

Department of Legislative Services
Maryland General Assembly
2019 Session

FISCAL AND POLICY NOTE
First Reader

House Bill 821
Appropriations

(Delegate Barve)

State Retirement and Pension System - Investment Management Fees

This bill expresses legislative intent that the State Retirement and Pension System (SRPS) use low-fee, passive investment strategies, and it limits investment management fees paid by SRPS to 0.45% of the market value of invested assets on the last day of the preceding fiscal year. It also bars SRPS from entering into an agreement for external investment management services that pays fees for unrealized investment gains. The bill does not affect contracts entered into before the bill's effective date. SRPS must report annually on the amount of carried interest fees on any assets in the system; the first such report must include data from fiscal 2015 through 2019. **The bill takes effect July 1, 2019.**

Fiscal Summary

State Effect: State pension liabilities and employer contributions (all funds) may increase significantly, as discussed below. No effect on revenues.

Local Effect: Local pension liabilities and employer contributions for participating governmental units in SRPS may increase significantly. No effect on local revenues.

Small Business Effect: None.

Analysis

Current Law/Background: SRPS is subject to a fee cap of 0.5% of the market value of its assets, not including real estate or alternative investments, which are not subject to any fee cap.

By December 31 of each year, the SRPS Board of Trustees is required to report to the General Assembly the actual amount spent for investment management services during the preceding fiscal year.

Exhibit 1 shows the investment management fees reported for the prior two fiscal years, by asset class and type of fee. In fiscal 2018, SRPS investments returned 8.1% net of fees paid. For fiscal 2018, SRPS finished the year with assets of almost \$52.0 billion, so investment management fees of \$372.0 million in that year represented about 0.72% of assets.

Exhibit 1
Investment Management Fees
State Retirement and Pension System
(\$ in Thousands)

| | <u>FY 2017</u> | | | <u>FY 2018</u> | | |
|---------------------------|--------------------------|-------------------------|---------------------|--------------------------|-------------------------|---------------------|
| | <u>Management</u> | <u>Incentive</u> | <u>Total</u> | <u>Management</u> | <u>Incentive</u> | <u>Total</u> |
| Public Equity | \$77,520 | \$2,596 | \$80,116 | \$83,023 | \$19,247 | \$102,270 |
| Fixed Income | 10,300 | 220 | 10,520 | 12,555 | 4,351 | 16,906 |
| Credit Opportunity | 33,674 | 2,043 | 35,717 | 29,668 | 3,111 | 32,779 |
| Real Return | 22,284 | 3,174 | 25,458 | 16,504 | 2,323 | 18,827 |
| Absolute Return | 45,301 | 8,832 | 54,133 | 44,189 | 10,939 | 55,128 |
| Private Equity | 85,950 | 47 | 85,997 | 103,714 | | 103,714 |
| Real Estate | 31,318 | 2,669 | 33,987 | 31,389 | 1,449 | 32,838 |
| Currency Overlay | 4,593 | 0 | 4,593 | 5,275 | 0 | 5,275 |
| Other Investment Expenses | 3,117 | 0 | 3,117 | 4,267 | 0 | 4,267 |
| Total | \$314,057 | \$19,581 | \$333,638 | \$330,584 | \$41,420 | \$372,004 |

Source: 2018 Comprehensive Annual Financial Report, State Retirement and Pension System

Carried Interest Transparency

In the past five years, calls for greater transparency in the reporting of carried interest have led to changes in the investment management industry. Carried interest is earned by investment managers in private markets (e.g., private equity, private real estate) and is the amount that a general partner (investment manager) retains as an ownership interest in the investment profits generated by the partnership. Carried interest typically represents 20% of the profits generated, but that proportion may be negotiated among the parties involved. As carried interest represents shared profits that are retained by the

general partner rather than paid by the investor, it is not typically reported as investment fees paid.

Recently, several public pension plans, including the California Public Employees' Retirement System (CalPERS) and the Pennsylvania Public School Employees' Retirement System (PSERS) have released reports showing carried interest earned by general partners managing investments on their behalf. In addition, the Institutional Limited Partners Association developed a reporting template that includes carried interest that has been endorsed by many investment managers and public pension funds (including SRPS).

In its initial report, CalPERS reported that general partners earned \$700 million in carried interest in fiscal 2015. PSERS reported that general partners earned \$5.17 billion in cumulative carried interest from 1980 through 2017. For calendar 2017, PSERS reported that general partners earned \$669 million in carried interest. Of note, PSERS indicated that it took 500 hours of staff and consultant time to generate the report on carried interest.

State Fiscal Effect: Consistent with modern portfolio theory, SRPS invests in a diversified portfolio of asset classes, including some passive (low-fee) and active vehicles. As each asset class performs differently under distinct market conditions, the purpose of the diversified portfolio is to both capture the up side in asset classes that perform well in some instances and minimize the losses when some asset classes perform poorly in other circumstances.

SRPS invests about \$3.4 billion in two low-fee equity index funds that had combined returns of 15.4% net of fees in fiscal 2018, when public equities were doing very well. Over the same time period, three actively managed public equity funds with higher fee structures earned 14.2% net of fees. This limited example seems to indicate that (1) the fund should invest more in public equity and (2) passive equity investing should be used exclusively. A broader look, however, reveals that, over the same time period, the system's private equity portfolio, which has substantially higher fees than public equity (including carried interest) returned 19.6% net of fees, outperforming both types of public equity.

Similarly, for the first six months of fiscal 2019, the system's public equity investments (active and passive combined) had negative returns of -9.9% net of fees, while private equity had strong positive returns of 8.7%. Had the fund been invested exclusively in public equities during that time, its losses would have been substantially larger. It bears noting that, since all returns are net of fees, the relative amount paid in fees may not be an appropriate measure if some high-fee classes outperform low-fee classes.

In short, restricting the asset classes that SRPS can invest in only to those with low-fee structures may have a dampening effect on the system's investment returns and on its

flexibility to respond to different conditions in the financial markets. To the extent that investment returns, net of fees, are substantially less over time, State pension liabilities and contributions (all funds) likely increase significantly.

Additional Information

Prior Introductions: None.

Cross File: None.

Information Source(s): State Retirement Agency; *Governing*; Institutional Limited Partners Association; Pennsylvania Public School Employees' Retirement System; Department of Legislative Services

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mm/vlg

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