

Trouble at the State of Maryland's Pension Fund?

\$ 3 Billion Investment Underperformance – Last 10 years

Abstract

The Maryland state pension fund has significantly trailed the median investment returns of its peers to the tune of \$3 billion over the last ten years.

The substandard results may be the result of asset allocation decisions, manager investment selections, or both. Underperformance impacts taxpayers since the state must divert tax revenues toward larger fund contributions.

The state's pension fund shortfall now stands at \$15 billion, over two times the state's entire general obligation debt of \$6.5 billion

Maryland Tax Education Foundation

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Introduction

In recent weeks, the matter of unfunded pension liabilities incurred by state governments has gained prominence, with articles in several national publications. At June 30, 2010, the Maryland state pension was underfunded by about \$15 billion. This estimate assumes the pension fund achieves a 7.75% annual rate of return on investment, but the fund has failed to match this return over long periods, in part due to low interest rates and low equity returns. Over the ten years ended June 30, 2010, for example, the investment performance was 2.1% annually. Using a lower rate of return, like 6%, inflates the underfunding from \$15 billion to \$20 billion, which is three times the state's entire outstanding general obligation debt (\$6.5 billion).

To ensure that the pension fund has sufficient money to pay existing (and future) retirees, the state government contributes money to the pension fund each year, and dictates that the fund invest in a broad array of stocks, bonds and other assets to generate income that supplement the state's contributions. The purpose of this study is to examine the investment returns of Maryland's pension fund and to compare them to surrounding states' returns.

Background—State of Maryland Pension Fund

At June 30, 2010, the fund had total assets of \$32 billion, invested in stocks, bonds and other assets. The fund is administered by a Board of Trustees headed by Nancy Kopp, Chairman, and Peter Franchot, Vice Chairman. Ms. Kopp is the State Treasurer and is elected by the State Legislature. Mr. Franchot is State Comptroller. Several trustees represent state employee groups, others are gubernatorial appointees and three are selected by the Board because of their financial expertise.

The pension fund does not have an in-house staff that makes “buy and sell” decisions on individual investments. Rather, it subcontracts this function to over 180 investment managers worldwide. These managers are monitored principally by state employees with financial experience, assisted in part by outside consultants.

In-house administrative expenses were \$27 million in fiscal 2009 (fiscal 2010 expense data should be available in December 2010), and investment manager fees totaled \$109 million. Assigning \$10 million of the state's administration expenses to the monitoring function and adding \$11 million of brokerage commissions provides total investment expenses of \$140 million for fiscal 2009. This amount represents 0.41% of average 2009 assets, or 41 basis points.

About 45% of these 2009 expenses (\$67 million) were attributable to the pension fund's growing commitment to alternative investments such as leveraged buyouts, venture capital and hedge funds, which tend to be riskier than “vanilla” stocks and bonds. As noted in an earlier MTEF report (July 2008), academic studies have demonstrated that such alternatives underperform the broader equity markets due to their high fees.

Comparative Investment Performance

MTEF compared the Maryland pension fund results to those of surrounding states for the latest 1, 3, 5 and 10 year periods for which data was available. We also looked at data covering public pension funds nationwide. The data indicates noticeable underperformance by Maryland. See Table 1. Note that the stock market peaked in 2007, bottomed in March 2009, and then rose sharply through April 2010. This explains the negative three year results, since state pension funds typically allocate 50% or more of assets to equities.

Table 1 :State Pension Funds
Investment Performance (Annualized %)

June 30 Period End

	2010 ⁽¹⁾	3 Yrs.	5 Yrs.	10 Yrs.
Maryland	14.0	(4.9)	2.3	2.1
Delaware	14.1	(1.9)	4.3	3.9
Virginia	14.1	(4.9)	3.1	----
North Carolina	12.0	(2.0)	3.0	3.7
New Jersey	14.4	(1.6)	4.2	2.6
Kentucky	15.8	(2.8)	3.0	3.1
West Virginia ⁽²⁾	16.0	-----	----	----
Public Fund Median (TUCS) ⁽³⁾	13.3	(4.0)	3.1	----
Public Fund Median ⁽³⁾	12.8	(2.7)	2.4	3.4

December 31 Period End

	2009	3 Yrs.	5 Yrs.	10 Yrs.
Maryland	21.9	(2.3)	2.9	2.5
Ohio ⁽⁴⁾	20.6	(1.6)	3.5	3.6
Pennsylvania ⁽⁴⁾	9.1	(3.0)	5.7	3.9
Public Fund Median ⁽⁵⁾	19.9	(1.1)	3.4	3.9

March 31 Period End

	2010	3 Yrs.	5 Yrs.	10 Yrs.
Maryland	(29.1)	(7.6)	(0.8)	2.4
New York ⁽⁴⁾	(25.5)	----	----	----

⁽¹⁾ Provided by news releases of the pension funds. Delaware releases June results later. Its March 2010 results matched Maryland, while its ten year results were much better.

⁽²⁾ West Virginia performance is not readily available for longer periods.

⁽³⁾ Source: Wilshire Associates (>5B TUCS) and Callan Associates (>1B)

⁽⁴⁾ Ohio and Pennsylvania have a December 31 year end. New York has March 31.

⁽⁵⁾ Source: Callan Associates.

The differences between Maryland and the eight states are set forth in the next table. A plus sign (+) indicates overperformance, a minus sign (-) the opposite.

Table 2
State Pension Funds Investment Performance
Maryland vs. Eight Other States and Public Fund Medians

Maryland vs.	2010	3 Yrs.	5 Yrs.	10 Yrs.
Delaware	----	----	----	----
Virginia	-0.1	0.0	-0.8	----
North Carolina	2.1	-2.9	-0.7	-1.6
New Jersey	-0.4	-2.9	-1.9	-0.5
Kentucky	-1.8	-2.1	-0.7	-1.0
Ohio	1.3	-0.7	-0.6	-1.1
Pennsylvania	12.0	+0.7	-2.8	-1.4
New York	-3.6	----	----	----
TUCS/Callan	0.9	-1.5	-0.4	-1.3

Table 2 shows demonstrable underperformance for the 10 year period (2000 to 2010). Assuming 1% per year is a reasonable opportunity cost, the state loses \$320 million per year on a \$32 billion portfolio (1% x \$32 billion = \$320 million). If the Maryland pension fund had matched the performance of other states, the fund's unfunded liability would have been \$3.2 billion less (10 years x. \$ 320 million/year = \$3.2 billion).

Alternatively, the state could have maintained the existing liability and reduced its pension contributions, thereby freeing up \$3.2 billion for new spending or tax reduction.

Reasons for the Shortfall

When confronted with sizeable discrepancies in large pension fund performance, experts normally point to asset allocation differences. For example, a pension fund with a heavy equity allocation performs better in a rising stock market than one with a fixed income emphasis. However, Maryland does not outperform New Jersey or Kentucky, which had lower equity (and more fixed income) exposure than Maryland, so there remains a puzzle.

In this instance, most of the other states have comparable asset allocations to Maryland, so the problem may reside in the manager selection process. In 2008 and 2009, most of Maryland's investment managers failed to meet their benchmarks, according to the pension fund's 2009 annual report. The 2010 report comes out in December 2010.

A state commission is being formed to study the pension liability question, and it is expected to deliver a report later in 2011. Other states have considered reducing

pension liability by cutting benefits, increasing retirement age, boosting employee contributions, heightening state contributions, placing new employees in 401k's (instead of defined benefit plans) or improving investment returns by taking on more risk. Given the dollars involved, taxpayers, retirees and current state employees may want to hear the candidates' views on investment performance before November.

At this time, MTEF is not aware of the commission's agenda for addressing investment performance.

Indexing as a Source of Expense Reduction and Better Returns

As noted earlier, the state pays an estimated \$140 million per year (41 basis points) to achieve its underperformance. Most of these monies go to over 180 managers who "actively" manage portions of the pension fund, as indexing does not yet represent a majority of the portfolio. Over the last 20 years, index funds have beaten actively managed funds in terms of investment performance, and it seems unlikely that the state can select those few active managers who are capable of beating equity (or bond) indexes consistently. Accordingly, it seems reasonable for the state to index the entire portfolio among stocks, bonds and other asset allocations in the hope of cutting costs and attaining median performance.

Active managers cost the state more money than indexes because the active manager must hire professionals to analyze individual stocks (or bonds) and make bets on which securities will outperform the market. The fees tend to fall in a 20-30 basis point range for public securities and 100-300 basis points for alternative assets.

In contrast, when indexing, the manager replicates the results of the target index by holding all—or in the case of a very large index, a representative sample—of the securities in the index. The result is a passive investment approach with low cost (1 to 2 basis points, as opposed to 41) since professional analysis is unnecessary. MTEF estimates indexing will save the Maryland pension fund \$100 million annually with no sacrifice in investment returns.

By way of example, MTEF constructed a model portfolio, using the same asset allocations as Maryland's pension fund (with the assumption that private equity funds and hedge funds roughly correspond to US equity indexes, as concluded by the academic literature). The index portfolio beat the state's "managed" portfolio by 0.5% annually over the last ten years (2.6% for indexing and 2.1% for the state). See Exhibit B. That's a ten year improvement of \$1.5 billion.

About MTEF

MTEF is a non profit, non partisan organization that studies budget and tax issues in the State of Maryland.

Acknowledgement

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Attachments

Exhibit A: Asset Composition by State Pension Funds

Exhibit B: Investment Returns of Model Index Portfolio.

Exhibit A	MD	DE	VA	NC	NJ	KY	WV	OH	PA	NY	Public Fund Median (TUCS)	Callan Public Fund
Equity	51%	48%	55%	48%	42%	50%	51%	63%	26%	45%	55%	na
Fixed Income	19	21	22	40	32	24	29	26	15	26	27	
Credit	3	0	5	1	0	0	0	0	0	0	0	
Tips	0	0	0	0	0	0	0	0	0	11	0	
Alternative:												
Real estate	6	7	6	5	5	3	1	5	8	7	1	
Hedge fund- Inflation	15	7	5	0	0	12	11	0	20	2	5	
Private equity	3	8	4	6	6	5	8	4	24	10	4	
Cash	2	7	3	0	0	5	0	3	3	0	3	
Other	1	0	0	0	3	1	0	0	4	0	5	

As of Jun 2010:	Last 1 Year (annual) Return	Last 3 Years (annual) Return	Last 5 Years (annual) Return	Last 7 Years (annual) Return	Last 10 Years (annual) Return
S&P 500 TR	14.43	-9.81	-0.79	2.84	-1.59
MSCI AC World Ex USA GR USD	10.87	-10.28	3.84	9.36	2.29
BarCap US Agg Bond TR USD	9.50	7.55	5.54	4.96	6.47
45-25-30 Portfolio	12.84	-3.60	3.25	5.95	2.58
10 Year Statistics	Geometric Mean (%)	Standard Deviation (%)	Maximum Decline (%)	Sharpe Ratio	
S&P 500 TR	-1.59	18.26	-45.80	-0.21	
MSCI AC World Ex USA GR USD	2.29	22.68	-51.36	0.04	
BarCap US Agg Bond TR USD	6.47	3.67	-2.44	0.65	
45-25-30 Portfolio	2.58	12.90	-32.51	-0.05	
Source: Ibbotson					