The Maryland Public Policy Institute

Maryland Policy Report

No 2016-02 May 24, 2016

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

FIGURE 1 MD PENSION FUND, 2015

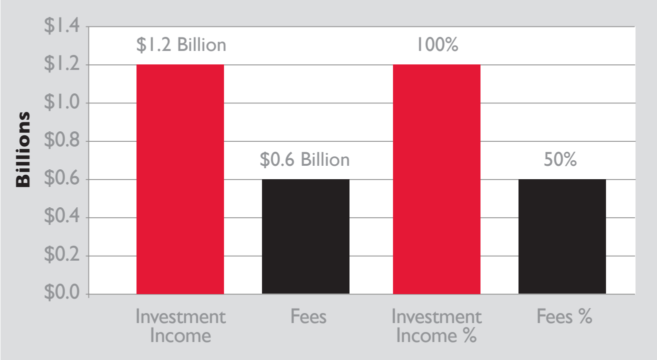


FIGURE 2 MD PENSION FUND, LAST 5 FISCAL YEARS

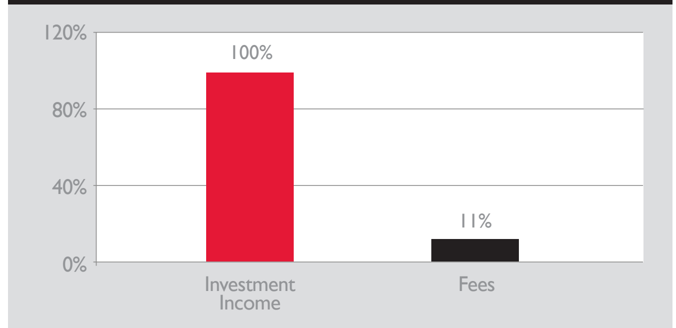


FIGURE 3 MARYLAND VS. MEDIAN LARGE PUBLIC FUND ANNUALIZED INVESTMENT RETURNS

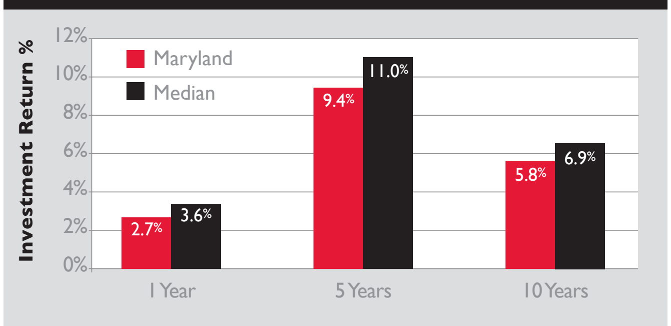
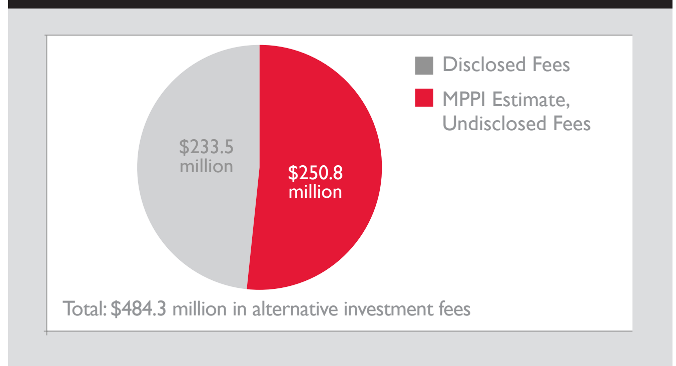


FIGURE 4 MD PENSION FUND, ALTERNATIVE INVESTMENT FEES, 2015



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.

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 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]

The Maryland Public Policy Institute's reports on Maryland's pension and related pension matters have been widely publicized, and Jeff Hooke, co-author of this report, has been quoted on such reports in the *New York Times*, *Wall Street Journal*, *Bloomberg News*, and other publications. No one in the pension fund industry has refuted the Maryland Public Policy Institute's conclusions.

Hooke has testified before the Maryland legislature several times about the Fund's fees and below-average returns. He asked the legislature to support state employee union members and state taxpayers through lower fee investments, with little result. In fact, the Fund has increased its allocation to high-fee investments in recent years.

FIGURE 5 BUYOUT FUND FEE EXAMPLE: MANAGER NEVER LOSES, $100 MILLION INVESTMENT IN YEAR 1

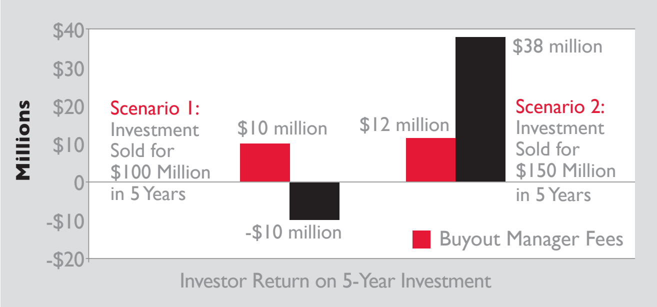


FIGURE 6 HEDGE FUND FEES VS. $100 MILLION INVESTOR FIRST YEAR -20%, SECOND YEAR +10%

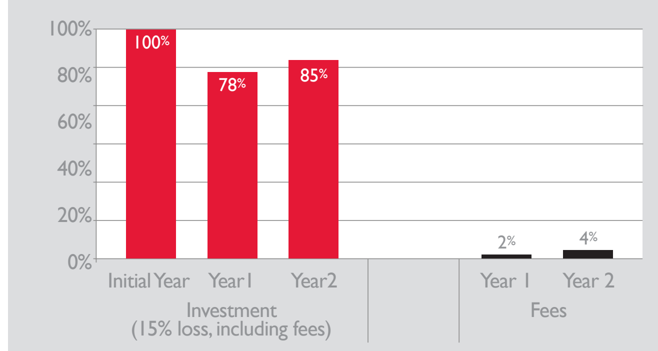


FIGURE 7 TYPICAL ANNUAL MANAGEMENT FEES AS A PERCENT OF ASSETS

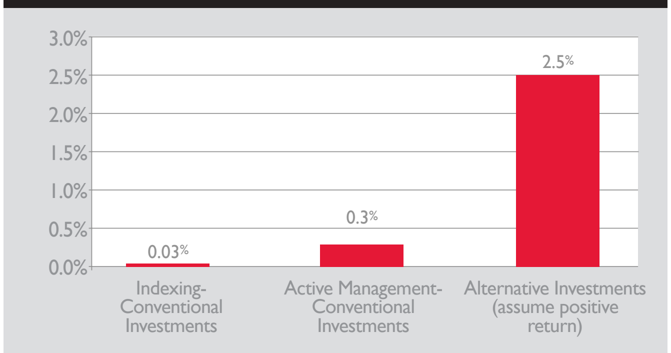
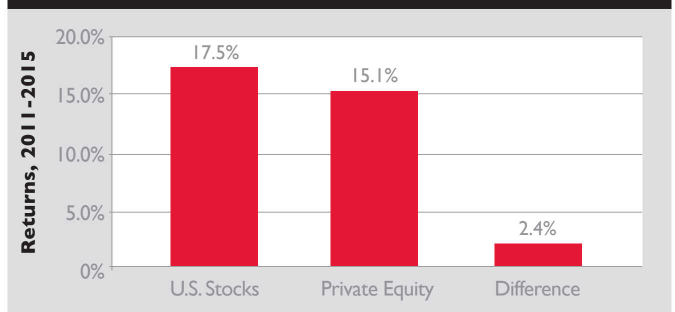


FIGURE 8 MD PRIVATE EQUITY, ANNUALIZED RETURNS OVER LAST 5 YEARS



ALTERNATIVE ASSET FEE STRUCTURE

When investing in alternative assets, pension funds pay outside managers:

1. A *fixed fee*, generally 1.0–2.0 percent per year, calculated on either capital committed or cash invested, payable whether or not the manager makes a profit or beats a preset benchmark
2. A *performance fee*, sometimes called a "carried interest"

For PE, the performance fee is only payable if certain investments or a group of investments provides a return in excess of a certain percentage per year ("hurdle rate"). The hurdle rate for most PE funds is 8 percent (see Figure 5). Hedge funds have a slightly different setup.

Performance fees are paid even if the investment value increased through no effort of the manager (e.g., a general stock market rise enhances the value of most PE-oriented investments).

PE fund managers have little downside in a market crash. They usually invest perhaps 2–3 percent of a fund's capital, most of which is recouped in the first few years from fixed fees.

Most hedge funds have no hurdle rate. Only 1 in 7 has a hurdle rate, usually between 4 percent and 8 percent, according to a Barclays Bank 2014 survey.[4]

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

FIGURE 9 ANNUALIZED HEDGE FUND RETURNS, LAST 5 YEARS ENDING JUNE 30, 2015

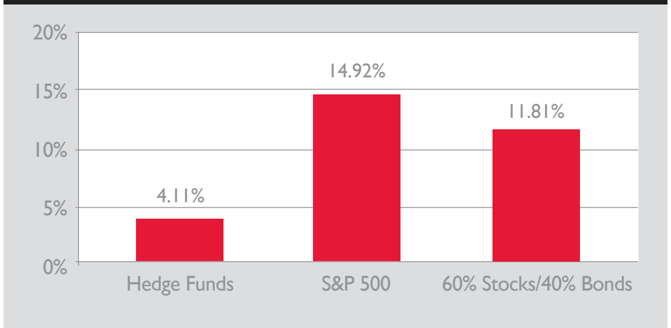
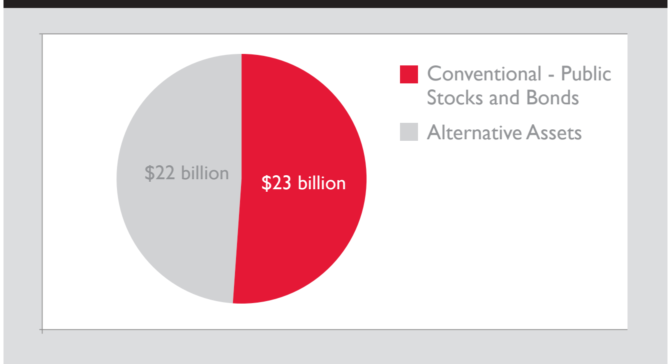


TABLE 1 MARYLAND STATE PENSION FUND, ALTERNATIVE ASSETS, AS OF JUNE 30 OF BOTH YEARS. (IN MILLIONS)

	2014	2015
CREDIT OPPORTUNITY (HEDGE)	$4,292.7	$4,219.9
ABSOLUTE RETURN (HEDGE)	4,252.2	4,873.9
PRIVATE EQUITY	3,184.9	3,675.5
REAL ESTATE	3,074.7	3,361.7
REAL RETURNS (HEDGE)	5,073.6	5,949.0
TOTAL	**$19,878.1**	**$22,080.0**

Source: Maryland Pension Fund CAFR

FIGURE 10 MD PENSION FUND, INVESTMENT ALLOCATION AS OF JUNE 30, 2015



leveraged buy-out PE funds originating after 2005 (i.e., 10 years ago) have not outperformed the broad public market,[5] 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.[6]

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

TABLE 2	MARYLAND STATE PENSION FUND. DISCLOSED ALTERNATIVE ASSET FEES, FISCAL YEAR ENDING JUNE 30 (IN MILLIONS, EXCEPT PERCENTAGES)	
	2014	2015
ALTERNATIVE ASSETS	$19,878.1	$22,080.0
ALTERNATIVE ASSET FEES:		
FIXED	$180.9	$ 197.3
PERFORMANCE	26.9	36.2
TOTAL	$207.8	$ 233.5
AS A PERCENTAGE OF ASSETS:		
FIXED	0.91%	0.89%
PERFORMANCE	0.14	0.16
TOTAL	**1.05%**	**1.05%**

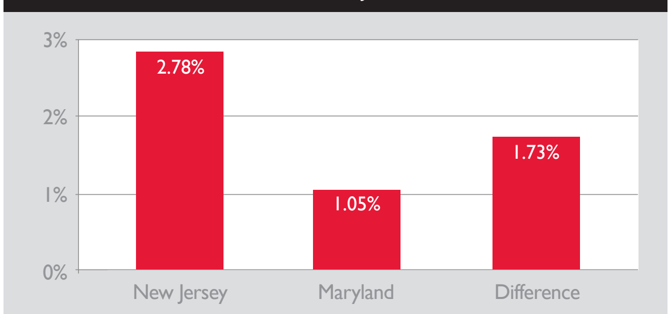
Source: Maryland Pension Fund CAFR (includes credit opportunity, absolute return, private equity, real estate, and real return segments)

TABLE 3	NEW JERSEY STATE PENSION FUND ALTERNATIVE ASSET FEES, YEAR ENDING JUNE 30 (IN MILLIONS, EXCEPT PERCENTAGES)	
	2014	2015
ALTERNATIVE ASSETS	$ 23,400.0	$ 25,288.4
ALTERNATIVE ASSET FEES:		
FIXED	224.5	373.0
PERFORMANCE	334.8	328.4
TOTAL	$559.3	$701.4
AS A PERCENTAGE OF ASSETS:		
FIXED	0.96%	1.48%
PERFORMANCE	1.43	1.30
TOTAL	**2.39%**	**2.78%**

Source: New Jersey Pension Fund CAFR (includes global diversified credit, absolute return, private equity, real estate, and real return segments)

TABLE 4	MARYLAND ALTERNATIVE ASSETS, PERFORMANCE FEE ESTIMATE, FISCAL YEAR ENDING JUNE 30, 2015 (IN MILLIONS)
MARYLAND ALTERNATIVE ASSETS	$ 22,080.0
APPLY NJ PERFORMANCE FEE PERCENT TO MD	X 1.30%
LIKELY ALT. ASSET PERF. FEES (MPPI CALC.)	287.0
LESS: DISCLOSED PERFORMANCE FEES BY THE MD FUND	(36.2)
MD ALTERNATIVE ASSET - UNDISCLOSED PERFORMANCE FEES	**$ 250.8**

FIGURE 11 ALTERNATIVE ASSET DISCLOSED FEES, FIXED PLUS PERFORMANCE, NEW JERSEY VS. MARYLAND



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 (i.e., 1.30% percent **x** $22,080 million = $ 287.0 million) (see Table 4).

As Table 4 shows, the undisclosed Maryland performance fees are reasonably estimated at $250.8 million.

TABLE 5	MARYLAND PENSION FUND – TOTAL WALL STREET FEES, YEAR ENDING JUNE 30, 2015 (IN MILLIONS)
MD DISCLOSED FEES—ALTERNATIVE ASSETS (FROM TABLE 2)	
FIXED	$ 197.3
PERFORMANCE	36.2
TOTAL DISCLOSED FEES (A)	**$ 233.5**
UNDISCLOSED PERFORMANCE FEES (ESTIMATED, TABLE 4) (B)	$250.8
TRUE COST OF ALT. ASSETS (A + B)	**$ 484.3**
CONVENTIONAL INVESTMENT FEES (C)	$ 106.3
TOTAL FOR MD FUND 2015 (A + B + C)	**$ 590.6**
TOTAL MD AVERAGE ASSETS	**$45,624.0**
MD ASSETS DIVIDED BY FEES	**1.29%**

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

FIGURE 12 MD PENSION FUND, 2015, TOTAL WALL STREET FEES

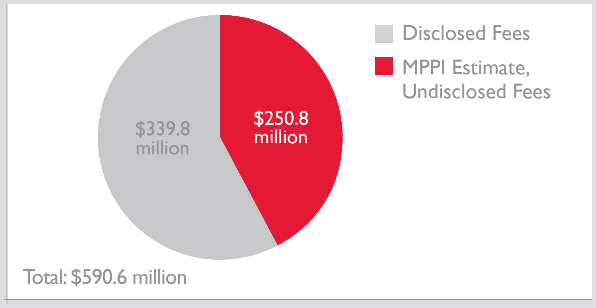


FIGURE 13 MD PENSION FUND, LAST FIVE 5 YEARS, TOTAL FEES

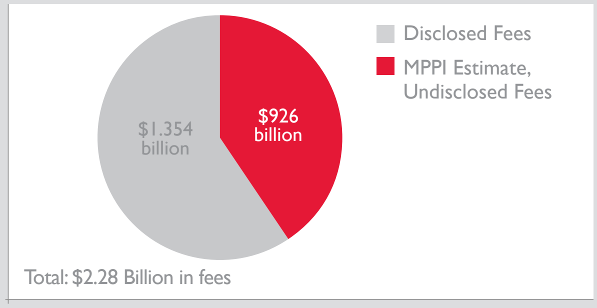
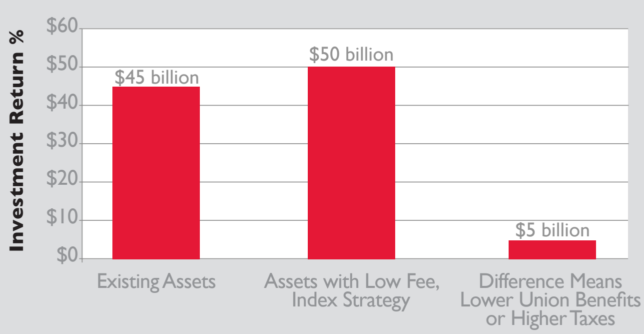


TABLE 6 MARYLAND PENSION FUND, DISCLOSED FEES AND MPPI ESTIMATE OF UNDISCLOSED FEES, LAST FIVE YEARS

	DISCLOSED FEES	MPPI ESTIMATE ON UNDISCLOSED FEES	TOTAL
2015	$339.8	$250.8	$590.6
2014	318.9	175.6	493.9
2013	261.1	200.0	461.1
2012	229.2	150.0	379.2
2011	205.3	150.0	355.3
	$1,354.3	$925.8	$2,280.1

FIGURE 14 MD PENSION FUND, JUNE 30, 2015



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

TABLE 7 REVIEW OF MARYLAND PENSION FUND PERFORMANCE, YEAR ENDING JUNE 30

MD ASSET CATEGORY	2015	5 YEARS	10 YEARS
US EQUITY	6.4%	17.5%	-
GLOBAL EQUITY	4.8	8.3	-
PRIVATE EQUITY	13.2	15.1	-
FIXED INCOME	2.0	-	-
CREDIT DIVERSIFIED	(0.8)	-	-
REAL ESTATE	12.1	14.1	-
REAL RETURN	(5.2)	-	-
ABSOLUTE RETURN	0.7	-	-
TOTAL MD FUND (A)	2.7%	9.4%	5.8%
MEDIAN RETURN (PUBLIC PLANS > $10B) (B)	3.6%	11.0%	6.9%
MARYLAND UNDERPERFORMANCE (A - B)	(0.9)%	(1.6)%	(1.1)%

Source: Maryland 2015 CAFR, Wilshire Associates.

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.

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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.
2. Robert Steyer, NYC Retirement Systems discloses $709 million in fees to managers," Pensions & Investments, November 16, 2015.
3. See the Maryland Public Policy Institute previous studies on 33 state pension funds in 2014 and 2015.
4. Stephen Foley, "Getting to the Bottom of Hedge Fund Fees," Financial Times, February 23, 2015.
5. Brown, Harris, Jenkinson, Kaplan, and Robinson, "What do Commercial Data Sets Tell Us About Private Equity Performance (Panel A)," Working Paper, December 5, 2015.
6. "The Time Has Come for Standardized Total Cost for Private Equity," CEM Benchmarking, April 2015.