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Testimony for House Bill 905
State Retirement and Pension System - Investment Management Fees
House Appropriations Committee

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1:00 P.M.

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The Board of Trustees for the State Retirement and Pension System (System) wishes to provide the Appropriations Committee with informational testimony regarding House Bill 905, State Retirement and Pension System - Investment Management Fees. This proposed legislation requires the Board, on or before December 31 of each year, to require each alternative investment vehicle in which it invests to disclose, at least annually, the fees and expenses paid to each vehicle for the preceding fiscal year. For purposes of the House Bill 905, an alternative investment vehicle is defined as the limited partnership, limited liability company, or similar legal structure through which the System invests in private equity funds, a venture funds, a hedge funds, or absolute return funds.

The Board is committed to transparency and robust reporting in all aspects of the administration of the State Retirement Agency, including the investment transactions for the System. Currently, the Investment Division receives quarterly unaudited and annual audited reports from its private fund investment managers, reviews the reported fees and incentives paid to its investment managers relative to the terms of the partnership agreements, and reports these investment management fees and incentives to the Board on a quarterly basis. Additionally, investment management fees and incentives are reported in the financial section of the System's annual financial report and carried interest is reported in the investment section. These reports provide asset class level reporting for long term partnerships and manager level reporting for other types of partnerships. These reports, which also include the operating costs of the Investment Division, are also provided to the General Assembly, annually, and are included in the annual investment overview performed by the Department of Legislative Services and presented to the Joint Committee on Pensions. It is also important to note that the System's returns are reported net of fees, including all the fees, expenses and carried interest referenced in House Bill 905. While the Board supports transparency and detailed reporting, the Appropriations Committee should be aware that compliance with the provisions of the bill would be challenging to implement and would come with a cost to the System.

The Investment Division expects that the increased workload associated with House Bill 905 will require two additional full-time positions in the Investment Division's Accounting and Operations unit. These two new employees will focus on the data collection, data management, manager communication and calculation requirements of this bill. The additional work-load is a function of the expanded level of reporting required by the bill and the focus on fiscal year reporting. The expanded level of reporting would require additional staff because this type of reporting is not standardized, and many data items will require research and may only be available as an estimate developed by staff.

The focus on fiscal year-end will also present two challenges. The first is the best and most complete data is provided in the annual audited financials based on a calendar year. These are usually available beginning in March. The June 30 quarterly statements do not always provide the same level of detail and are not audited, as a rule. The second issue with a June 30 focus is that relevant staff are engaged from June to December in producing the annual financial report and likely would not be available to implement the requirements of this bill. Therefore, we have concluded that two additional positions would need to be added to the Investment Division to satisfy the requirements of the bill, with a total estimated cost of these additional resources, including salary and benefits, equaling $200,000, per year.

The Committee should also note that House Bill 905 will also likely have a material impact on investment performance through opportunity costs. The System's private equity program, which currently represents 18.7% of the total fund, is the System's highest performing asset class over the last ten years, averaging returns of 18.0% annualized. This performance has consistently ranked in the top quartile among a peer universe of other public pension plans. In fact, for the ten-year period ending December 31, 2021, the System's private equity program was ranked in the first percentile, meaning it outperformed 99% of the peer universe. This strong performance demonstrates that staff has been effective in sourcing and partnering with successful, top quartile private equity managers.

The provisions of House Bill 905 will require managers to agree to provide the level of detail included in the bill as a condition for the System's investment. This level of detail is greater than current industry standards. As a result, some managers, most likely top-performing managers who do not need the System's capital, will want to avoid the greater reporting burden and not agree to the System's terms. This would preclude the System from investing in these managers, and the managers will re-allocate the System's existing allocation to another investor that would not share the System's customized reporting requirements.

While it is difficult to quantify the impact on investment performance due to the necessity on the use of assumptions, the direction and degree of the impact can be derived by using reasonable and conservative estimates. For venture capital over the last decade, the return multiple for top quartile managers is 2.85, while the multiple for median venture managers is 1.84. Assuming a $50 million investment, a top quartile manager would generate total proceeds of $142.5 million, compared to $92 million for a median manager. This performance difference equates to $50 million.

This example represents just one private equity investment worth $50 million. The System typically makes fifteen private equity commitments per year with an average size of $100 million, totaling $1.5 billion. If only one of those managers declines to allow the fee disclosure requirements, the System would miss out on that fund and be forced to use a lower performing fund. If this scenario is experienced each year over a ten-year period, the total impact on the pension plan would be $500 million. Based on these numbers, it is easy to see how the economic impact could be much greater.

While some managers likely will not agree to the terms of House Bill 905, others may agree to them at the expense of a higher fee. The Investment Division is able to negotiate favorable economic terms with some of its managers based on the aggregate size of investments across multiple products or through the creation of a custom product for the System. These managers may not want the System's fee structure made public since it is not available to all investors. As a result, the System will not be able to take advantage of its scale and be forced to pay more in fees due to the individual manager reporting requirements of the bill.

We are aware of a small number of states that are subject to similar legislation as House Bill 905. We have reached out to these funds and have been told that while individual plans have used different methods to meet the requirements of the bill, the non-standardized level of detail has resulted in increased costs of reporting and restricted access to high performing funds. In addition, we were told that not all information included in the legislation is provided or available so those data points are either omitted or estimated. Further, the extra disclosure may not be necessary as no instances of overpayment of fees or other discrepancies have been uncovered through the increased disclosure requirement. In fact, managers have an incentive to minimize fees and expenses because the System must earn all fees and expenses back before the partner can participate in incentives. Finally, as noted above, performance for these funds is reported net of all fees, expenses and incentives. More reporting has not impacted the value these investments have brought the System.

The Board wants to impress upon the Committee that it does not oppose the spirit of House Bill 905 and the interest it is trying to achieve through greater detail in the reporting of investment fees, expenses and carried interest. Ideally, the Investment Division would be able to present the reporting requirements associated with the bill to its managers and they would easily be able to comply with, and agree to, its provisions. However, the requirements of the bill are not consistent with current industry reporting standards. The Committee should understand that this mismatch will likely result in some managers disengaging with the System, which will likely lead to lower investment returns that significantly outweigh the explicit resource costs of implementing the bill.

We appreciate being given the opportunity to share this information with the Committee and stand ready to provide any further information or services the Committee might request.