“Think Tank’s” Poor Research Leads to Poor Conclusions

By R. Dean Kenderdine & Andrew C. Palmer

The Maryland Public Policy Institute (“MPPI”) has published a report by Jeff Hooke claiming that the Maryland State Retirement and Pension System (“System”) paid over a half-billion dollars in management fees in fiscal year 2015, cancelling out the tax revenue the state collected from the lottery and casino industries. And so he frames his poorly researched report with the spurious notion that the fees somehow negated the state’s gaming revenue. In fact, the fees helped the system generate over $800 million in additional net return, reducing the impact of a poor investment market on state finances. It also misleads the reader into believing that the System’s investment costs are paid out of the State’s General Fund when in fact, they are paid out of the System Trust Fund.

Unfortunately, and consistent with past analyses produced by Mr. Hooke, this report is riddled with errors and based on methodologies that are both unscientific and flawed. The System did not pay $590 million in fees in fiscal 2015, and the fees that were paid generated gains in both absolute and relative terms. The System will continue to respond to and correct MPPI’s sensationalized style of reporting as long as it continues to demonstrate a complete disregard of the facts, and resorts to selection bias and fanciful analysis to support its ideology.

In February 2016, Mr. Hooke requested information regarding the amount of performance-based carried interest incentives earned by asset managers engaged by the System for the fiscal year ended June 30, 2015. The System provided Mr. Hooke with data for the calendar year ending December 31, 2014 in order to align with the reporting schedule for audited financial statements for most of the System’s alternative investment vehicles. The total amount of carried interest provided to Mr. Hooke in response to his request was $85.2 million. Apparently, Mr. Hooke did not like this response, as he ignored it and created a number on his own that better supports his position. According to Mr. Hooke, the “real” amount was closer to $287 million.

The methodology used to arrive at this fabricated number is flawed and based on incorrect assumptions. Mr. Hooke observed the amount of carried interest relative to assets reported by the state of New Jersey, and extrapolated that ratio to the System’s exposure to alternative assets. This process incorrectly assumed that both plans were identical. Had Mr. Hooke been interested in obtaining the facts and bothered to contact the System for an explanation, he would have been informed that the differential was primarily due to average program maturity, and the dynamics of private equity investing. While New Jersey and the System began investing in alternative assets at roughly the same time, New Jersey was much more aggressive in its pacing of investments. As an illustration, as of December 31, 2007, New Jersey’s exposure to alternative assets was $7.6 billion, while the System’s allocation was $1.6 billion. Private equity investments are typically structured with terms, or maturities, of ten years. The first several years are considered the investment period, when the manager makes the fund investments. The remaining years are the harvesting period, when investments are sold and proceeds are distributed to investors. It is typically during this period, when investments are sold at a profit, that the manager receives earned carried interest. More mature programs can be expected to receive more distributions, and hopefully allocate more in performance-based incentive fees, than programs that are earlier in the investment cycle. Because Maryland began investing in private equity only relatively recently, most of its investments have yet to be sold.

In its response to Mr. Hooke's request for carried interest information, the System attempted to add some context around this issue by distinguishing the difference between management fees and incentive fees, as many do not consider incentive fees to be management fees. Management fees are contractual obligations that must be paid regardless of performance. Incentive fees represent a portion of investment profits that are 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. Because of this disproportionate sharing of profits, the amounts realized by the System would far exceed any incentive fees paid to managers. Large amounts of carried interest should be considered a positive result, as this would imply much greater gains to the investor at a level of roughly fourfold. While the System would like to see an improved profit sharing allocation in favor of the investor, and negotiates contract terms aggressively where possible, the overall market, consisting of both managers and investors, establishes the sharing percentages. If the System avoided these investments based on the fee structure alone, it would not have experienced the superior net-of-fee returns provided by private equity relative to all other asset classes.

In addition to his error in calculating the appropriate ratio of carried interest, Mr. Hooke compounds the error by miscalculating the System's exposure to alternative assets. As reported by Mr. Hooke and reflecting a lack of understanding of the System's asset allocation, the System's exposure to alternative assets was $22.1 billion as of June 30, 2015, representing 49% of the total fund. It appears that the MPPI report is incorrectly categorizing all assets not listed as Public Equity, Fixed Income and Cash as alternative assets. For example, the Real Return asset class included an allocation to Treasury Inflation-Protected Securities and other inflation-linked bonds of roughly $3.6 billion as of June 30, 2015. It is doubtful that Mr. Hooke would consider these securities as alternative assets. Other examples include high yield bonds, investment grade bonds and emerging market debt in the Credit asset class, and publicly-traded real estate investment trusts in the Real Estate asset class. Mr. Hooke cited the Maryland State Retirement and Pension System Comprehensive Annual Financial Report as the source for much of his information. Within pages of the section covering fees is a discussion of the different asset classes and the types of investments employed. A casual reading of those descriptions might have caused Mr. Hooke to dig deeper in an effort to better understand the System's exposure to alternative assets.

The MPPI report also asserts that private equity has underperformed public equity. As a long-term asset class, private equity performance should be evaluated over a long time period, and should be measured against a broadly-diversified global benchmark, as most institutional investors invest in both domestic and foreign stocks. Instead, Mr. Hooke applied selection bias to his analysis by choosing an end date, time period and benchmark that all advanced his personal philosophy. A fair, comprehensive and objective analysis of the System's private equity performance is shown below as of April 30, 2016, the most recent performance available.

Maryland Private Equity Annualized Performance as of April 30, 2016 (net of all fees)

	1-Year	3-Years	5-Years	10-Years	15-Years
Maryland Private Equity	12.85%	15.17%	13.15%	11.40%	8.32%
S&P 500	1.21%	11.26%	11.02%	6.91%	5.49%
Russell 3000	-0.18%	10.77%	10.50%	6.85%	5.88%
MSCI ACWI (global)	-5.66%	5.06%	4.69%	3.89%	4.71%

The MPPI report also benchmarks the performance of a broad universe of hedge funds against a portfolio represented by 60% S&P 500 and 40% bonds. While this benchmark may be suitable for some investors,

it is not appropriate for the System as it does not reflect the objectives of the program. The System invests in hedge funds to manage risk and diversify the total plan.

Hedge funds are not a specific asset class in Maryland's portfolio. Instead, they are blended-in to other asset classes and sub-asset classes. The Absolute Return asset class is one such asset class that includes several hedge funds. The objective of the Absolute Return asset class is to provide equity-like returns with roughly half the volatility of the equity market over a full market cycle. The focus is on strategies that employ an absolute return orientation, with low exposure to broad equity and credit markets. The targeted beta, or exposure to traditional asset classes, for the hedge funds in this portfolio is less than 20%. While the Absolute Return asset class is expected to achieve equity-like returns over the long term, performance relative to long-only public equity indices will vary significantly over the short and intermediate term. During periods of very strong public equity returns like the last five years, absolute return strategies can lag dramatically. However, these low equity exposure strategies should outperform during periods of market stress.

Hedge funds in general have struggled in this difficult market environment over the past several years, and the System's hedge fund program is no exception. Several factors have contributed to their underperformance, including low interest rates, global central bank intervention, low market volatility and the lagging performance of value-oriented stocks relative to growth stocks. However, the System is confident that hedge funds serve an important risk-reducing role in the total portfolio and their performance should improve.

The MPPI report also incorrectly attributes the System's ranking against a peer universe to the inaccurate and exaggerated level of fees fabricated by Mr. Hooke. The System's peer ranking is a function of risk tolerance and asset allocation, as opposed to active management fees. In fact, active management has consistently generated value in excess of the System's policy benchmark, which can be considered as the passive alternative implementation of the System's asset allocation. Over the ten years ended June 30, 2015, active management has added over $1 billion in excess of the passive portfolio. The chart below compares the System's actual net-of-fee returns against the all-passive alternative over the ten-year period ending June 30, 2015.

Maryland Total Fund Annualized Performance as of June 30, 2015 (net of fees)

	1-Year	3-Years	5-Years	10-Years
Maryland Total Fund	2.68%	9.10%	9.36%	5.77%
Passive Benchmark	0.86%	7.70%	8.52%	5.30%
Excess	1.82%	1.40%	0.84%	0.47%

While the MPPI report misses the mark regarding active management, it correctly notes that the System's peer group ranking is unimpressive. This ranking can be attributable to a more defensive asset allocation relative to the peer group. After the large market drawdowns that occurred during the tech bubble in the early 2000s and again during the financial crisis in 2008-2009, the System determined that the fund was too exposed to the public equity market, which historically has been one of the most volatile asset classes. As a result, some of the public equity assets were re-allocated to other asset classes with less exposure to the stock market. While the System's allocation to public equity represents an underweight versus the peer group, it enables to System to achieve its actuarial return target, based on modeled long-term risk and return assumptions, with lower risk and a smoother return stream than the overall peer group. The System accepts that during periods of strong public equity performance, as has been experienced over the past five years, it will lag the peer group. However, the System should perform better during periods of market stress and public equity drawdowns.

Throughout its report, MPPI intimates that the System is not transparent in reporting fees. The differences between fixed management fees and performance-based incentive fees have been addressed earlier in this response. 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 in typical drawdown cash flow structures. Because of this unique structure, applicable accounting standards do not require the reporting of incentive fees. The auditor of the Comprehensive Annual Financial Report has indicated that the System's treatment of private equity incentive fees is in compliance with accounting standards and consistent with the way most public funds report fees.

To encourage greater reporting transparency and standardization in the private equity industry, the System recently endorsed the Institutional Limited Partners Association's Fee Reporting Template. 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 Board of Trustees of the System is aware of the importance of asset allocation in achieving risk and return objectives. Each year, the System's general investment consultant and Investment Division conduct an asset allocation review which incorporates assumptions for asset class returns, risk and correlations. Other factors such as liquidity needs and liabilities are also considered. Typically, several asset allocation options are presented for the Board's consideration. After analyzing the risk and return profiles of each option, and evaluating how each might perform in different economic environments through stress testing and scenario analyses, the Board adopts an allocation that can meet return objectives in a balanced and diversified way. Over the last three years, the System's asset allocation has been reviewed by three separate expert, independent investment consultants. All three have confirmed that the System's asset allocation is reasonable and appropriate. Mr. Hooke's proposed naive asset allocation may have achieved return objectives over the recent time period when domestic equities experienced strong performance. However, based on most current capital market assumptions, this portfolio falls short in meeting targeted returns in the future.

The System would like to assure plan participants and state taxpayers that the assets of the fund are being managed in a professional, prudent and diversified manner. Mr. Hooke and MPPI continue to resort to irresponsible and 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.

About the authors: R. Dean Kenderdine is Executive Director of the Maryland State Retirement Agency, Andrew C. Palmer is the agency's Chief Investment Officer.