolio companies.

Mr Hooke said the issue of hidden fees paid to Wall Street managers was widespread in the US public pension system. The records of 33 of the largest US public pension funds examined by MPPI shows they paid $6.8bn in disclosed investment fees in the year to June 30 2017. At least $3bn more was paid in undisclosed performance fees, the institute said.

Yet the figure was likely to be substantially larger as a conservative methodology was used to estimate hidden fees, said Mr Hooke. He noted that all 21 of the pension funds reporting 10-year performance figures had underperformed the 60/40 stock and bond-indexed portfolio.

Some observers are concerned that pension funds will be disappointed by future returns from their private equity investments.

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Strong competition among private equity managers has driven buyout deal valuations above the peak reached before the 2008 financial crisis. Private equity managers paid record valuations to acquire US target companies, averaging 12.5 times earnings before interest, taxes, depreciation and amortisation in 2017, according to PitchBook, the data provider.

"The high prices being paid by private equity firms to acquire desirable companies for their portfolios will make it difficult to earn high returns that beat a stock and bond-indexed portfolio when these investments are exited," said Ms Appelbaum.

Efforts to improve transparency across the private equity industry have had mixed success.

A group of senior elected US officials in 2015 wrote to the Securities and Exchange Commission, the regulator, to complain that a lack of consistent fee disclosure by private equity managers meant public pension schemes were unable to provide a full breakdown of costs.

The officials said all private equity fees should be reported clearly and consistently to investors, a call that was followed by the development of a new reporting template by the Institutional Limited Partners Association.

More than 250 private equity managers use the template if asked by clients, according to ILPA, the largest association representing investors in buyout funds.

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