TREASURY NOTES
October 2019

Pension Investment Transparency

The call for transparency has become common in many public policy debates. Often lost, however, is an identification of the underlying objective associated with the demands for greater openness and transparency. In other words, why is transparency important? In the realm of public pension funds, transparency leads to better management of assets, better budgeting and planning of contributions, and better oversight of both. Transparency serves to keep public pension systems accountable to their beneficiaries and the general public.

The call for transparency led the General Assembly to establish the Public Pension Management and Investment Review Commission (PPMAIRC) in Act 5 of 2017. The General Assembly directed the PPMAIRC to provide specific recommendations on cost savings and transparency. In December 2018, the PPMAIRC released its comprehensive report, which included nearly 100 recommendations and $10 billion of actuarial savings opportunities for the Commonwealth.

This edition of Treasury Notes highlights the PPMAIRC's recommendations on transparency and provides a framework for legislative solutions.

The PPMAIRC found that:

- Costs matter. Transparency can reduce investment costs and improve performance.
- Alternative investments can be structured to hide the true cost of investing. Nearly $5 billion in costs have gone previously unreported in Pennsylvania.
- Transparency does not harm investment performance, rather it can prevent inappropriate investment decisions.

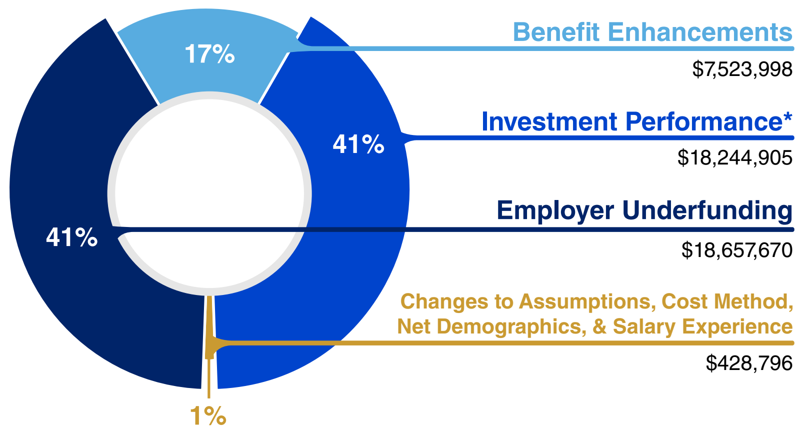
PPMAIRC Commission Members

- **James Bloom** - *Appointed by the Minority Leader of the Senate*
- **Bernie Gallagher** - *Appointed by Minority Leader of the House*
- **Michael Tobash, Chair** - *Appointed by the Speaker of the House*
- **Michael Tobert** - *Appointed by the President Pro Tempore of the Senate*
- **Joe Torsella** - *Appointed by the Governor*

Background

Pennsylvania's two large state-affiliated pension systems, the State Employees' Retirement System (SERS) and the Public School Employees' Retirement System (PSERS), have less than sixty cents for every dollar owed to retirees. Causes of this shortfall include years of insufficient contributions, retroactive benefit increases, and subpar investment performance. Act 5 of 2017 aims to reduce taxpayer costs and risks going forward through the creation of three new pension options: a defined contribution plan and two hybrid pension plans. Despite reforms, General Fund contributions to the pension systems are projected to consume approximately 10% of revenues for the foreseeable future. Any expenditure of this magnitude should be managed with a high degree of prudence and transparency.

PSERS Sources of Unfunded Liability as of June 30, 2018
($ amounts in thousands)

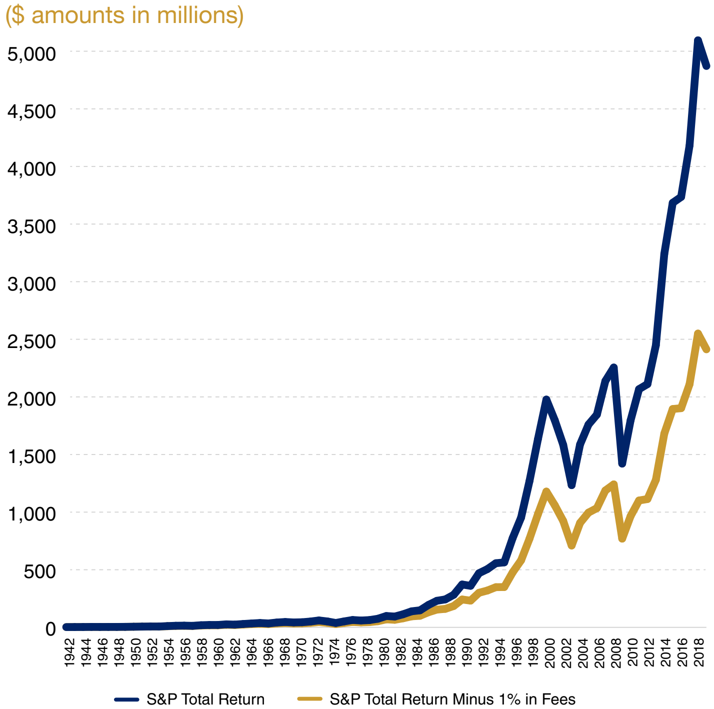


Souce: PSERS
*Note: The investment performance figure represents the liability created by assets that generated returns below their original expectations.

Why does transparency matter?

Increased focus on transparency leads to innovation in both retail and institutional financial services that lowers costs and improves outcomes for investors, such as the development of index funds. Dr. Ashby Monk reported in his PPMAIRC analysis that complex investment strategies can only be executed after first understanding the complete cost of investing. In addition, Warren Buffet's 2018 shareholder letter provided the following simple illustration of the profound impact investment costs can have:

How Just 1% in Fees Cuts Value in Half Over Time*
($ amounts in millions)



Souce: Pennsylvania Treasury
*Note: January,1942 – December, 2018

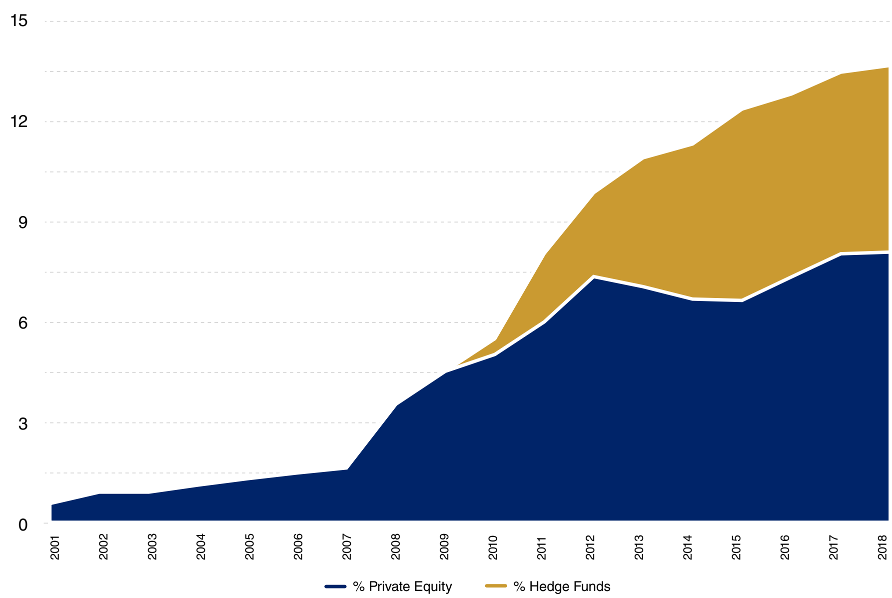
If my $114.75 had been invested in a no-fee S&P 500 index fund, and all dividends had been reinvested, my stake would have grown to be worth (pre-taxes) $606,811 on January 31, 2019 (the latest data available before the printing of this letter). That is a gain of $5,288 for 1. Meanwhile, a $1 million investment by a tax-free institution of that time – say, a pension fund or college endowment – would have grown to about $5.3 billion. Let me add one additional calculation that I believe will shock you: If that hypothetical institution had paid only 1% of assets annually to various "helpers," such as investment managers and consultants, its gain would have been cut in half, to $2.65 billion.

The first step in reducing costs is to improve transparency of the investment decision-making process. Transparency especially matters for pensions, as investment contracts are typically awarded upon recommendations from external investment consultants and pension staff. These awards result in billions of dollars in long-term investment commitments with no guarantee of superior returns. Investment managers, however, are guaranteed ongoing annual management fees often in the range of 1-2% and a share of any potential profits ranging from 15-30%.

As highlighted by the PPMAIRC, sales presentations, contract provisions, and summary-level fee terms, are often treated by investment managers as confidential trade secrets. The investment cost expert retained by the PPMAIRC, Marcel Staub, reported that "not being transparent about asset manager's contractual details serves only one party's interests: the asset manager… whenever clients are told that contractual terms are a trade secret of the manager, it is an indication that these should be reviewed immediately."

Transparency is becoming a greater priority nationally as pension funds increase their allocations in complex alternative investments, such as private equity and hedge funds. These allocations are made with the expectation that alternative investments will outperform low-cost public markets. This trend was particularly pronounced in Pennsylvania, where allocations to private equity reached around 25% as recently as five years ago. SERS' and PSERS' current allocations to private equity investments have decreased, yet they still hold more private equity than 75% of all public pension funds.

Median Public Pension Allocations in Private Equity and Hedge Funds



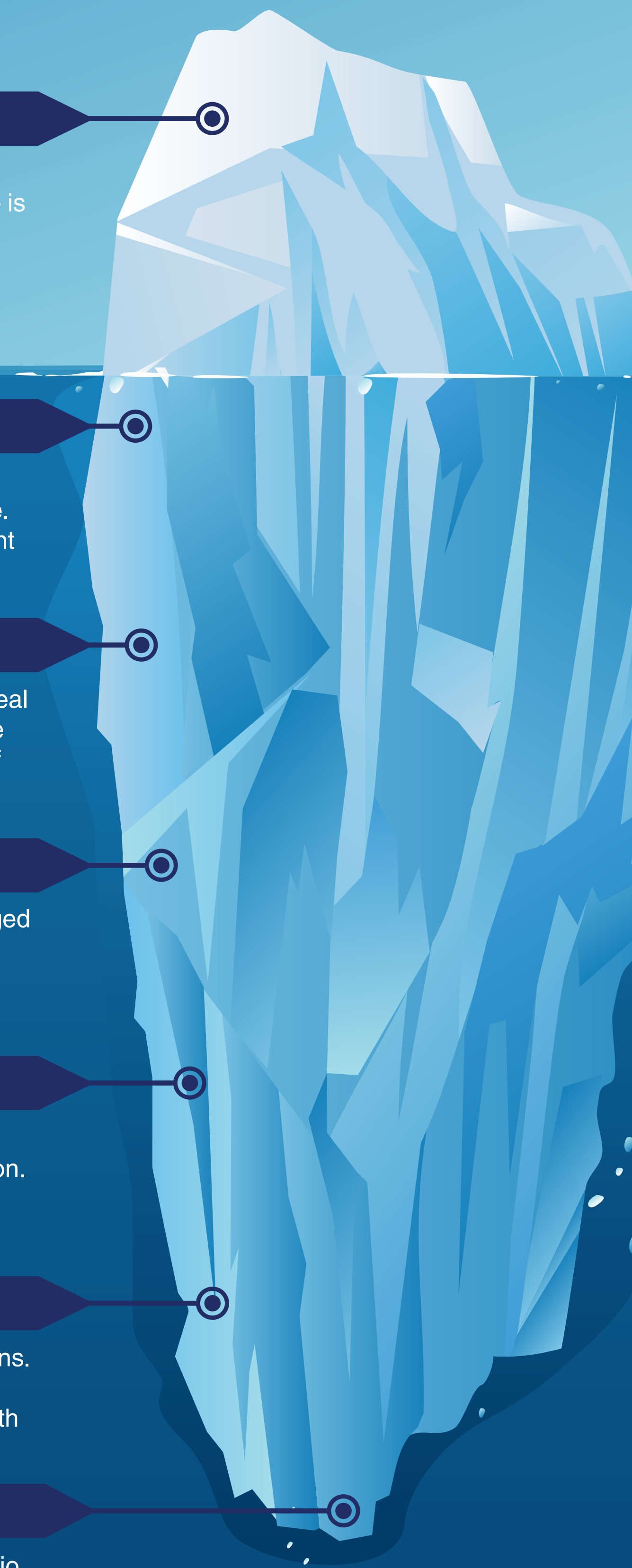
Souce: Boston College Public Plans Database

Alternative investments often have increasingly elaborate structures that obscure how much is being charged to public pension investments. The next illustration was included in Private Funds Management's October 2016 Fee and Expenses survey. It describes fees typically associated with a private equity investment, along with costs and expenses that aren't always tracked or disclosed consistently.

Unclear guidance on pension transparency practices from groups such as the Governmental Accounting Standards Board has led to inconsistencies in how states are reporting fees and performance. This has led to certain pension plans, including SERS and PSERS, being reported as more expensive than other plans. While the PPMAIRC did find PSERS (8th of 73) and SERS (16th of 73) highest in costs relative to other peer public pension plans, transparency and the use of standardized reporting is the only solution that will allow plan members, policymakers, and other stakeholders to thoroughly evaluate costs and performance.

WHAT LIES BENEATH?

Management fees and carried interest make up most of a GP's income, but numerous other 'hidden expenses' lie in wait for LPs and portfolio companies.



TWO AND 20

The two-and-20 fee structure – typically a 2 percent flat rate on the total asset value of the fund and an additional 20 Percent of any profits earned – is the traditional model, but times are changing. Sophisticated LPs have been pushing for concessions and GPs – eager to secure large commitments – have been willing to concede ground. The upshot is that many GPs have turned to other streams of revenue.

MONITORING FEES

Justified by fund managers who point to the resources that go into adding value to investments. These fees are ongoing and unrelated to performance. Accelerated monitoring fees, charged when a GP exits a portfolio investment ahead of schedule, are even more contentious.

CLOSING FEES

Following an acquisition, a private equity firm will pay itself a fee after the deal closes using the proceeds. This is for raising the capital needed to close the deal with the justification that the PE firm is saving investors the expense of using outside advisors.

EXIT FEES

Paid to GPs once they sell a company. Some portfolio companies are charged twice: first when the private equity firm comes in, and then when it exits. Even if a bank is involved, the GP will often justify an exit fee by their close involvement in the process.

RECAP FEES

Occur whenever there is a liquidity event or additional transaction within a portfolio investment, such as a dividend recapitalisation or bolt-on acquisition. These are often charged whether the GP deploys additional equity from the fund or not.

BROKEN DEAL EXPENSES

Typically charged by a seller if the buyer wants to enter exclusive negotiations. These will normally only occur at late stages of competitive deals. Their definition can be so broad that GPs stretch it to include costs associated with routine deal-sourcing.

DIRECTOR FEES

PE firms will often bring outside directors to sit on the boards of their portfolio companies. The problem is when these directors collect a fee from the company while also being paid by the fund manager.

> **"…complexity is the enemy of transparency, and complexity is not a good thing in finance."**
>
> Hank Paulson, former U.S. Treasury Secretary under President George W. Bush, 2013.

Why a legislative solution?

In the absence of federal legislation, industry leadership, or voluntary limitations on alternative investments by the pension systems themselves, some states have sought to increase transparency of pension fund investments through legislative action. Most of these actions dictate open meetings, open records, and reporting of pension fund investments and fees. Recently, states have focused legislation on increased transparency in the reporting of alternative investment performance and fees. Legislation has been introduced or passed in California, Colorado, Illinois, Kentucky, Maryland, and in Pennsylvania with the introduction of HB 1460 of 2017, and now with HB 1964 of 2019.

The reporting of fees should be standardized and based on industry-recognized formatting, such as the Institutional Limited Partners Association (ILPA) template. Not only have many pension systems (Limited Partners) embraced the ILPA standards, investment managers (General Partners) are increasingly utilizing the standards as it provides for consistent reporting and reduces their administrative costs. Also, a popular portfolio monitoring software used by pension systems integrates the ILPA template to provide consistent tracking and reporting of fees without significant staff or budgetary burdens.

Pension Transparency Best Practices

The PPMAIRC's recommendations on transparency were based on a review of over 60 public pension plans and investment boards, which found that:

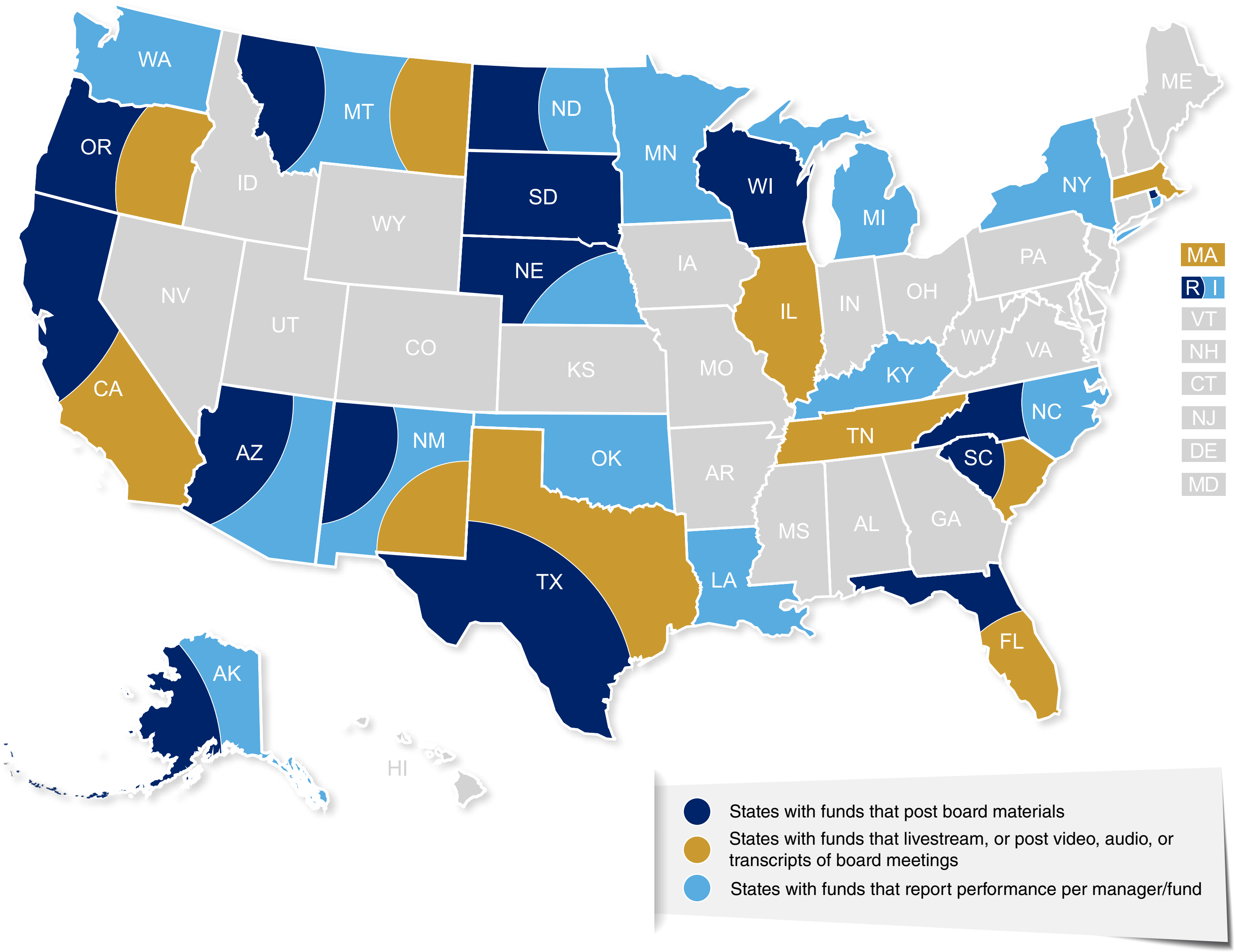
39% Post full board packets online, many including investment manager presentations with proposed fee terms.

30% Provide live streaming, video, audio, and/or full transcripts of board meetings.

44% Publish quarterly performance reports that show each manager's performance against its benchmark, many on both a gross- and net-of-fees basis.

A significant and growing number of leading funds are reporting carried interest/performance fees for private equity, including funds in Arizona, California, Maryland, Missouri, Rhode Island, South Carolina, and Texas.

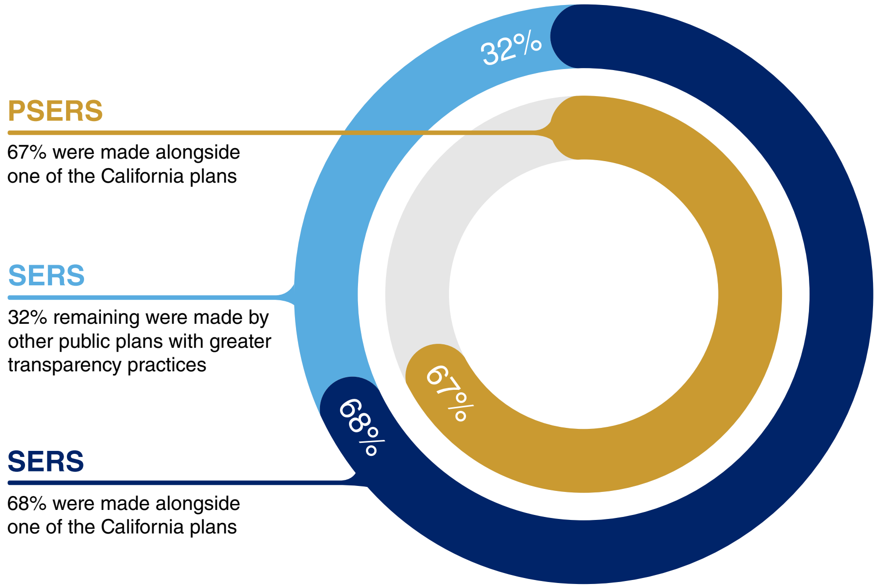
Pension Transparency Best Practices



Manager Access

Some on Wall Street have attempted to convince pension fund board members and staff that transparency will cut off their access to the best managers in the business, thereby harming investment returns. There is little evidence of this. California's comprehensive pension transparency legislation took effect in 2017 and applies to other public plans in the state, including local plans. California pension plans made at least 350 private equity commitments totaling more than $44 billion in the two calendar years following implementation of its transparency legislation, a majority of which were also committed to by SERS and PSERS.

Of the $2.7 billion of private equity commitments made by PSERS in the past two calendar years, at least $1.8 billion – or 67% – were also made by one of the transparent California plans. At SERS, at least $1.1 billion of its $1.6 billion in private equity commitments – or 68% – also were made by one of the California plans. All of these investments were subject to California's comprehensive transparency requirements. The remaining 32% of private equity commitments made by SERS were also made by other public plans with greater transparency practices. This strongly suggests that enhanced transparency requirements would not have affected a single private equity commitment made by SERS in the past two calendar years.



Summary of PPMAIRC Transparency Recommendations

- Stream board meetings for pension members unable to attend.
- Share the reports and information evaluated to make new investments with pension members.
- Share the quarterly performance reports prepared by the third-party general investment consultant. Reports should show per-manager/fund performance metrics over multiple time periods.
- Publish annual reports of all fees, costs and expenses per manager/fund.
- Prohibit pension funds from entering into contracts that shield performance and fee/cost information from pension members and the public.

Conclusion

Improved transparency of pension fund investments is a commonsense policy position supported by diverse stakeholders across the political spectrum, including numerous labor unions, Pew, and the National Association of State Treasurers. Any legislative solutions on pension transparency should include the best practices identified by the PPMAIRC that consider the entire life cycle of investments, from how decisions are made to how costs and performance are regualy reported.