

Department of Legislative Services  
Maryland General Assembly  
2020 Session

FISCAL AND POLICY NOTE  
First Reader

House Bill 1254  
Appropriations

(Delegate Barve, *et al.*)

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State Retirement and Pension System - Investment Management Fees

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This bill caps investment management fees that the Board of Trustees of the State Retirement and Pension System (SRPS) can pay to external asset managers in a given fiscal year at 0.2% of the value of the system's assets as of the last day of the preceding fiscal year. The cap does not apply to agreements entered into before June 30, 2020. The bill also expresses legislative intent that SRPS use low-fee, passive investment strategies in the management of system assets, consistent with its fiduciary responsibilities. **The bill takes effect July 1, 2020.**

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Fiscal Summary

**State Effect:** A reliable estimate of the bill's effect on SRPS investment performance and, therefore, on State pension liabilities and contribution rates is not feasible. The bill restricts or eliminates the system's flexibility to invest in alternative asset classes and with firms that provide active investment management services; any effect on the system's investment performance is dependent on market conditions and the system's investment strategy and asset allocation, which cannot be predicted.

**Local Effect:** Local governments that participate in SRPS as participating governmental units (PGUs) are affected to the extent that the bill affects investment performance and SRPS liabilities. As with the State, a reliable estimate of the effect on PGUs is not feasible.

**Small Business Effect:** Potential meaningful.

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## Analysis

**Current Law:** The SRPS Board of Trustees is vested with the responsibility for the management, general administration, and proper operation of the several systems. The board has full power to invest the assets of the several systems. Statute establishes an Investment Committee to advise the board and make recommendations on the investment programs, compliance of the investment programs with board policies, and bonding for employees of the State Retirement Agency.

As fiduciaries of the system, members of the board and investment staff are statutorily subject to the “prudent person” standard. They must discharge their duties with the care, skill, prudence, and diligence that a prudent person, under similar circumstances and acting in a similar capacity, would use. They must also diversify the system’s investments to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so.

The board is subject to a 0.5% cap on the fees it can pay to external investment managers, not including assets invested in real estate or alternative asset classes. There is no cap on the fees that the board can pay for external real estate or external alternative asset management.

**Background:** In fiscal 2019, the board had assets of \$33.2 billion, not including real estate and alternative assets, and paid fees of \$109.0 million to external managers of those assets. Thus, fees constituted 0.33% of assets, well below the 0.5% statutory cap.

For real estate and alternative asset classes, which are not subject to the statutory cap, the board paid fees of \$263.5 million on assets of \$21.0 billion, or 1.26% of assets. Overall, the system paid fees totaling 0.69% of total assets.

In general, as shown above, fees for the management of public equity and fixed income assets are lower than fees for alternative asset classes for a number of reasons. First, public equity and fixed income markets are publicly accessible and highly efficient, so the cost of investing in them is low. Second, there are many passive investment options, which generally involve a manager tracking a publicly available index instead of trying to add value through active management. Passive investment funds generally carry very low fees for that reason, and the system makes extensive use of passive options in the public markets.

By comparison, alternative asset classes are often not publicly available and less efficient, and their fee structures reflect the additional risk involved. The industry norm for these assets is a fee consisting of 2% of the value of the assets and 20% of the profits generated by the investment manager. In many cases, the board has negotiated lower fees, but they

still remain substantially higher than fees paid to managers of publicly available assets. Nevertheless, alternative assets provide important diversification options in the system's portfolio, and they often outperform publicly available assets, even after accounting for fees paid. For instance, in fiscal 2019, *private* equities returned 13.9% net of fees, while *public* equities returned 3.9% net of fees.

**State Fiscal Effect:** Given fee structures in the various financial markets, the bill has the practical effect of precluding the system from investing in real estate and alternative asset classes because doing so would likely result in the system exceeding the 0.2% cap on fees. The bill has the further effect of requiring the system to invest largely in passive investment options within the public equity and fixed income markets, removing the option of hiring active managers that may be able to provide returns in excess of market benchmarks. The payment of lower fees does not, by itself, ensure better investment returns. It does ensure that more assets are available for investment, but it does not ensure that those investments perform any better than they would in higher-fee options, even on a net-of-fee basis.

The effects of the restrictions on the system's investment strategies that result from the bill cannot be predicted reliably. Financial markets can be volatile, and different asset classes perform better than others in different economic climates. To the extent that the bill restricts the system's ability to diversify assets in a manner that both protects the system from large losses, as required by statute, and that takes advantage of economic conditions during different time periods, the bill may have a detrimental effect on investment returns. Lower returns result in fewer assets being available to pay for benefits, which results in higher State pension contributions to pay down the increase in system liabilities. As indicated above, an estimate of any such effect is not feasible.

Another factor that may reduce assets available to the system are the transaction costs that the system would endure over time to divest itself of its current real estate and alternative assets. Although the bill does not affect any existing investment management agreements, it does not allow the system to renew those agreements when they expire, thereby requiring the system to liquidate those assets and transfer them to passive accounts. Those liquidation transactions likely generate significant transaction costs.

**Small Business Effect:** Through its Terra Maria program, SRPS invests with a substantial number of small and minority-owned emerging management firms. In fiscal 2019, assets in the program totaled \$2.6 billion. Most of the Terra Maria firms provide active management services with fee structures that exceed the bill's cap. To the extent that the system can no longer invest with these firms, the firms are negatively affected.

## **Additional Information**

**Prior Introductions:** None.

**Designated Cross File:** None.

**Information Source(s):** State Retirement Agency; Department of Legislative Services

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