Managing Against Escalating Pension Investment Fees

BY GIRARD MILLER

Like other public pension plans of similar size, the Orange County (California) Employees Retirement System has migrated toward a broadly diversified portfolio with substantial commitments to alternative investments. Excluding real estate, more than 25 percent of the system's $11 billion portfolio was invested in alternative investments at the end of 2013. Projected fees for targeted performance, including indirect fees paid to advisors through the investment funds they offer, total approximately $90 million a year, of which $30 million is billed directly and roughly $60 million is charged to the respective investment funds and netted against performance. The latter indirect advisory fees had not been visible to decision makers under traditional governmental budgeting and financial reporting conventions, and some were concerned and surprised when trustees were enlightened as to the magnitude of the "total cost" of investment fees in an October 2012 budget workshop. At that time, the retirement board identified fees and risk management as its two top priorities for the investment committee in 2013.

Staff developed a comprehensive fee policy, which was adopted by the board investment committee in April 2013 (available at http://www.ocers.org, under the finance and investments tab). It provides guidance to marketers and a framework for negotiations with investment advisors who are invited to make finals presentations, as well as tips for incumbent managers who are updating the staff or attending biennial meetings with the system's manager monitoring subcommittee.

THE FEE POLICY

The fee policy encourages staff and consultants to obtain the lowest possible fees using traditional measures and techniques. These include "most favored nations" clauses; comparisons with peers; negotiating early in the selection process via consultants who have bargaining power through their broad client base; and pitting competitors against each other in or before final presentations. Beyond simply seeking the lowest possible fees, however, the fee policy also focuses on alignment of interests, including the use of performance-based fees. The policy provides specific guidance to investment managers and staff regarding the preferred structure of fulcrum fees (fees centered on a target, or "fulcrum," performance level, which are increased or decreased for better or worse performance) and performance fees (additional, performance-based fees paid when an investment manager achieves an investment return that beats a specified benchmark). The policy also addresses the design of hurdle rates (the minimum rate of return required for payment of performance fees) and fee caps. The policy does not take a "one size fits all" approach because there will be some instances in which a low fixed fee is more suitable than a performance fee, and in some markets, the formula for an optimal performance fee is premised on expected returns that vary from one strategy or sector to another.

> The standard hedge fund fee was 2 percent of the assets managed (per annum) plus 20 percent of the profits. In their quest to obtain returns that beat bonds and real estate rental yields, investors naively or reluctantly accepted these terms.

The OCERS fee policy emphasizes that fees are only one factor to consider in selecting investment managers. Demonstrated track records, proven investment talent, repeatable investment processes, competitive and strategic investment advantages, and qualitative factors are the primary factors to consider in evaluating expected returns from a manager. The policy also acknowledges that expected returns are just that — they are uncertain and variable. Fees are certain, however, and can be known in advance. Therefore, fees rise to a higher level of importance when screening finalists and close contenders during the selection process. The policy thus states that "absent an evidently superior investment strategy and capability, or a discernible reason to expect materially superior investment performance from a competitor looking forward, OCERS will give selection preference to firms that offer the most advantageous fee structures."

PREFERENCE FOR PERFORMANCE FEES

As a general rule, the OCERS fee policy expresses a preference for performance-based fees that align the interests of the investment manager with the system's stakeholders, so long as the cost is expected to compare favorably or reasonably to a flat fixed fee when performance meets expectations.

On the other hand, many investment management firms value the certainty of a fixed-income stream over the uncertainty of performance fees and will price accordingly, so a fixed-fee proposal from the same manager will sometimes offer a superior, lower pricing alternative that should result in lower costs over time. There are also times when a given manager may not be able to offer a performance-based fee in its least costly delivery mechanism; sometimes a fixed fee in a commingled fund offers the lowest costs, and there may be other administrative factors to consider (such as the cost and risks of establishing international swap dealer agreements) in a separate account structure in order to obtain a performance fee. The accuracy of performance often needs to be internally audited, which imposes an additional cost on the system, although that is usually trivial in comparison with the fees themselves.

OCERS's performance fee philosophy is that a base fee is appropriate to provide sufficient operating income for the manager to "keep the lights on." Because firms vary in size and structure, no single base fee level is appropriate to all investment disciplines. The OCERS fee policy generally encourages base fees that fall between the market cost of passive management and 40 percent of the prevailing fixed fees for a given investment strategy. For the performance fee, managers of traditional asset classes often design a fulcrum fee that centers on the expected return, which is preferably an "alpha" return over the benchmark for that strategy — for instance, "benchmark plus 200 basis points." The total fee at that level of performance would then equal the competitive fixed fee, in a symmetrical structure that also includes a fee cap that is equidistant from the fulcrum point to the base and the ceiling.

For alternative investments, it is more common to see "carried interest," or participation fees (expressed as a percentage of returns over a hurdle). OCERS prefers performance fees that compensate the manager for "alpha, not beta" (performance and skill, not just taking risk), so its preferred structure is a "hard hurdle" (a performance fee only on returns above the hurdle rate) that approximates the manager's declared expected return. That said, many managers today fail to offer such a structure, which underscores the importance of collective professional efforts to assert and establish a new norm in this industry through best practices that encourage "alpha-based hard hurdles." The sample resolution in Exhibit 1 addresses this performance-fee issue and advocates broader industry-wide implementation of hard hurdles for performance fees.

The OCERS fee policy assigns responsibility for negotiating fees to the chief investment officer, who is accountable for reporting new contract arrangements to the investment committee at closing. As a practical matter, the CIO often requests guidance from trustees when alternative fee structures are offered, such as a low fixed fee versus a performance fee that might have a higher expected cost when performance is exceptional. In such situations, the fee policy provides guidance but cannot offer a simple universal algorithm.

P-SHARE CLASSES

One of the newer fee strategies included in the OCERS fee policy advocates more widespread use of pension-fund share classes in funds that offer alternative investments. A P-share class is a special pricing structure established within an investment fund that gives pension funds access to lower fees than mainstream investors get. The rationale for this includes the "sticky" and patient nature of public pension capital, as well as the growing importance of public pension commitments to the profitability and stability of investment advisory firms. In the hedge fund industry, for example, many investment advisors learned the hard way in 2009 that their fast-money investors were fickle and quick to redeem their shares, causing mayhem in their operations and, in some cases, a liquidity crisis, followed by a plunge in operating profits and employee compensation. Public pension funds, with their longer-term perspective and willingness to ride out short-term market turbulence, have become an attractive client base that deserves preferential pricing.

> The 3,000 U.S. public retirement systems that have less than $5 billion in assets are particularly disadvantaged in their ability to secure advantageous pricing.

Most commingled funds, hedge funds, private equity funds, and other fund structures can construct a P-share class that would reward the entire class of public pension fund investors with lower fees, if the fund receives aggregate investments that are large enough to create beneficial economies of scale. The share class can also reward the larger public pension funds

Exhibit 1: Sample

Resolution Supporting Pension Share-Classes and Hard Hurdles for Institutional Investment Funds

Whereas public pension plans including the _____ retirement system are reliable, long-term investors of patient capital, which is highly attractive to institutional investment advisory firms, and

Whereas the institutional investment industry spends hundreds of millions of dollars annually marketing to public pension plans because this is a lucrative business for them, and

Whereas the fees charged by investment advisors in certain market sectors do not reflect the true costs of operating a business, but often represent "scarcity rent" or "economic rent" that inures solely to the benefit of the advisory firm. This anomaly reflects an inefficient market and a failure by this highly scalable, high-margin industry to recognize the value of public pension fund commitments, and

Whereas a more rational and justifiable industry fee structure would include a system of "pension share-classes," or "P share-classes," that automatically provide competitive and justifiable graduated fee discounts to public pension plans when the aggregate of their patient long-term institutional investments is sufficiently large to reward the advisor with sustainable profit margins, and

Whereas many managers of alternative asset strategies receive performance fees for total returns, rather than for performance above a "hard hurdle" that actually represents skill in producing "alpha" and not just taking risk ("beta") in achieving expected returns.

Now therefore be it resolved that the (board/committee) of the __________ retirement system hereby endorses the concepts of graduated "P-share-classes" and "hard hurdles" for hedge funds, private equity funds, commingled investment funds, and similar vehicles for institutional investment, and encourages our incumbent and prospective investment advisors to offer such fee structures.

Be it further resolved that absent an evidently superior investment strategy and capability, or a discernible reason to expect materially superior investment performance from a competitor looking forward, public pension plans should generally give selection preference to firms that offer the most appropriate and advantageous fee structures aligned with professional best practices and the best interests of plan sponsors, beneficiaries, taxpayers, stakeholders, and the general public.

Be it further resolved that a copy of this resolution shall be forwarded to other retirement systems in our state, our relevant investment advisors, and Investments@ocers.org, where a log of such resolutions will be retained for public and industry reference.

A Brief History of Alternative Investment Fees

Over the past two decades, public pension plans have allocated ever-larger percentages of their portfolios to "alternative assets" — hedge funds, private equity and private lending, commodity funds, and other illiquid investments such as timber, farmland, and energy ventures. This trend accelerated when market yields on bonds plunged to lifetime-low levels during and after the Great Recession, as central banks sought to deleverage their economies with aggressive monetary policies that suppress interest rates in the hopes of avoiding deflation. With bonds yielding very little (and likely to suffer price erosion whenever the economy normalizes, which would push market rates higher), public pension plans have migrated away from traditional 60/40 stock-bond portfolio allocation strategies to more diversified assets in the hope that they will be sufficiently uncorrelated to offset traditional stock risk during economic downturns.

To build those new-breed investment strategies into their portfolios, public pension plans have been compelled to pay fees that are much higher than what they have accepted from highly competitive traditional investment portfolio managers. In some cases, the higher fees reflect unique skills and talent that has migrated to the hedge funds and private equity world, plus the stronger bargaining power of money managers that have investors lining up outside their doors if they can produce a strong track record. In some markets, such as private equity, the superior returns have been captured by the top 25 percent of the firms in that business. The rest have had substantially inferior results. As a result, the successful players can extract "economic rent" through fee structures that compensate them well beyond their actual operating costs and normal partnership profits. They essentially capture an oligopoly profit that is based on merit as well as their preferred access to entrepreneurs who are seeking start-up funding or buyout capital to take private control of a company for several years (with the intent to later take it public at much higher valuations).

The largest public pension plans, such as the California Public Employees' Retirement System, the California State Teachers' Retirement System, and the New York State Common Fund, have significant bargaining power because of their sheer account size, as well as the marquee marketing value of their prominent names and credibility. As a result, they often can cut for themselves a better deal on pricing than smaller public pension plans. The 3,000 U.S. public retirement systems that have less than $5 billion in assets, however, are particularly disadvantaged in their ability to secure such advantageous pricing, and even midsize public plans with assets of $5 to $20 billion often find themselves on the "take it or leave it" end of the bargaining table. Public pension plans with assets of less than $200 million do not typically invest heavily in alternative assets because of limited resources and market access. Such funds would benefit especially from joint procurement or pooling arrangements.

that invest larger blocks of capital in the P-share-class with yet-lower graduated fees. OCERS encourages more prevalent use of this pricing structure as the simplest and fairest way for public pension funds to realize meaningful economies of scale and pricing concessions that are appropriate to their patient, long-term investment horizon. Exhibit 1 presents a sample resolution endorsing the P-share-class concept, which can be modified for presentation to local pension plan governing bodies.

PIGGYBACKING THROUGH MINI-POOLS

Another of the strategies advocated in the OCERS fee policy is the creation of "mini-pools" for public pension plans — a selected investment manager would offer a separate fund or pool that offers lower pricing, based on the combined assets in the pool. Such "break points" are common in the mutual fund industry and can be replicated in commingled pools or funds established for public pension funds.

In September 2013, OCERS awarded an engagement to an emerging markets equity manager that has, in turn, created a trust for public pension plan investments that will offer fee discounts based on the total size of the pool. This investment was first deposited in a separate account to provide time for implementing the new trust fund, and then OCERS's assets were migrated into the new pooling fund as seed capital. Other public plans that join the pool will receive price benefits by "piggybacking" on OCERS's assets.

> OCERS prefers performance fees that compensate the manager for "alpha, not beta" (performance and skill, not just taking risk).

This strategy, if implemented by other public plans nationwide, would offer a convenient structure that traditional money managers could use to offer aggregate pricing that captures the benefits of economies of scale. Participating money managers would gain a marketing advantage as they acquired additional assets from plans seeking these lower fees.

> A P-share class is a special pricing structure established within an investment fund that enables pension funds to enjoy lower fees than mainstream investors.

THE CALAPRS AND P4 NETWORKS

The OCERS fee policy encourages staff to pursue collaborative procurement strategies and other methods of lawfully increasing the pension plan's bargaining and purchasing power. To this end, the CIO drafted an internal whitepaper that outlines the vision of a Public Pension Portfolio Procurement (P4) Network that could formally or informally pool or bundle public pension assets to improve their collective or aggregate bargaining power. That whitepaper was circulated among CIOs who belong to the California Association of Public Retirement Systems, sparking a dialogue that resulted in a collaborative effort to develop an innovative strategy for soliciting proposals from private equity fund-of-fund managers.

As a fiduciary precaution, the OCERS trustees requested a memorandum of law from expert outside counsel on whether such a collaborative effort would raise anti-trust issues. That privileged legal guidance, which was prepared confidentially for OCERS, represents a pioneering step in addressing a perennial concern that has haunted others who had suggested similar collaborative procurement strategies.

How the procurement process for this specific service will culminate is not yet certain; the RFP selection process is underway. The RFP structure permits other public pension funds to co-invest in the selected fund or fund platform, which would be subject to local approval by each participating plan. Bidders will be allowed to propose a California-specific product and pricing structure, or a platform eligible for public plans nationwide. To encourage broad competition, those who instead wish to offer their fund to non-governmental investors can do so through a P-share class.[1] An innovative provision of the RFP is a requirement for the winning bidder to underwrite the cost of obtaining a formal legal opinion that addresses the anti-trust issue, for the comfort of public pension trustees who would be considering their product after the firm is selected by the CIO working group. This feature would allocate the cost of obtaining that legal opinion fairly among the ultimate investors and the successful bidder. Once presented to public plan investors, the legal research and opinion would become a public document available for reference by public pension systems nationwide.

At OCERS, the concept of a P4 Network is more expansive than this single exploratory effort in California, but the system's in-state peer professionals suggested that the collaborative procurement concept must be market-tested in the public pension investment community before discussions of a broader structure or network would be fruitful. The legal guidance prepared for OCERS did address this broader national P4 Network potential, which could ultimately include many investment disciplines and participants nationwide, but OCERS trustees are "starting with baby steps," with an abundance of caution, to see first how this private equity procurement works in practice.

CONFRONTING THE ANTI-TRUST CONCERN

The concept of collaborative or joint procurement of investment services for public pension funds is not new. In some states, such as Michigan and Pennsylvania, a statewide fund enables local plan sponsors to participate in a multi-employer plan with a common investment fund. What nobody has accomplished heretofore is a structure or network for pooling or bundling the assets of independent pension boards in order to achieve lower fees and stronger bargaining power. It is generally thought that such arrangements have not been attempted previously because of simple inertia and the fragmentation of municipal pension funds, along with the specter of anti-trust liability and risk.

In lay terms, one of the key issues OCERS officials considered, with guidance from their expert counsel, is an issue of "market power" that must be addressed when evaluating anti-trust risk. OCERS is seeking to achieve a modicum of bargaining power (but not dominant market power) by joining with its colleagues in other pension plans to obtain pric-

ing comparable to the terms the larger, goliath plans get. To achieve this bargaining position, however, the system's share of the total market should not exceed levels previously identified as potentially problematic by the U.S. Justice Department and the courts.[2] Fortunately, that is a very high threshold — a full order of magnitude greater than the largest scale that municipal and midsize public pension CIOs could ever hope to achieve in the global capital marketplace.

In this initial private-equity fund-of-funds initiative, the approximate level of potential common investment would likely be approximately $300 million to $600 million in the first year, and perhaps twice that level if the bidder offered to provide public-pension pricing discounts nationwide — in a private equity marketplace that totals $3 trillion. A collaborative procurement for municipal and midsize public pension plans at such a small level (less than 1 percent) is highly unlikely to distort fair competition or industry structure, and it represents a miniscule fraction of the threshold standards referenced by authorities in this field. Even with their private equity allocations combined, the bargaining power of the CALAPRS CIO network is less than either of the state's two largest public pension plans, which are not participating in the bidding group concept.

In addition, the California pension plans' collaboration has been designed to be pro-competitive. Some public pension plans, notably the smaller ones in this association, would gain access to a market sector they would never be able to secure individually, in a cost-effective way. Thus, the whole should be greater than the sum of its parts in the field of private equity, where access to top-performing (and scarce) general partners is a critical factor in achieving worthwhile returns. Further, in the case of this private equity procurement, the RFP allows bidders to propose a customized fund for the sole use of public pension funds either statewide or nationwide, or alternatively, to create a P-share-class in an existing shelf product, which encourages more bidders to qualify and compete on such terms as they prefer, given their respective business models and market niches.

The design of this network's collaboration is open-ended and non-exclusive. Nothing in OCERS's "bundling" process prevents a participating plan from selecting another investment manager, and nothing prevents an unsuccessful bidder from seeking to offer its products to any individual plan.

Finally, public pension plans are not competitors. They are consumers of investment services and do not remarket the product or seek profits for private inurement. Stakeholders in these systems, including public employers, taxpayers, public employees, and retirees, all benefit from fee reductions achieved through this kind of collaboration. Any fee reductions that result from collaborative procurements are likely to reduce economic rent, but they would not drive prices lower than their factor costs and a reasonable return on investment for the owners of investment management firms. This would not seem to be contrary to public policy or the public interest.

OTHER "JOINT POWERS" APPROACHES

Each of the 50 states has enacted statutes permitting intergovernmental service and procurement arrangements. Going beyond the P4 Network concept of bundling individual plans' investments, a joint powers authority or intergovernmental investment pool might be worth exploring as an additional possibility for collaborative procurement for states that have decentralized municipal retirement systems.

Under such a structure, the retirement systems or their plan sponsors would enter into contracts to provide the administrative structure for one or more investment pool for specific investment disciplines, with each to be managed by a common investment specialist. Such local government investment pool arrangements are commonplace for pooling municipal operating cash in many states and could offer municipal pension plans a viable model for achieving cost savings without relinquishing local control of the overall portfolio strategy and

asset allocation. Such a structure would be viable, with a similar pro-competitive legal status, provided that anti-trust issues are addressed in its design.

> A whitepaper sparked a dialogue that resulted in a collaborative effort to develop an innovative strategy for soliciting proposals from private equity fund-of-fund managers.

CONCLUSIONS

Investment fees matter, and they are growing rapidly for public pension funds that invest in non-traditional strategies and fund structures. Stronger efforts by state and local pension plan administrators and investment teams to manage these fees could save taxpayers and workers a billion dollars annually. Those would be sustainable savings. A fee policy can help provide sustainable guidance to investment staff, consultants, and both prospective and incumbent money managers. P-share-class structures and hard hurdles for performance fees would offer immediate and fair cost savings with minimal negotiation if they were to become more prevalent, which should encourage public pension plan officials to endorse and seek out those pricing structures. As legal clarity is achieved on the anti-trust issue through the California CIO procurement effort, collaboration between municipal and midsize public pension plans is likely to become a viable strategy to pool or bundle assets in order to obtain lower fees while maintaining local control over asset allocation, portfolio strategy, and plan governance.

Notes

1. A copy of the RFP can be obtained at the OCERS website throughout 2014, or through the OCERS offices thereafter, as a public record.
2. See Michael Dorsey, "Antitrust and Group Purchasing", *Antitrust*, Vol. 23, No. 3, Summer 2009. Articles from the American Bar Association and others on the general subject frequently cite a market share threshold in the range of 35 to 40 percent.

GIRARD MILLER is the chief investment officer of the Orange County Employees Retirement System. He can be contacted at gmiller@ocers.org.

GSA FABS Schedule No. GS-23-F-0052T
Financial Accounting and Business Schedule
FABS SINs:
520 1 Program Financial Advisor
520 7 Financial & Performance Audits
520 8 Complementary Audit Services
520 9 Recovery Audits
520 11 Accounting
520 12 Budgeting
520 13 Complementary Financial Management Services
520 15 Outsourcing Recurring Commercial Activities for Financial Management Services
520 17 Risk Assessment and Mitigation Services
520 21 Program Management Services
520 22 Grants Management Support Services
Visit:www.fmshq.com\FABS

GSA MOBIS Schedule
Contract No. GS-10F-0173K
SINs 874-1, 874-4, 874-6 and 874-7

GSA IT Schedule
Contract No. GS-35F-0070J
SIN 132-51

FINANCIAL PREPAREDNESS

...when it matters most.

For over two decades, FMS has prepared its clients for the changing financial and management regulatory environment by providing high quality and mission focused services. We lead in the understanding and integration of government's diverse objectives, missions and goals as evident in awarded GSA SINs. We are always prepared. To learn more on how FMS can support your agencies preparedness, please contact us at: getprepared@fmshq.com

www.fmshq.com | 202-842-3003