Annual State Retirement and Pension System's Investment Overview

Presented to the
Joint Committee on Pensions

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At the request of the Joint Committee on Pensions, the Department of Legislative Services (DLS) annually reviews the investment performance of the State Retirement and Pension System (SRPS) for the preceding fiscal year. This report is intended to provide an overview of the SRPS performance, a comparison of this performance to its peers, and an identification of issues meriting consideration by the joint committee during the upcoming legislative session.

State Retirement and Pension System Investment Performance

The system's investment return for fiscal 2014 was 14.4% net of management fees, exceeding its investment return target of 7.70% for the fourth time in the last five years. Public equities continued to lead the fund's strong performance, with broad indices of public equities surging upward – the U.S. domestic S&P 500 index rose 24.6% and the MSCI international index rose 21.8%. With public equities making up 38.9% of the portfolio, this impressive performance propelled the system to generate returns well in excess of its target.

As shown in **Exhibit 1**, the system's assets totaled $45.42 billion as of June 30, 2014, an increase of 12.8% over fiscal 2013 after accounting for benefit payouts and other expenses. This is the highest fiscal year-end balance in the fund's history and the second year in a row that the fund has exceeded the $40.0 billion level. As noted above, the strongest performing asset classes in fiscal 2014 were public equity (22.2%), private equity (19.6%), and real estate (14.2%). With financial markets still operating in a low interest rate environment, the two weakest classes were fixed income (4.6%) and real return (7.0%). Asset class performance is discussed in greater detail later in this report.

Exhibit 1
State Retirement and Pension System of Maryland
Fund Investment Performance for Periods Ending June 30*
($ in Millions)

			Time Weighted Total Returns		
	Assets	**% Total**	**1 Year**	**5 Years**	**10 Years**
Domestic Equity	$4,660.7	10.3%	26.1%	18.9%	7.7%
International Equity	5,502.6	12.1%	20.4%	11.5%	7.6%
Global Equity	7,508.0	16.5%	21.1%	15.4%	n/a
Fixed Income	6,706.3	14.8%	4.6%	6.5%	5.6%
Credit and Debt	4,557.2	10.0%	11.5%	12.0%	n/a
Real Estate	3,082.2	6.8%	14.2%	12.3%	8.4%
Real Return	5,461.7	12.0%	7.0%	6.9%	n/a
Private Equity	3,185.0	7.0%	19.6%	15.3%	12.8%
Absolute Return	4,252.1	9.4%	7.6%	6.1%	n/a
Cash	500.0	1.1%	0.8%	2.7%	n/a
Total Fund	**$45,415.6**	**100.0%**	**14.4%**	**11.7%**	**6.5%**

*Data presented here includes money invested by the system on behalf of the Maryland Transit Administration.

Note: Returns beyond one year are annualized. Returns are net of fees, except for 10-year returns, which are gross of fees. Columns may not add to total due to rounding.

Source: State Street Investment Analytics

As shown in **Exhibit 2**, total system assets increased by almost $5.0 billion from fiscal 2013 to 2014. In fiscal 2014, the system paid out $3.1 billion in benefits, the first time that figure has exceeded $3.0 billion, and total deductions were $3.2 billion. Income derived from employer and employee contributions totaled $2.5 billion, leaving an initial funding deficit of $0.7 billion; however, total investment income was $5.7 billion, more than covering the funding gap on a cash basis. Total deductions increased by 5.8%, and total additions increased by 4.5% over fiscal 2013 levels. This pattern is expected to continue due to restrained payroll growth combined with increasing rates of retirement among active members, which will put continued pressure on the investment program to continue covering the ongoing and expanding funding gap.

Exhibit 2
State Retirement and Pension System of Maryland
Statement of Changes in Net Assets Available for Plan Benefits
Fiscal 2013-2014
($ in Millions)

	2014	2013
Increase in Assets		
Contributions		
State and Other Employers	$1,733.6	$1,643.1
Member	727.7	710.9
Net Investment Income*	5,706.3	3,845.8
Total Additions	**$8,167.6**	**$6,199.8**
Decrease in Assets		
Benefit Payments	-$3,121.8	-$2,950.7
Administrative Expenses	-26.1	-26.3
Refunds	-42.9	-38.3
Total Deductions	**-$3,190.8**	**-$3,015.3**
Change in Assets During Period	**$4,976.8**	**$3,184.5**

*Dividends, interest, realized and unrealized capital gains.

Note: Data presented here includes the system's bank cash account but excludes money invested by the system on behalf of the Maryland Transit Administration. Columns may not add to total due to rounding.

Source: State Retirement Agency

Terra Maria Program

The Terra Maria program, the system's emerging manager program, continued to add value to the portfolio, but its performance has weakened compared with its early years. Now in its eighth year, the program's returns continue to exceed benchmarks, both on an annual basis and since inception. However, with the program exceeding its benchmark by just 24 basis points in fiscal 2014, annual performance has dipped considerably from its early years, when performance exceeded the benchmark by more than 100 basis points. The program has also continued to experience some retrenchment in size, both relative to total assets and in the total number of managers involved. After hitting its peak of 110 asset managers in fiscal 2012, the Terra Maria program finished fiscal 2014 with 89 managers, down from 94 in fiscal 2013. Total assets devoted to the program increased slightly, from almost $2.8 billion in fiscal 2013 to almost $3.0 billion in fiscal 2014. However, as a proportion of total assets, Terra Maria dropped from 6.9% of total assets in fiscal 2013 to 6.6% in fiscal 2014, reflecting stronger growth in total assets. These trends are driven in part by continued retrenchment in the system's public equity holdings, which comprise the vast majority of the Terra Maria program, as well as manager performance, with a handful of managers terminated during the year. **Exhibit 3** provides an overview of the Terra Maria program by program manager and asset class.

Exhibit 3
Terra Maria Program Performance
June 30, 2014
($ in Millions)

		Performance			
Program Manager	**Total Assets**	**Fiscal 2014 Actual**	**Fiscal 2014 Benchmark**	**Inception Actual**	**Inception Benchmark**
Attucks	$450.8	21.3%	21.3%	17.7%	16.3%
Bivium	333.9	22.2%	22.4%	16.5%	16.4%
Capital Prospects	455.0	22.5%	20.8%	20.1%	19.4%
FIS Group	388.4	23.3%	23.2%	16.8%	16.2%
Leading Edge	395.9	21.0%	21.2%	17.1%	16.6%
Northern Trust	650.4	19.4%	20.0%	6.1%	5.0%
Progress	306.9	4.6%	3.5%	9.8%	9.6%
Asset Class					
U.S. Equity	$1,356.3	25.3%	25.0%	9.2%	8.0%
International Equity	850.6	22.1%	22.0%	3.0%	1.1%
Global Equity	22.3	23.0%	23.0%	13.3%	14.5%
Fixed Income	509.2	4.2%	3.5%	7.7%	9.2%
Credit/Debt	208.0	13.6%	14.5%	10.0%	10.4%
Real Return	34.7	5.9%	4.4%	6.6%	6.4%
Total	**$2,981.2**	**19.6%**	**19.3%**	**6.5%**	**5.1%**

Note: Actual returns are net of fees; returns beyond one year are annualized. Total assets may not sum to total due to rounding.

Source: State Retirement Agency

For fiscal 2014, four of the seven program managers met or exceeded their performance benchmarks, and on the whole, program performance exceeded its benchmark by 24 basis points. Results are more positive when analyzed by asset class, with managers in five of the six asset classes meeting or exceeding their performance benchmarks. Only credit/debt failed to meet its benchmark, where three out of five asset managers failed to meet their individual benchmarks.

Since its inception, the Terra Maria program continues to add value to the portfolio, beating its overall composite benchmark by 139 basis points. This is the lowest level of excess annualized returns above benchmark since the program's inception, which reflects its maturation. Among asset classes, only domestic and international equity and real return have exceeded benchmarks since inception. All seven program managers are now beating their benchmarks since inception.

Performance Compared to Other Systems

According to the Trust Universe Comparison Service (TUCS), the system's fiscal 2014 investment performance was among the worst of 25 public pension funds with at least $25 billion in assets. The system's fiscal 2014 performance placed it at the ninety-fourth percentile, as shown in **Exhibit 4.** In the TUCS analysis, the one-hundredth percentile is the lowest ranking, and the first percentile is the highest. Maryland's ranking, therefore, showed no meaningful change in relative performance from fiscal 2013. Long-term performance rankings place SRPS in the bottom quartile for every timeframe examined. The TUCS rankings are based on returns gross of fees.

Exhibit 4
TUCS Percentile Rankings for Periods Ending June 30
Fiscal 2011-2014

	2011	2012	2013	2014
1 Year	87	75	93	94
3 Years	55	60	87	94
5 Years	87	81	68	84
10 Years	100	93	99	99

TUCS: Trust Universe Comparison Service

Source: Trust Universe Comparison Service

The TUCS rankings are useful for providing a snapshot assessment of the system's performance relative to other large public pension plans. However, the rankings do not identify the other funds against which SRPS is measured, and provides only limited information on their asset allocation, which has been shown to be responsible for most variation in performance among investment portfolios. Therefore, the rankings by themselves offer little by way of explaining why Maryland's performance lags behind that of other funds. However, data provided by TUCS on the risk-return profile of its members provide some explanation. The data show that the system's level of risk over the three-year period ending September 30, 2014, was below the median for other public funds with assets greater than $25.0 billion. In expanding markets, low-risk portfolios tend to generate lower rates of return than high-risk portfolios, so the system's below-median performance is somewhat predicted by its low-risk profile. However, the system's returns were lower than at least five other systems with lower-risk profiles, which indicates that its returns are lower than would be expected given its risk profile. Again, TUCS only measures relative performance at a given point in time, but provides very little information regarding the reasons for relative performance levels of its member funds.

A more in-depth examination of asset allocation and returns in comparable state pension plans further illustrates the relationship between allocations to equity and fund performance. In short, high allocations to public and private equity are associated with higher returns due to the run-up in those markets over the last few years. Based on data compiled by the State Retirement Agency (SRA), DLS identified eight other state pension funds with asset levels that exceed $25.0 billion, which is considered the SRPS peer group; these are shown in **Exhibit 5**. All eight funds outperformed SRPS in fiscal 2014. Five of the eight funds have public equity allocations that exceed Maryland's which largely explains their overperformance relative to SRPS. Of the three remaining funds with public equity allocations equal to or below Maryland's, Pennsylvania Teachers and Washington have the highest allocations to private equity, resulting in very high total exposure to equity. This largely explains their over-performance relative to Maryland. By contrast, South Carolina had lower allocations to both public and private equity but generated stronger returns than did Maryland in other asset classes, including real estate, fixed income, private equity, and hedge funds, to exceed Maryland's annual investment return. The system's asset allocation strategy is discussed further in the following section.

Exhibit 5
Performance and Asset Allocation of Public Pension Fund Peers
As of June 30, 2014

			Asset Allocation			
	Fiscal 2014 Performance	**Assets ($ in Millions)**	**Public Equity**	**Private Equity**	**Real Estate**	**Total Equity**
Massachusetts	17.6%	$60.7	43.1%	11.1%	8.9%	63.1%
Florida	17.4%	149.1	60.2%	5.4%	7.4%	60.2%
Washington	17.1%	78.0	38.9%	22.8%	12.9%	74.5%
New Jersey	16.9%	n/a	50.7%	7.6%	3.6%	61.9%
North Carolina	15.9%	90.1	46.8%	4.8%	8.4%	60.0%
Virginia	15.7%	66.0	43.6%	7.8%	8.8%	60.2%
South Carolina	15.3%	29.8	30.8%	8.9%	3.6%	43.3%
Pennsylvania Teachers	14.9%	53.3	21.9%	21.0%	14.3%	57.2%
Maryland	**14.4%**	**45.4**	**38.9%**	**7.0%**	**6.8%**	**52.7%**

Source: State Retirement Agency

Looking Ahead: The Future of SRPS Investments

Asset Allocation Continues Transition to Long-term Targets

In its annual spring review of asset allocation, the board did not make any changes to the overall strategic asset class targets. However, it did raise its maximum hedge fund allocation across all asset targets from 15.0% to 20.0% of total assets. At the time, total hedge fund allocation was 12.1% across all asset classes, including 6.9% outside of the absolute return asset class. The increase in the cap has little practical effect in the short term because the fund would not have exceeded its previous cap for another year or two. In the long term, it gives the system more flexibility to invest in a greater diversity of hedge funds. Aside from this one change, the system has focused its efforts on achieving its long-term strategic targets, as shown in **Exhibit 6**.

Exhibit 6
State Retirement and Pension System Asset Allocation
Fiscal 2012-2014

	Strategic Target 6/30/2014	Actual 6/30/2014	Actual 6/30/2013	Actual 6/30/2012
Equity				
Domestic Stocks		10.3%	11.6%	13.0%
International Stocks		12.1%	13.8%	15.0%
Global Equity		16.5%	17.0%	14.4%
Total Public Equity	**35.0%**	**38.9%**	**42.4%**	**42.4%**
Private Equity	10.0%	7.0%	6.2%	5.7%
Real Estate	10.0%	6.8%	5.8%	6.4%
Fixed Income	10.0%	14.8%	16.2%	19.2%
Real Return Strategies	14.0%	12.0%	12.6%	10.0%
Absolute Return	10.0%	9.4%	7.3%	6.8%
Credit/Debt	10.0%	10.0%	8.4%	7.8%
Cash and Other	1.0%	1.1%	1.3%	1.7%
Total Assets	**100.0%**	**100.0%**	**100.0%**	**100.0%**

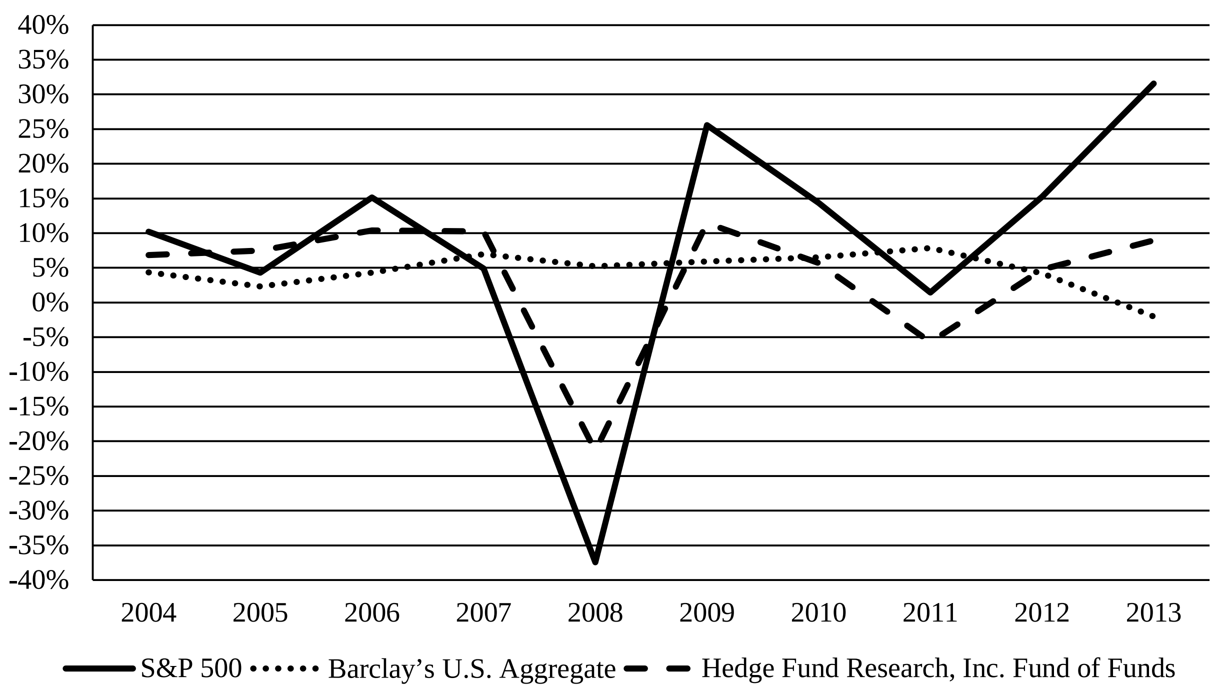
Note: Data reflects all system assets held at State Street. Columns may not add to total due to rounding.

Source: State Retirement Agency

Exhibit 6 also shows that, with the exception of real return, all asset classes moved closer to their strategic targets, continuing a trend that began with significant restructuring of the portfolio in fiscal 2008 and 2009. Most notably, public equity dropped from 42.4% to 38.9%, approaching its target of 35.0%, and fixed income dropped from 16.2% to 14.8%, moving closer to its target of 10.0%. There were corresponding increases to alternative asset classes, including private equity and absolute return.

DLS has consistently supported the system's overall strategy of diminishing its allocation to public equity as part of an overall approach to decrease risk through diversification in the wake of the 2008 financial crisis, and continues to do so. **Exhibit 7** shows why a shift from public equity to alternative strategies like hedge funds can benefit the fund in turbulent markets. In general, hedge fund performance tracks domestic equity performance, but with less volatility, and this has been especially true of the system's hedge fund portfolio. In fiscal 2009, for instance, when domestic equities dropped 26.3%, the system's small absolute return allocation (it was then only 2.6% of total assets) dropped only 6.4%, net of fees. These patterns are, in large measure, what prompted the system to shift assets from public equities to alternative strategies like hedge funds in an effort to derisk the portfolio. The overall strategy should not be abandoned just because public equities have been on a multi-year growth pattern, because doing so will not provide sufficient protection when equity markets decline.

Exhibit 7
Equity, Bond, and Hedge Fund Annual Returns
Calendar 2004-2013



Source: Standard & Poors, Barclays, Hedge Fund Research, Inc.

Nevertheless, in expanding markets, Exhibit 7 also shows that hedge fund returns frequently trail equity returns. In fiscal 2014, the system's public equity portfolio grew 22.1%, and the absolute return asset class grew just 7.6%. The persistent strength of the public equity markets raises legitimate questions about the extent to which the system has implemented its plan. Specifically, the long-term strategic target of 35.0% for public equity is among the lowest of large public pension plans and has resulted in bottom-tier performance compared with peer funds. Although DLS supports the system's diversification into alternative asset classes to reduce reliance on volatile public equities, it may be the case that the board has opted for a public equity allocation that is too low. **The Board of Trustees and SRA should comment on the appropriateness of the system's 35.0% target for public equities in light of persistent underperformance relative to large state pension funds. It should also comment on the system's underperformance relative to other public pension funds with low-risk profiles.**

Appendix 1 presents the fiscal year-end performance by each investment manager for fiscal 2011 and prior periods, by asset class, and subclass.

Investment Management Fees Continue to Grow, Providing Opportunity for Internal Management

SRPS incurred $331.2 million in investment management fees during fiscal 2014, a 20.5% increase over fiscal 2013 fees. As shown in **Exhibit 8**, management fees for the plan as a whole have grown substantially since fiscal 2008, when the system adjusted its asset allocation to invest more heavily in alternative asset classes with higher fee structures. The shift of public equity assets to global equity managers, which are almost all active managers, contributed significantly to the growth in fees over the past two years. However, the shift was also responsible for a significant improvement in public equity performance relative to its benchmark.

Rapid growth in investment management fees is not unique to Maryland, and it is prompting more large public pension funds to examine the option of moving more investment management functions in-house instead of relying solely on external managers. A major motivating factor in those decisions has been reducing investment management costs. According to *Pensions & Investments,* 26% of large public defined benefit pension funds report using internal management for at least a portion of their portfolio, but the proportion is growing. North Carolina became the latest state to expand internal management with the addition of 10 new investment positions with flexibility to pay market rate salaries. With SRPS assets reaching record levels, consideration should be given to examining the costs and benefits associated with employing internal asset management in selected areas to reduce management costs. DLS notes that moving to internal management would require substantial increase in staffing and flexibility to provide market rate compensation to a larger number of investment staff, but could also generate substantial net savings in management costs. **DLS asks that the board and SRA discuss the advantages and disadvantages of implementing internal management of some system assets, the prerequisites for implementing internal management, and the asset classes that would be the best candidates for internal management.**

Exhibit 8
Asset Management Fees Paid by Asset Class
Fiscal 2008-2014
($ in Millions)

	2008	2010	2012	2013	2014
Public Equity	$40.6	$55.4	$49.5	$67.2	$86.7
Fixed Income	10.0	7.9	9.4	11.5	9.6
Real Estate	20.9	25.1	30.0	24.7	26.4
Private Equity	12.6	35.6	44.6	53.8	59.3
Real Return	n/a	15.9	20.9	24.0	26.4
Credit and Debt Related	n/a	10.3	33.0	46.3	63.0
Absolute Return	n/a	13.5	26.0	34.7	33.2
Currency	n/a	14.4	9.2	9.0	7.0
Service Providers/Other	5.2	1.4	3.1	3.7	3.8
Terra Maria	n/a	n/a	16.5	n/a	15.6
Total	**$89.3**	**$183.7**	**$242.3**	**$274.9**	**$331.2**

Note: Columns may not sum to total due to rounding.

Source: State Retirement Agency

Currency Program Has Mixed Results

The currency hedging program was a drag on returns during fiscal 2014 but has since provided significant benefits to the system. Adopted in fiscal 2009, the program is designed to protect against losing value when the dollar appreciates relative to currencies in countries in which the system holds assets. During periods when the dollar is weak, the currency management program offers a hedge, or protection, against dollar appreciation that can devalue international earnings. During those periods, the program's modest cost ($7.0 million in management fees during fiscal 2014) manifests as a slight drag on international equity holdings. However, when the dollar appreciates, the program provides returns that help offset, and sometimes exceed, the currency losses generated by the strengthening dollar. During fiscal 2014, with the U.S. dollar relatively weak against foreign currencies, the program lowered international and global equity returns. In international equity, for instance, the system earned 22.0% absent the currency program, but 20.4% after factoring in the cost of the currency program. As of June 30, 2014, the currency program had a net loss of $108.3 million since inception.

However, with the Eurozone and Japanese economies still struggling, and both central banks taking steps to stimulate growth through monetary policies, the dollar began strengthening over the summer. As a result, the performance of the currency program has rebounded, with net returns of $160 million since inception as of December 5, 2014. This is consistent with the program's overall design, which is intended to break even over the long term. The system has taken steps to lock in the program's gains, however.

Given the currency program's volatile performance since its inception, DLS questions the long-term need for the program. Over time, gains and losses due to currency fluctuations are expected to break even. The program is designed to minimize downside risks from currency fluctuations, but it has shown on several occasions that the drag on portfolio performance during times that the dollar is weak can be considerable. **The board and SRA are asked to discuss the program's weak performance during fiscal 2014 and its effect on their plans for the program's future.**