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Are State Pension Funds Paying Wall Street Too Much?

Posted By Mike Maciag | August 15, 2012

A recent report by two Maryland think tanks makes the case for state retirement systems to dump Wall Street investment firms for more passive equity index funds.

The study by the conservative-leaning Maryland Tax Education Foundation and Maryland Public Policy Institute outlines fees state pension funds pay investment firms, totaling $7.8 billion nationwide in 2011. This price tag is too high, the authors argue, given their meager returns in recent years.

Pension experts interviewed for this story, though, question the validity of the report, which compares investment firm fees with each plan's net assets. Even with the higher fees, they say additional returns from investment managers outweigh the added cost in the long run, and tossing more money into equity index funds wouldn't diversify portfolios.

"The suggestion that all public pensions should be shifted into index accounts is just not well informed," said Keith Brainard, research director for the National Association of State Retirement Administrators.

Index funds -- more passive than actively-managed funds -- are structured to mirror a market index, typically making up a fourth to a third of a retirement system's total assets, Brainard estimated. These funds also come with fees, but at lower rates than actively-managed funds.

In exchange for higher fees, managers with investment firms pledge to beat the stock market. State pension systems paid fees averaging 0.409 percent of beginning-of-year assets in fiscal year 2011, according to the report.

By investing 80 to 90 percent of portfolios in index funds, the study estimates retirement systems could pocket more than $6 billion annually in payments otherwise going to investment firms.

"This would be a safer, more responsible use of system resources than paying Wall Street management firms millions of dollars each year to deliver sub-par results on public stocks and bonds and risky private alternative investments," the

report states.

But Brainard of NASRA, whose members are directors of public retirement systems, says funds can't attain true diversification if nearly all their money is tied to market indices. Fund managers often shift money between active and passive funds depending on market conditions.

No one disputes that firms failed to meet targets in recent years. The report cites S&P Dow Jones Indices data showing 84 percent of actively-managed U.S. equity funds failed to achieve benchmarks in 2011. But in the long run, Brainard argues pension funds usually earn back fee costs. "[The report's authors] are overlooking the potential value that is being added," he said.

Fees paid by Missouri state, local and public school employee retirement systems, as calculated as a percentage of assets, topped all others for fiscal year 2011. Combined fees for the three retirement systems totaled $506.7 million, or 1.4 percent of beginning-of-year net assets.

Accordingly, one of these pension funds, the Missouri State Employees' Retirement System, reported a 7.1 percent annualized return for the 10-year period up through June 2011, the highest rate of all state funds surveyed in a recent report by investment firm Cliffwater.

Of the 69 funds the firm surveyed, the following systems recorded the strongest performance over 10 years:

After the Missouri systems, the Oregon Public Employees Retirement System and Maryland State Retirement and Pension System paid the next-highest fees as a percentage of beginning-of-year assets.

Much of the report focuses on Maryland's performance, which the authors argue lagged behind others in recent years despite paying higher Wall Street fees. The Maryland Tax Education Foundation compiled data showing the system's returns trailed six nearby state pension funds by an average of 0.9 percent over the past 10 years.

Jeffery Hooke, an investment banker who serves as chairman of the foundation, co-authored the report with Michael Tasselmyer of the Maryland Public Policy Institute, which has received funding from the conservative Cato Institute and is a member of the State Policy Network, a national group of "free-market think tanks."

Many of these pension funds face pressure to assume lower rates of return. Shifting money to index funds would only exacerbate this, said Lisa Lindsley, director of capital strategies for the American Federation of State, County and Municipal Employees.

The amount of assets funds allocate to index funds typically relates to specific investment objectives. "I think we need to allow the governing structure of the pension funds to work," Lindsley said.

Some systems, including the California Public Employees' Retirement System, are actively negotiating with firms to push down fees.

"We really encourage our trustees to look at the predatory nature of investment managers," Lindsley said.

Howard Pohl, a principal at Chicago-based investment firm Becker, Burke Associates, faulted the report for not examining how well funds achieved their individual objectives. Some funds are more aggressive than others, with performance relative to different mixes of assets.

While the funds require higher fees, Pohl said it's more important to assess whether the actively-managed funds translate into larger returns. In general, these returns trump the cost when compared to passive index accounts over longer periods exceeding a decade, he said.

But few funds have fared well in recent years.

"We've been in a period of non-selectivity in the markets," Pohl said. "An index in that environment should do better."

Pohl also questioned why the report compared fees to beginning-of-year net assets rather than to totals at the end of the year.

"The implication that all these plans all over the country are being duped by these city slickers from Wall Street is extremely naïve and not supported by the facts," he said.