Image: Jonathan Ruchti

California's pension plans eye 'game changer' for PE

An innovative approach to private equity investment could unlock the asset class for California's public pension plans, says Girard Miller, chief investment officer of Orange County Employees Retirement System

Alternatives have been part of Orange County Employees Retirement System's (OCERS) portfolio for some time. Private equity was initiated relatively early on and while this allocation may have grown over time, historically it has not comprised a huge component, according to Girard Miller, chief investment officer of the OCERS.

This is set to change following his appointment last June. "We have come to the conclusion that we need a heftier commitment to the private equity space, so there is an increase of one per cent of the portfolio – or $100m of additional capital.

"As we're a cashflow-positive plan, we have the capacity to accept greater illiquidity than we have undertaken in the past, and this was not ever addressed on a ten-year basis before I arrived," he says.

Located in Santa Ana, California, OCERS is a multiple-employer defined benefit pension plan covering employees of Orange County and 14 other participating employers. Historically, OCERS has invested in private equity through several fund of funds managers. It currently has multi-year commitments through Abbott Capital, Adams Street, and Mesirow Financial.

Private equity has been at the five per cent level for OCERS for some time – and as some of the managers have yet to deploy the capital, it is close to 3.5 per cent. The portfolio allocation for private equity, set at five per cent of the total portfolio in 2012, was increased to six per cent in 2013, following a recommendation by Miller to the OCERS board.

Fees a "huge issue"

With $10.9bn of assets under management the plan has a "conservative history", which can be attributed to Orange County's bankruptcy in 1994, alongside a largely conservative political backdrop. Alternatives as a whole have grown in recent years, reflecting a move away from traditional bonds into absolute return and credit managers that go long/short.

"It is a very broadly diversified portfolio which attempts to take into account all-weather considerations," says Miller, an experienced pension reform advocate described as an "absolute genius" by one industry insider.

As the plan has moved away from traditional investments, the percentage of its cost structure and fees has risen – against close to 26 per cent allocations to alternatives, OCERS has an 80 per cent share of total fees. As this allocation has increased to nearly 40 per cent, fees have gone up in tandem.

Fees had become a "huge issue", Miller says, not just in private equity but across the board. As a result, OCERS has been exploring ways to mitigate this cost and find solutions.

He says, "A large portion of our portfolio is indexed against very low fees, so a two per cent management fee plus carried interest is quite a jump."

In a bid to address this issue, Miller and OCERS are spearheading a private equity investment programme that aims to bundle together local institutional capital, and which culminated recently in a request for proposals on behalf of a number of Californian county pension plans.

Strong support

"There was very strong support from trustees to pursue this strategy as part of an ongoing initiative to whittle fees lower," says Miller, who has extensive experience in the private sector investment-management business, with expertise in investing local government funds. For ten years, he was president of an intergovernmental trust fund for several thousand smaller systems and was also chief operating officer for global money manager Janus Capital.

He says, "I know what it costs to run an investment firm, as I've been on the other side – it's a whole lot less than 2/20. Three decades of professional experience have given me insights to how pension funds in this space can play in the big leagues. This broader context and experience helped give me the conviction that this could be done."

The aim was to address a mounting wall of fees, while enjoying the bargaining position not always afforded to smaller investors in the asset class. Miller explains, "When I interviewed for the job back in the spring of 2012, one of the issues I raised was the fee structure of alternatives. Though some believed we should be wrestling down the money managers, in practice it is difficult for a fund of our size to have the same bargaining power as the largest

'Absolute genius': OCERS CIO Girard Miller is leading the charge for smaller public pension funds to grow their presence in private equity

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pension funds. In some instances the fund structures are very much take it or leave it, with a zero ability to negotiate.

"In April 2013 our board adopted a fee policy that advocates the use of pension share classes [P-shares] which provide a lower fee structure for public pension funds. I was also given the green light to collaborate with my peers to see if we could collaborate in some way to bundle this allocation in a procurement process that would enable us to get a better bargaining position."

Miller took up the challenge of finding a fresh approach in a bid to reap its rewards, while avoiding the worst of its fee pressures. He adds, "Working with my peers here in California, I have been working behind the scenes to find a common procurement strategy where we would enter the marketplace with our arms linked, as opposed to running out on our own."

Following one of the semi-annual meetings of the CIOs of California's public pension plans, CALAPERS, it was agreed that the idea had merit, though the challenge was clearly to find a working model.

Herding cats

"The American way of decentralised local governments brings with it its own hodge-podge of approaches, committees and advisors, and it is clearly inefficient from the standpoint of economies of scale. One only needs to look at Ontario as an example of how a consolidated pension fund investor can operate at scale. It took great persistence to orchestrate a peer group just to get to a starting point," Miller says.

"It's not only an immense exercise in herding cats, there was also a lurking legal issue that needed to be overcome."

There was a concern that this aggregation could be an antitrust issue, creating a monopsony, where a single large buyer group holds the purse strings and causes unfair trade practices, Miller says. And there was a definite "lingering stigma" overhanging this idea as a result. For this to be overcome, OCERS had to create a structure to be reviewed by attorneys to assess whether this was actually an issue in practice, and not just theory.

The OCERS board wrote a cheque to pay for a legal memorandum to ultimately see if it would work in practice, even before it was fully formed and agreed upon. OCERS has since conferred with its counsel and satisfied itself that the request for proposal can proceed without an antitrust issue.

Typically, the larger the public pension plan the greater the proportion of assets in private equity, and as you go down to smaller municipal plans, they often have no exposure – a lot of this is a function of the fee issue, along with the complexity of the asset class and the selection process.

As a result, OCERS' approach to its alternative asset investments started where the fees were at their highest – the private equity fund of funds space, where 2/20 sees a layer of additional fees on top. Miller says, "Some investors are paying 3/30 for a return that is broadly equivalent to public markets. Some of the smaller plans don't even bother with private equity as a result, even though this would be a very useful asset class for them.

"We needed to devise a process that delivers a highly desirable product that the small and mid-size plans cannot achieve on their own, which brings in all the expertise our teams can muster, and delivers the lowest possible price in the marketplace by bundling our purchasing power and working together."

The idea for the RFP was to find an all-purpose, multi-strategy fund of funds that gives the manager the discretion to invest in buyout, venture capital, secondaries depending on the situation.

In addition to that all-purpose fund, there will also be the opportunity for complementary platforms that focus specifically on individual strategies.

OCERS leads pension plan bundling to boost access

OCERS' recent request for proposals for a private equity fund of funds has been described as a potential "game changer" for US public pension plans.

A working group of California county pension plan CIOs collaborated with OCERS in the development of this strategy and will participate in a collaborative selection process that is scheduled for February 2014.

The focus of this procurement will be an all-purpose, multi-strategy private equity fund of funds, although a platform of related products may be considered in a proposal that includes a core all-purpose fund of funds.

The committee approved the OCERS' fee policy, which includes a step authorising the CIO to engage in collaborative procurement efforts to secure investment-related services, potentially at lower fees by 'bundling' or pooling investments with other public pension plans.

Since that time, the CIO has met with a small working group of California pension plan CIOs, known as the CALAPRS CIO working group, to devise a strategy to "bundle" individual plans' private equity allocations through a common procurement process.

The aim is to obtain better investment products, access to superior underlying fund managers, and preferential fees for public pension plans.

Chairman of OCERS' investment committee Chuck Packard said, "Our board's fee policy gave full support to our CIO to work with his peers to develop this strategy."

OCERS CIO Girard Miller added, "This could be a game changer in the public pension world. By working together with other plans we should be able to secure lower fees. Private equity is the logical place to start. This innovative process will give smaller and mid-size public pension funds superior access to the nation's best general partnerships."

He adds, "There are different structures that could work, and could either be a fund that is specifically for Californian investors or a fund that is specifically for public sector investors, or an institutional fund with a special P-share class for public pension funds. If capacity is limited or we need to dangle an incentive for trustees to act on this early in the subscription period, we want to make sure we reap the rewards and get in at the first closing."

Miller says, "We would be happy if we could get the same sort of fees as the big guys, as we would bundle our assets together to get the same sort of market access and pricing. Realistically, this was not going to happen overnight, so our most immediate aims were to bring like minds together to help prove the concept works."

With proof of concept in place, OCERS issued the RFP towards the close of 2013, with least 15 registered bidders already before the end of the year. With the bidding process set to close January, OCERS will act as the central administrative co-ordinator of the screening committee that will create the final shortlist.

He adds, "We don't want the tail to wag the dog – the aim is not just to find the manager that can offer the lowest possible bid, but rather select the manager whose risk-adjusted rate of fees, net of return, offers the best package.

"There is a strong qualitative aspect, and we don't want to become completely obsessed about fees. Ultimately the goal is to achieve the best risk-adjusted return on our capital net of fees, so there is far more to this than just the pricing."

"We think we have found a way for the little guys to put their money into a fund of funds structure that offers the same rewards as if we were a bigger system"

Antitrust boogeyman

The intention is that the process maintains a high level of credibility as the winner has to come out of the screening process and then go forward to get the final approval from individual pension plans. Miller adds, "The winner will have a considerable marketing advantage compared to its peers, having gone through this process. Word will travel fast in the public pension community, and the burden will be on challengers to show what they offer that our winner does not."

In California there is still a noteworthy pool of institutional capital available for private equity investment that is not finding its way there; nationally the amount is even greater. If this programme finds success, there is considerable opportunity for the approach to be replicated elsewhere.

"Once we complete the process, put to rest the antitrust boogeyman and select a winning manager, I anticipate there will be interest from other pension plans across the US," he notes. "After that, there is also the opportunity to translate the model to other asset classes."

An admittedly arduous process to undertake, the programme would be almost unthinkable were it not for the considerable advantages it affords if it meets its aim. When the terms are right, private equity and pension funds prove a good fit, argues Miller, to the extent that investors that do not commit to the space often find themselves at a notable disadvantage.

"There has been a dramatic reduction in publicly listed shares in the US, and a significant share of company ownership, both at home and globally, is through private equity ownership. If you don't invest in private equity you are effectively shutting yourself off from a large portion of global companies, and often the ones on a significant growth trajectory."

He adds, "Operating a publicly trading company can present roadblocks, inefficiencies and a considerable competitive disadvantage, so there is no doubt in my mind that higher returns are achievable in the private equity space. Without all the trappings of public ownership, there is clearly an opportunity for many firms to operate leaner and faster."

Fortunately, public pension funds are often better positioned to take illiquidity risk than almost any other kind of investor. He says, "As pension funds we are natural investors in private equity, and it is only because it comes packaged inconveniently and is too costly that people have been deterred or frustrated with the asset class."

In the US, the great majority of returns are produced by only the top 25 per cent of managers, so getting access to the top players is frequently easier said than done, particularly for plans of OCERS' size and below. Miller is optimistic that he is nearing a solution that could open the doors for a greater range of institutional investment in private equity.

"It is a compelling proposition," he says. "We think we have found a way for the little guys to put their money into a fund of funds structure that offers the same rewards as if we were a bigger system, gaining access to deals that otherwise we would not be able to get close to." ■