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Testimony for House Bill 1254
State Retirement and Pension System - Investment Management Fees
House Appropriations Committee
March 10, 2020
1:00 P.M.

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The Board of Trustees for the State Retirement and Pension System (System) wishes to express its opposition to House Bill 1254, State Retirement and Pension System - Investment Management Fees.

House Bill 1254 would cap annual external investment management fees for the System to 0.20% of the market value of the fund on the last day of the preceding fiscal year. This cap would not apply to investment manager agreements entered into on or before June 30, 2020. The bill prohibits the Board from entering into agreements on or after July 1, 2020 with external management services that would pay fees for unrealized investment gains. Finally, the bill includes language that states it is the intent of the General Assembly that the Board shall utilize low-fee, passive investment strategies in the management of system assets, consistent with its fiduciary responsibilities.

Section 21-123(d)(1) of the State Personnel and Pensions Article states that "each quarter of the fiscal year, the Board shall estimate one-fourth of an amount, not exceeding 0.5% of the market value as of the last day of the preceding quarter of invested assets that are externally managed exclusive of assets invested in real estate or alternative investments, necessary to procure and retain investment management services other than external real estate or alternative investment management services." In addition to the forty percent reduction in the amount of allowable investment management fees, House Bill 1254 would also apply to real estate and alternative investments. Section 21-123(d)(2) provides that the existing 0.5% fee cap does not apply to external real estate or alternative investment management services. In fact, current law places no cap on the amount the Board may pay in investment management fees for these particular asset classes. The fee cap set in House Bill 1254, however, would apply to all investments made by the Board, including real estate and alternative investments. By reducing the cap, and applying it to all asset classes, House Bill 1254 would force the Board and the Investment Division to make sweeping changes to the System's current asset allocation, and potentially expose the fund and plan participants to significant additional risk. Specifically, the Committee should be aware that these changes would directly impact the System's Terra Maria program and the Maryland venture capital investments. The Terra Maria program is the System's emerging manager program that focuses on investing System assets with small and minority-owned managers. A number of these managers are based in Maryland. Regarding the Maryland venture capital investments, this is a program the legislature implemented in 2016 with the intent to generate greater investment of System assets in commercialization of technology sponsored or created by a university based in Maryland. It should be expected that if House Bill 1254 is enacted, each of these programs will ultimately be eliminated.

House Bill 1254 would have serious consequences in how the Board sets the System's asset allocation, primarily by limiting, or eliminating, exposure to higher cost alternative asset classes like private equity and real estate. While the cost structures for these asset classes are higher than traditional stocks and bonds, the Committee should be aware that the net-of-fees returns justify the costs. In addition to generating attractive returns, these asset classes provide important diversification benefits that reduce the risk profile of the total plan. Exhibit 1 below shows that the System's private equity and private real estate returns have performed very well relative to the broad global public equity benchmark.

Exhibit 1

Annualized Net Returns as of December 31, 2019

	1 Year	3 Years	5 Years	10 Years
MD Private Equity	10.31%	16.31%	14.46%	14.43%
MD Private Real Estate	5.44%	7.63%	9.51%	10.96%
MSCI ACWI Index	26.60%	12.44%	8.41%	8.79%

House Bill 1254 would also force the Board to adopt an investment policy comprised almost exclusively of low-cost passive strategies. It is important to note that the System is not fundamentally opposed to passive investing in more efficient areas of the capital markets. In fact, as of December 31, 2019, 16.4% of the total fund was invested in passive strategies. However, in less efficient asset classes or where passive options are not available, the System employs active mandates with the objective of generating higher returns.

The Board and Investment Division recognize the impact management fees have on net returns. However, to focus solely on this metric without considering the added value generated by the fees paints an incomplete picture. To determine whether the System is receiving value for the amount of fees paid, the total fund net returns should be compared against the total fund policy benchmark, which is a combination of passive indices for public markets and pooled universe returns for alternative asset classes that together represent the System's asset allocation. Exhibit 2 below compares the net total fund returns against the System's policy benchmark over the last ten years. The Committee will note that while shorter-term excess returns have been challenging, the System has added significant value over the last ten years. To provide greater context for the information in Exhibit 2, the 0.50% excess annualized returns achieved over the ten-year period translates into approximately $3 billion of additional value to the fund that would not have been earned had the fund utilized strictly passive investments.

Exhibit 2

Annualized Net Returns as of December 31, 2019

	1 Year	3 Years	5 Years	10 Years
MD Total Fund	14.99%	9.16%	6.65%	7.53%
Policy Benchmark	15.93%	9.03%	6.68%	7.03%
Excess	-0.94%	+0.13%	-0.03%	+0.50%

House Bill 1254 would also likely change the risk profile of the fund, resulting in greater volatility to the fund and ultimately to the employer contribution rate. In addition to generating excess returns, the System also invests in alternative assets to increase diversification and reduce risk, or portfolio volatility. Volatility has a large negative effect on investment performance. Recognizing the importance of volatility in portfolio construction, the objective of the System's asset allocation is to achieve the target rate of return (the System's assumed rate of return, currently set at 7.4%) with an acceptable level of risk.

With the strong returns of U.S. public stocks over the last ten years, it might seem obvious to simply invest all of the plan assets in low-cost passive vehicles that mirror the S&P 500. What is not obvious from a cursory review of past performance is the level of risk associated with such a concentrated strategy. A concentrated asset allocation represented by 100% in S&P 500 stocks would subject the System to periods of extreme drawdowns in the market value of assets. As noted earlier, volatility erodes the value of plan assets and must be carefully managed. As an example, a 50% loss in the portfolio would require a recovery of 100% just to break even. But because the liabilities are growing at a 7.4% rate, the System would have to earn roughly 108% to be back on track the next year. In fact, because the System is a mature plan and pays out approximately 2% of plan assets net of contributions each year, the System would need to earn more than 108% to fully recover from the 50% drawdown. Recoveries of this magnitude typically take several years, during which the liability gap will continue to compound. This situation would result in less predictable and outsized contribution rates which could negatively impact the budgeting process.

While a concentrated portfolio consisting of a passive U.S. stocks would have produced strong returns over the last several years, it is unlikely this allocation will produce similar returns over the next ten years. Past performance tends to be a poor predictor of future returns. Exhibit 3 below illustrates the pattern of rolling ten-year price returns for the S&P 500 index going back to 1927. The returns oscillate between +15% and -10% over ten-year periods, with no statistical support to expect the next ten years to mirror the performance of the prior ten years. The returns have gone through periods of escalating performance, followed by several years of decline. Historically, when rolling ten-year returns reached the current levels, subsequent years produced declining performance. In fact, there have been several instances where the ten-year average returns were zero or negative. It is because of this volatile and extreme tendency that the System's Board has adopted a balanced and diversified asset allocation policy that is not overly reliant on single asset classes like the S&P 500. Protracted periods of returns that are significantly below expectations would be very damaging to the sustainability of the plan.

Exhibit 3

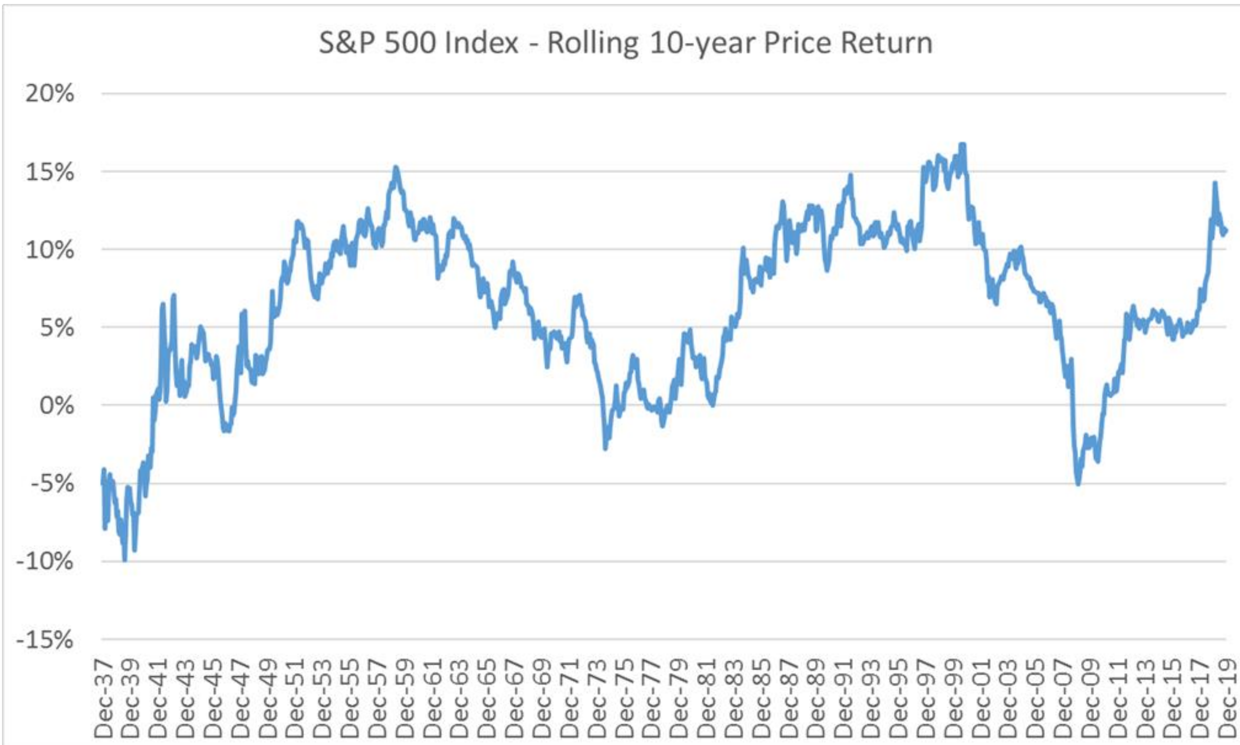
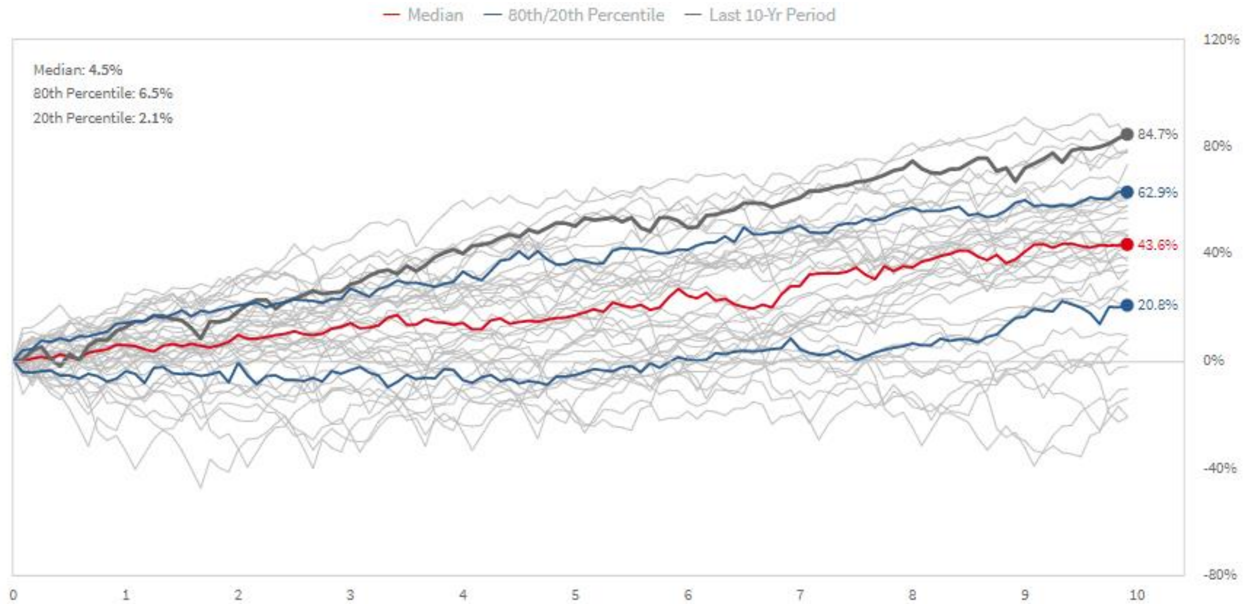


Exhibit 4 below is another graph that may provide additional perspective when reviewing the recent performance of the S&P 500 in the context of a portfolio consisting of 60% stocks and 40% bonds. The lines on the graph represent rolling monthly ten-year periods of performance for a 60/40 portfolio since 1970, adjusted for cash returns. The dark gray line represents the ten-year period ending December 31, 2019. This period of returns falls in the 90^{th} percentile, and is one of the best performing decade in the time series, achieving a cumulative return of 85%. However, most of the periods have generated returns well below those achieved in the last ten years. In fact, the prior decade ended December 31, 2009 produced returns in the bottom decile of the chart, with a negative cumulative return. It is for this reason that the Board has adopted a more diversified asset allocation, as negative returns over a ten-year period would be detrimental to the funding position of the plan and cause extreme volatility and uncertainty in employer contribution rates.

Exhibit 4



While the Board hopes that the strong returns over the last ten years will continue, it may be more reasonable to expect lower performance going forward as a result of reversion to mean historical returns. Based on recent capital market assumptions developed by Meketa Investment Group, the System's general investment consultant, a balanced blend of passive U.S. stocks and bonds is projected to produce much lower returns than the System's current asset allocation. Exhibit 5 shows return projections for a 60/40 passive portfolio versus the System's more diversified asset allocation.

Exhibit 5

10-Year Projections Using Capital Market Assumptions as of December 31, 2019

	Return
Passive 60/40	4.7%
Current Allocation	6.9%

The Board of Trustees of the System is aware of the importance of asset allocation in achieving risk and return objectives. Each year, the System's general investment consultant and Investment Division conduct an asset allocation review which incorporates assumptions for asset class returns, risk and correlations. Other factors such as liquidity needs and liabilities are also considered. Typically, several asset allocation options are presented for the Board's consideration. After analyzing the risk and return profiles of each option, and evaluating how each might perform in different economic environments through stress testing and scenario analyses, the Board adopts an allocation that can meet return objectives in a balanced and diversified way. Over the last six years, the System's asset allocation has been reviewed by three separate expert, independent investment consultants. All three have confirmed that the System's asset allocation is reasonable and appropriate.

The Board and staff are taking steps to manage the fund in a more efficient and cost-effective manner. During the 2018 legislative session, the General Assembly passed SB 899 which grants the Board of Trustees broader authority in its management and oversight of the investment of System assets. The legislation authorizes the Board to set and approve the budget for the personnel and operational expenses of the Investment Division. The Board is now able to determine and create the type and number of investment positions necessary for carrying out the functions of the Investment Division. SB 899 also provides the Board with the authority to determine the qualifications, salary levels and performance incentives for Investment Division staff, subject to certain restrictions.

This broader authority and flexibility has allowed the System to begin to manage a portion of the fund internally, instead of relying exclusively on external managers. The initial mandate, which consists of Treasury Inflation-Protection Securities was funded on July 1, 2019, with a current market value of roughly $2.2 billion. The second internal account, comprised of long-duration nominal Treasury bonds, was incepted on March 1, 2020 with approximately $1.3 billion. These mandates currently are passive strategies that are managed to match the respective benchmarks. This capability will enable the Board and staff to manage the fund with a lower cost structure without impacting the risk and return profile of the plan.

In addition to its impact on overall asset allocation, House Bill 1254 also seems to impose restrictions on the System's contractual fee arrangements. Specifically, the Board may not enter an agreement for investment management services that would pay fees for unrealized investment gains. If interpreted correctly, this restriction would have the largest impact on publicly traded stock and bonds, since fees and performance incentives associated with private structures are typically not based on unrealized gains. Typically, management fees associated with public mandates are charged quarterly in arrears based on the market value of assets as of the prior quarter. Because the market value represents the aggregate value of all existing securities, it is an unrealized number. While the quarter-end market value of assets might include realized gains of securities that were sold during the quarter, it is possible that the account value represents solely unrealized gains and losses. From an administrative perspective, this constraint would likely be unworkable to implement. In addition, it is inconsistent with standard industry fee structures, and would likely restrict the pool of managers willing to do business with the System.

We also think it is necessary to address Section 2 of House Bill 1254, which states it is the intent of the General Assembly that the Board utilize low-fee, passive investment strategies in the management of System assets, consistent with its fiduciary duties. We appreciate the sponsor's recognition that any investment strategy employed by the Board must be consistent with its fiduciary duties. However, in light of the restrictions House Bill 1254 places on the Board's management of System assets, we believe it would be helpful to provide the Committee with a brief discussion of what is included in the Board's fiduciary duties.

In accordance with Sections 21-202 and 21-203 of the State Personnel and Pensions Article, as fiduciaries, the Board and the Investment Division of the Agency is required to discharge its duties "solely in the interest of the participants" and "for the exclusive purposes of providing benefits to the participants and for reasonable expenses of administration." The Restatement (Third) of Trusts states, "Implicit in a trustee's fiduciary duties is a duty to be cost-conscious," indicating that a trustee may incur expenses that, in the exercise of fiduciary judgment, are reasonable and appropriate. As qualified plans under the Internal Revenue Code (IRC), plan assets may not be used or diverted for purposes other than the exclusive benefit of the participants. Specifically, IRC § 401(a)(2) provides that the trust instrument governing a qualified plan must make it impossible, at any time before satisfaction of all liabilities to the participants, for the assets of the trust to be used for or diverted to purposes other than for the exclusive benefit of the participants.

Like a majority of states, Maryland has adopted fiduciary standards that are very similar to the ERISA standards. Consequently, the Department of Labor (DOL) interpretations of ERISA provide useful guidance to the System regarding issues addressing fiduciary standards. The DOL has interpreted fiduciary duties under ERISA as prohibiting a fiduciary from subordinating the interest of participants in their retirement income to unrelated objectives. The DOL further explains that "the focus of plan fiduciaries on the plan's financial returns and risk to beneficiaries must be paramount," and fiduciaries "may not accept lower expected returns or take on greater risks in order to secure collateral benefits." (29 CFR 2509.2015-01) According to recent Department of Labor guidance, "A fiduciary's evaluation of the economics of an investment should be focused on financial factors that have a material effect on the return and risk of an investment based on appropriate investment horizons consistent with the plan's articulated funding and investment objectives." (See Field Assistance Bulletin No. 2018-01, available at: https://www.dol.gov/agencies/ebsa/employers-and-advisers/guidance/field-assistance-bulletins/2018-01)

The Committee should be aware that plan fiduciaries may currently utilize passive investments (investing assets with lower management fees) so long as these investments have an expected rate of return that is commensurate to rates of return of alternative investments with similar risk characteristics that are available to the plan, and the passive investments are otherwise an appropriate investment for the plan in terms of such factors as diversification and the investment policy of the plan. In other words, a passive investment must satisfy what has been referred to by some commentators as the "all things being equal" standard. An investment will not be prudent if it would be expected to provide a plan with a lower rate of return than available alternative investments with commensurate degrees of risk or is riskier than alternative available investments with commensurate rates of return.

In sum, we are concerned that, while Section 2 of House Bill 1254 states that utilizing low-fee passive investment strategies should be consistent with the Board's fiduciary duties, other provisions of the bill expressly limit the amount of management fees that may be paid by the System in a manner that is not consistent with the Board's fiduciary duties. As discussed above, the fee cap set in House Bill 1254 would force the Board to alter its asset allocation, exposing the System to greater risk for the sake of lowering the System's investment management fees. In accordance with DOL guidance, we believe this outcome would not adhere to the Board's fiduciary duties.

We appreciate being given the opportunity to raise these issues with the Committee and stand ready to provide any further information or services the Committee.