HB 1332

Department of Legislative Services

Maryland General Assembly
2012 Session

FISCAL AND POLICY NOTE

House Bill 1332 (Delegate Serafini)
Appropriations

State Retirement and Pension System - Investments - Independent Investment Advisory Firms

This bill eliminates the State Retirement Agency's (SRA) Investment Division, including the position of Chief Investment Officer (CIO). It requires the Board of Trustees of the State Retirement and Pension System (SRPS) to hire independent investment advisory firms to invest the assets of the several systems and to establish criteria to be used to hire the firms, including recommended asset allocations, fees, and commissions to be charged and conditions for termination of a contract.

The bill takes effect July 1, 2012.

Fiscal Summary

State Effect: State expenditures for the State's share of SRA's administrative costs decrease by approximately $811,900 beginning in FY 2013, which are assumed to be allocated 60% general funds and 20% each for special and federal funds. Reimbursable and special fund revenues and expenses by SRA decrease by approximately $2.3 million in FY 2013 due to the elimination of the Investment Division. Those savings continue to accrue in the out-years, but they are offset by increased nonbudgeted expenditures by SRA on commissions and fees paid to one or more investment advisory firms. The overall impact on State finances is negative due to local governments no longer sharing in the cost of these expenses. The board can establish the criteria specified in the bill with existing resources.

(in dollars)	FY 2013	FY 2014	FY 2015	FY 2016	FY 2017
SF/RF Rev.	($2,319,600)	($2,309,500)	($2,466,700)	($2,571,400)	($2,680,700)
GF/SF/FF Exp.	($811,900)	($808,300)	($863,300)	($900,000)	($938,200)
NonBud Exp.	$2,319,600	$2,309,500	$2,466,700	$2,571,400	$2,680,700
SF/RF Exp.	($2,319,600)	($2,309,500)	($2,466,700)	($2,571,400)	($2,680,700)
Net Effect	($1,507,700)	($1,501,200)	($1,603,300)	($1,671,400)	($1,742,500)

Note:() = decrease; GF = general funds; FF = federal funds; SF = special funds; - = indeterminate effect

Local Effect: Local government expenditures for SRA's administrative expenses decrease by approximately $1.5 million beginning in FY 2013, in proportion to their membership in SRPS.

Small Business Effect: None.

Analysis

Current Law: SRA's Investment Division is charged with investing the assets of the several systems. The division is led by the CIO, who has sole authority to hire and fire external investment managers to manage the system's assets. The board must determine the qualifications and appointment, as well as compensation and leave, for the CIO. The board is authorized to provide financial incentives to the CIO based on objective benchmarks of investment performance and criteria used by comparable public pension funds. Subject to the recommendation of the board's investment committee or SRA's Executive Director, the board may terminate the CIO with a majority vote.

Chapter 397 of 2011 (the Budget Reconciliation and Financing Act) requires the State and each local employer within SRPS to pay its prorated share of SRA's administrative and operational expenses (including employee compensation), based on the proportion of the system's total members employed by each employer in the second prior fiscal year. However, the State pays the local share attributable to local public libraries.

Background: All SRPS assets are currently managed by external asset managers, subject to monitoring and oversight by Investment Division staff. External asset management is common in both public and private pension fund management. However, outsourcing the oversight function provided by the CIO and Investment Division staff is rare among public pension plans. The most notable recent example is San Diego County, which outsourced its CIO position to an independent "portfolio strategist" but retained its investment staff (which the strategist is barred from managing because he is not a county employee). Some small private-sector plans do outsource their investment management function because it is often more cost-effective to do so for small pension funds, but no State pension plans have outsourced their investment management function.

SRPS incurred $219.6 million in nonbudgeted asset management fees in fiscal 2011. **Exhibit 1** shows the asset allocation and returns for SRPS investments. Five-year annualized returns are not available for several asset classes because those classes have been added within the past five years in an effort to diversify the system's portfolio. By diversifying its holdings, SRPS seeks to minimize risk, defined in terms of the volatility of returns. Exhibit 1 shows the advantages of a well-diversified portfolio. For instance, equities performed very well during fiscal 2011, but their performance over the past decade has been quite poor. Conversely, while fixed income performed poorly in fiscal 2011, its 5- and 10-year returns are higher than those for domestic equities. Among the newest alternative asset classes, real return and credit opportunity have performed very well.

Exhibit 1
State Retirement and Pension System of Maryland
Fund Investment Performance for Periods Ending June 30, 2011[1]
($ in Millions)

			Time Weighted Total Returns		
	Assets	**% Total**	**1 Year**	**5 Years**	**10 Years**
Domestic Equity	$6,131.3	16.35%	32.38%	3.12%	3.45%
International Equity	7,012.7	18.70%	24.55%	3.60%	6.30%
Global Equity	4,571.8	12.19%	29.71%	3.77%	n/a
Fixed Income	7,623.8	20.33%	4.80%	7.01%	6.16%
Credit Opportunity	2,198.7	5.86%	13.46%	n/a	n/a
Real Estate	2,164.0	5.77%	23.30%	0.38%	8.37%
Real Return	3,900.6	10.40%	13.11%	7.85%	n/a
Private Equity	1,618.3	4.31%	24.45%	9.45%	6.37%
Absolute Return	1,635.1	4.36%	8.54%	n/a	n/a
Cash and Other	652.2	1.74%	3.43%	n/a	n/a
Total Fund	**$37,508.6**	**100.00%**	**20.04%**	**4.03%**	**5.01%**

Note: Returns beyond one year are annualized. One-year returns are net of fees; returns beyond three years are gross of fees. Columns may not add to total due to rounding.

Source: State Street Investment Analytics

State Fiscal Effect: SRA's Investment Division consists of 20 positions with a total payroll, including salaries and fringe benefits, of $2.2 million. In addition, the division has a travel budget of approximately $100,000, and an estimated $10,000 in other associated operating expenses, including supplies and communication charges.

Under the provisions of Chapter 397, all agency operating expenses are paid from reimbursable and special funds paid by the State and local governments, respectively, in proportion to their shares of system membership. Of the system's 195,059 total active members as of June 30, 2011, 101,289 (51.9%) are employed by local school boards or community colleges, and 25,633 (13.1%) are employed by participating governmental units (PGUs). Therefore, local employers are responsible for a combined total of 65.0%

of SRA's administrative and operational expenses (including employee compensation), and the State is responsible for the remaining 35%.

Based on the bill's July 1, 2012 effective date, reimbursable and special fund revenues and expenditures by SRA each decrease by approximately $2.3 million in fiscal 2013 due to the elimination of the Investment Division. As those amounts represent administrative costs for the agency, they reduce the expenses paid by the State and local governments. The State's 35% share of the reduced costs is approximately $811,900, which is assumed to be allocated 60% general funds, 20% special funds, and 20% federal funds, based on the approximate distribution of funding sources for State employee compensation.

At the same time, SRA's expenditures for fees and commissions paid to one or more independent investment advisory firms increase; because they are investment management fees, those expenses are nonbudgeted under the bill and must be paid from the pension trust fund. A reliable estimate of those fees is not possible because they are subject to the procurement process and negotiation. Legislative Services assumes that the fees increase by roughly the same amount as the reduction in Investment Division expenditures since the advisory firms perform the same functions as the Investment Division. It is unclear whether SRA would have sufficient time to procure investment advisory firms by the bill's effective date. Overall, the impact on State finances equates to roughly the loss of the local share of administrative costs.

Although the selection of one or more investment advisory firms to oversee the system's investment program likely results in changes among the external asset managers who currently manage the system's investments, there is no assumed change in the system's asset allocation, which is determined by the board. Therefore, there is likely not a meaningful change in the other nonbudgeted asset management fees paid by SRPS for existing external managers, although there may be some short-term transaction costs associated with changing external managers. Those expenses would be nonbudgeted and are not reflected in this analysis.

Local Fiscal Effect: Local expenditures for SRA administrative costs decrease by approximately $1.5 million beginning in fiscal 2013. Those savings are distributed across the 24 counties (including Baltimore City) and PGUs in proportion to their membership in SRPS.

Additional Information

Prior Introductions: HB 1326 of 2011 received an unfavorable report from the House Appropriations Committee.

Cross File: None.

Information Source(s): Maryland State Retirement Agency, Department of Legislative Services

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ncs/rhh

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