“Think Tank’s” recent work of fiction

By Andrew Palmer, CIO

The Maryland Public Policy Institute (MPPI) recently published a report criticizing the level of management fees, transparency and asset allocation of the Maryland State Retirement and Pension System (System), as well as other state pension plans. Unfortunately, and consistent with past analyses, the report is poorly constructed, using inaccurate data, flawed methodologies and erroneous assumptions, leading to conclusions that have no practical application to the management of the System’s assets.

The System’s Board of Trustees has as a primary objective, the protection and enhancement of System asset value and has consistently used all tools and strategies available to minimize the risk associated with achieving the System’s expected return. The report fails to acknowledge this critical fact. As before, MPPI misrepresents the fees associated with the System and the value received for those fees. In addition, the report creates inaccurate summaries of the characteristics of other public plans, then uses those inaccurate descriptions to compare favorably to the System. The report further uses a benchmark of 60% S&P 500 and 40% U.S. bonds as the performance standard for the pension plans rather than the Systems’ liabilities and risk and return objectives.

MPPI’s recommended 60/40 passive portfolio has outperformed the System’s more balanced and diversified portfolio over the last ten years. However, this outperformance is unlikely to be repeated over the next ten years. During this period, U.S. stocks have experienced nearly unprecedented outperformance relative to foreign stocks, and interest rates were on a steady decline. Over the past year, these trends have reversed.

The System’s Board of Trustees reviews the asset allocation annually with Investment Division staff and expert external investment consultants. The focus of this exercise is not on past performance, but on forward-looking risk and return assumptions for the global investment opportunity set. The objective is to construct a portfolio that will provide the highest probability of achieving the return target in the most efficient, risk-balanced way. The Board’s goal is to build a portfolio that will perform well in most economic environments. Based on forward-looking assumptions, MPPI’s recommended 60/40 portfolio is expected to be inferior from a risk and return perspective, with a much lower probability of achieving the System’s return target.

MPPI claims that the System paid $505.6 million in management fees in the fiscal year ending June 30, 2017, which includes an assumption for performance-based compensation (known as carried interest) earned by the System’s asset managers. This is an assumption not based on actual historical experience or quantitative modeling, but rather, it was simply made-up. This fabricated number overstates the amount of the System’s most recent performance-based fee calculation by an astonishing $84.6 million, or nearly 97%. Errors of this magnitude have a profound impact on the results of the report, rendering it completely unreliable.

It is important to distinguish the difference between management fees and incentive fees, as many private market investors do not consider incentive fees to be management fees, something the authors of the MPPI report either don’t understand or refuse to acknowledge. Management fees are contractual obligations that must be paid regardless of performance. Incentive fees, which primarily apply only to private market investments and not traditional asset classes, represent a portion of investment profits that is earned by a manager, and are only paid if performance thresholds are achieved. They are used to motivate the manager to make profitable investments, and to ensure alignment of interests. The percentage of profits that is allocated to the manager is substantially lower than the amount received by the System. Simply put, large amounts of carried interest should be considered a positive result, as this would imply much greater gains to the System at a level of roughly fourfold. While MPPI’s reported incentive fee amount is grossly exaggerated, if given the choice, the System would choose it over any lower amount.

Throughout its report, MPPI intimates that the System is not transparent in reporting fees, using provocative rhetoric like “top secret,” “military codes” and “Wall Street Fees.” The System provides comprehensive reporting of fixed management fees, and hedge fund incentive fees that are not netted against investment income and gains. Currently, there is no standard for reporting performance-based fees in private equity. Incentive fees in private equity are treated differently in that they are generally netted against investment income and gains. Because of this unique structure, applicable accounting standards do not require the reporting of incentive fees. The independent auditor of the System’s Comprehensive Annual Financial Report (CAFR) has affirmed that the System’s treatment of private equity incentive fees are in compliance with accounting standards and consistent with the way most public funds report fees.

As is common among public pension plans, the System does not include performance incentives earned by its private equity managers in the CAFR due to differences in reporting schedules. However, the data is calculated and maintained. In calendar year 2016, the most recent period for which the data is available, the System paid $87.4 million in private equity performance incentives, which is far less than the amount reported by MPPI. The same data will be available for calendar year 2017 when all of the audited financial statements have been reviewed. The System will continue to monitor accounting and reporting standards as they apply to private equity incentive fees, and will be prepared to adapt to any changes to ensure continued compliance.

The MPPI report suggests that management fees and incentive fees act as a drag on total fund performance, and should be minimized by having the System invest only in a passive portfolio consisting of 60% U.S. stocks and 40% U.S. bonds, with no exposure to alternative assets, such as private equity and real estate. According to MPPI, the System’s allocation to alternative assets is 39.1%, which represents another egregious overstatement. As of June 30, 2017, the System’s allocation to alternative assets like private equity, real estate and hedge funds totaled 30.3%, which is 29% lower than the number used by MPPI in its report.

The System invests in alternative assets to enhance returns, which may increase investment risk, and to diversify sources of return, which reduces risk. For example, while private equity is an expensive asset class, it is included in the System’s portfolio to provide returns in excess of public stocks. Table 1 below shows the performance of the System’s private equity portfolio, which ranks among the top programs of its peer group in the country.

Table 1

Maryland Private Equity Annualized Performance as of March 31, 2018 (net of all fees)

	1-Year	3-Years	5-Years	10-Years	15-Years
Maryland Private Equity	22.68%	16.16%	15.82%	10.10%	12.99%
S&P 500	13.99%	10.78%	13.31%	9.49%	10.10%
Excess	*8.69%*	*5.38%*	*2.51%*	*0.61%*	*2.89%*

It is important to note that the returns in Table 1 are net of all fees, including management fees and performance incentive fees. As is their custom, MPPI fails to include this analysis in its report, as it does not support its investment ideology, which does not endorse the use of alternative assets, like private equity.

In its flawed attempt to demonstrate that the higher relative fees associated with active investing result in lower returns, the MPPI focuses on the fee structures and returns of ten public pension plans. However, the analysis is fraught with inconsistencies and inaccuracies. In fact, the data for at least four out of the ten funds was inaccurate, resulting in an error rate of at least 40%. The System pays careful attention to ensure that it is compensated for the higher fees it pays to active managers. In efficient asset classes where the likelihood of successful active management is low, the System employs a predominantly passive strategy. As of March 31, 2018, the passive investments represented 18.3% of the total fund, or roughly $9.5 billion. In inefficient asset classes and asset classes that cannot be managed passively, active strategies are utilized. Table 2 below shows that the System has added value, net of all fees and expenses, over a fully passive alternative to its asset allocation. While not shown, the System achieved these superior returns while experiencing lower return volatility than the Passive Benchmark.

Table 2

Maryland Total Fund Annualized Performance as of March 31, 2018 (net of fees)

	1-Year	3-Years	5-Years	10-Years
Maryland Total Fund	11.04%	6.30%	6.90%	5.39%
Passive Benchmark	10.44%	6.34%	6.36%	4.89%
Excess	*0.60%*	*-0.04%*	*0.54%*	*0.49%*

Like the broken clock, which gets the time right at least two times a day, the MPPI report isn't completely wrong. It correctly notes that the System has underperformed its peer group, as well as a passive portfolio represented by 60% U.S. stocks and 40% U.S. bonds. The primary reason for this shortfall is due to the remarkable and unprecedented outperformance of U.S. stocks over non-U.S. stocks. In 2008, the System adopted a global public equity structure that did not favor or overweight U.S. stocks in an effort to enhance diversification benefits. At that time, the ten-year return assumptions for U.S. stocks and non-U.S. stocks were roughly equal. However, while the returns for U.S. equities essentially met expectations, foreign stocks fell drastically short. Table 3 shows the returns of U.S. stocks relative to non-U.S. stocks as of June 30, 2017. Table 4 shows the outperformance of foreign stocks relative to U.S. stocks for the ten-year period ending June 30, 2007.

Table 3

Annualized Returns as of June 30, 2017

	1-Year	3-Years	5-Years	10-Years
S&P 500 (U.S. stocks)	17.90%	9.61%	14.63%	7.18%
MSCI ACWI x-U.S. (foreign stocks)	20.45%	0.80%	7.22%	1.13%

Table 4

Annualized Returns as of June 30, 2007

	1-Year	3-Years	5-Years	10-Years
S&P 500 (U.S. stocks)	20.59%	11.68%	10.71%	7.13%
MSCI ACWI x-U.S. (foreign stocks)	29.62%	24.52%	19.45%	8.58%

Another factor contributing to the System's underperformance versus the peer group and 60/40 portfolio, is an under-allocation to private equity ten years ago. Many of the System's peers began investing in private equity in the 1980's, while the System only started to allocate to the asset class in 2005. As of June 30, 2007, the System had only 1% invested in private equity. As the System's top-performing asset class, a larger exposure to private equity would have had a positive impact on total plan performance.

The System wants to assure plan participants and beneficiaries that the promise to pay retirement benefits on time each month in the correct amount will be a promise kept. This assurance is achieved by investing plan assets in a professional, prudent and diversified manner. The assets are diversified by geography and asset class to mitigate risk and volatility. While analyzing historical performance is helpful for informational and attribution purposes, it is of little utility when constructing an investment portfolio for the future, as economic cycles change investment risk and return patterns. The MPPI continues to resort to inaccurate reporting using flawed methodologies in an effort to advance a specific ideology. The System will continue to respond to this style of reporting by correcting errors with facts, and affirming to constituents that best practices and standards are being applied in the management of the plan assets.

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