

Department of Legislative Services
Maryland General Assembly
2011 Session

FISCAL AND POLICY NOTE

House Bill 1326 (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 also 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, 2011.

Fiscal Summary

State Effect: Special fund expenditures by SRA decrease by approximately \$2.2 million in FY 2012 due to the elimination of the Investment Division. Those savings continue to accrue in the out years due to inflation, but they are at least partially offset by increased expenditures on commissions and fees paid to one or more investment advisory firms hired to manage and oversee the system's investment program. Although a reliable estimate of those expenditures is not feasible, based on recent increases in SRA asset management fees, commission and fee expenditures likely increase by at least as much as the annual savings, at least in the short term. The board can establish the criteria specified in the bill with existing resources. No effect on revenues.

Local Effect: None.

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.

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 \$183.7 million in nonbudgeted asset management fees in fiscal 2010. Management fees have recently grown at a substantially faster pace than assets. For instance, total assets grew by 10.7% from fiscal 2009 to 2010, but total fees grew by 74.8%. This trend is due largely to the expansion of holdings in alternative asset classes, which tend to have higher fee structures than traditional equity and fixed income managers. Fee structures for private equity contracts vary, but typically include a component that is based on the amount of capital that is committed by an investor. Even within the traditional classes, however, the system has expanded the number of active managers, who also have higher fees than passive managers.

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. Indeed, an analysis conducted by SRPS' investment advisor at the request of the Department of Legislative Services (DLS) shows that, for the most part, the recent additions of these asset classes and the expansion of the portfolio's private equity holdings have reduced volatility and increased expected returns. **Exhibit 1** shows the advantages of a well-diversified portfolio. For instance, equities performed very well during fiscal 2010, but their performance over the past decade has been quite poor, as

reflected by the negative 5- and 10-year returns for domestic equity. Conversely, while real estate has performed very poorly in recent years, its 10-year return is the highest of any asset class shown. 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, 2010¹
(\$ in Millions)

	<u>Assets</u>	<u>% Total</u>	Time Weighted Total Returns		
			Unaudited		
			<u>1 Year</u>	<u>5 Years</u>	<u>10 Years</u>
Domestic Equity	\$6,250.9	19.51%	15.91%	-0.82%	-1.09%
International Equity	6,815.9	21.27%	15.17%	4.19%	1.56%
Fixed Income	5,918.2	18.47%	14.31%	5.96%	6.70%
Global Equity	2,941.8	9.18%	15.44%	n/a	n/a
Real Estate	2,041.4	6.37%	3.55%	0.47%	7.77%
Real Return	3,245.9	10.13%	12.10%	n/a	n/a
Private Equity	1,009.4	3.15%	14.16%	9.11%	3.51%
Absolute Return	1,422.1	4.44%	7.47%	n/a	n/a
Credit Opportunity	1,068.7	3.34%	19.23%	n/a	n/a
Cash and Other	1,329.1	4.15%	2.48%	n/a	n/a
Total Fund	\$32,043.4	100.0%	14.03%	2.30%	2.10%

¹Data presented here include the system's cash account and money invested by the system on behalf of the Maryland Transit Administration (totaling \$119.8 million across all asset classes).

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

Source: State Retirement Agency

State Fiscal Effect: SRA's Investment Division consists of 21 positions, 16 of which are investment professionals and 5 are administrative staff. Their total payroll, including salaries and benefits, is approximately \$2.0 million. In addition, the division has a travel budget of approximately \$100,000, and an estimated \$53,000 in other associated operating expenses, including rent, supplies, and communication charges. All agency operating expenses are special funds paid from the pension trust fund.

Therefore, based on the bill's July 1, 2011 effective date, special fund expenditures by SRA decrease by approximately \$2.2 million in fiscal 2012 due to the elimination of the Investment Division. That savings is at least partially offset by fees and commissions paid to one or more independent investment advisory firms, but a reliable estimate of those fees is not possible because they are subject to the procurement process and negotiation. However, based on recent increases in SRA asset management fees, commission and fee expenditures likely increase by at least as much as the annual savings, at least in the short term. Those expenditures may be classified either as nonbudgeted (as is the case with investment management fees paid to external asset managers) or special funds (which is how other professional consulting services are reflected). It is unclear whether SRA would have sufficient time to procure investment advisory firms by the bill's effective date.

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 nonbudgeted asset management fees paid by SRPS for existing external managers.

Additional Information

Prior Introductions: None.

Cross File: None.

Information Source(s): Maryland State Retirement Agency, Sign On San Diego, Department of Legislative Services

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mc/rhh

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