February 11, 2022

Letters to the Editor
The Washington Post
1150 15th Street NW
Washington, DC 20071

Editor:

A recent op-ed argued that “Maryland is wasting its pensioners’ money” by investing system assets in a diversified portfolio rather than simply investing the $70 billion portfolio in a couple of index funds.  Doing so would cost the Maryland State Retirement and Pension System, and ultimately State taxpayers, billions of dollars in lost investment earnings. Of even greater concern, the proposal would significantly increase the risk to the portfolio.

Asset allocation has a far greater impact on both risk and return than manager selection or fees. Well diversified portfolios manage risk by ensuring that an investor does not “put all of his or her eggs in one basket.” Reliance on a portfolio that is limited to two index funds would be irresponsible for a pension system because of the very real possibly that both investments could suffer market declines at the same time. While an individual investor with a long investment horizon could wait until the market recovers, pension systems must continue to make payments to retirees and beneficiaries regardless of market conditions.

When managing investments in accordance with an appropriate asset allocation plan, it is important to manage fees properly, which we do. The use of index funds can make sense in efficient markets, where it is more difficult for a manager to beat the index. Other ways to reduce fees that are available to institutional investors include fee negotiations, co-investments, and internal management. Our professional investment team’s use of these tools to effectively manage fees greatly contributes to the substantial outperformance we have experienced.

Last year, we earned $13.3 billion in total returns, beating our benchmark by 2.3%, including $1.2 billion of outperformance, after paying $375 million in management fees. The System paid $373 million in performance-based incentive fees and carried interest to earn more than $1.5 billion in cumulative profits over time.

The highest performing asset class in the portfolio last year was private equity, which earned nearly 52% net of fees. If we had the benefit of hindsight, we would have invested the entire portfolio in private equities last year and generated billions of dollars in additional returns. However, without the benefit of hindsight, it would have been wildly irresponsible.

It would be similarly irresponsible to drastically increase our exposure to stocks and bonds in the manner that has been suggested at this point in the market cycle. Doing so would also be very expensive. Based on current assumptions, the suggested portfolio would be expected to produce a return of 5.4%, significantly lower than the System’s actuarial target of 6.8%. Adopting such a portfolio would cost taxpayers an additional $25 billion over the next twenty years. As the saying goes, “Penny wise and pound foolish!”

Sincerely,

Martin Noven
Executive Director

# Opinion: Maryland is wasting its pensioners’ money

By Jeff Hooke
***The Washington Post***
February 6, 2022

Jeff Hooke, the author of “The Myth of Private Equity: An Inside Look at Wall Street’s Transformative Investments,” is a senior finance lecturer at the Johns Hopkins Carey Business School and a former investment banker and private investment executive.

Seven hundred and forty-four million dollars. That is the amount of Wall Street fees paid by the Maryland state pension plan for investment advice in fiscal 2021.

Over the past 10 years, the fees totaled roughly $4.5 billion, or about 15 percent of the plan’s earnings. For that kind of money, you would think the state gets only the prime stock and bond picks from its advisers, but, during that time, Maryland, as with most other states, failed to beat the returns of a simple 60 percent stocks/40 percent bonds index. Many large institutional investors, including public pension plans, use this 60/40 index as a barometer to gauge their portfolios’ results. They structure their portfolios to avoid a 100 percent exposure to the sometimes volatile stock market. If their results are better than the index for a given year, they claim success. Many mutual funds attract smaller individual retail and 401(k) retirement accounts by copying the index and charging low fees for passive management.

The $70 billion Maryland pension fund acts as a giant piggy bank for state retirees. Current employees contribute a portion of their monthly paycheck to the fund, and taxpayers supplement these amounts with an annual billion-dollar payment. Adding to these two sources is fund investment income. From this combined pool of money come the allowances paid to retirees. People assume that the promised retirement benefits are guaranteed, but financial problems in other jurisdictions have resulted in retirement benefit cuts and higher taxpayer costs. Thus, proper fund management is important for both state workers and other taxpayers.

The Maryland legislature has a broad oversight role with respect to the pension fund’s investment activities, but it has little power to interfere directly in decisions, such as which stocks to buy or sell. For such matters, the fund’s professional civil service staff selects a small army of outside money managers to pick and choose investment opportunities. The fund staff negotiates the payments to outside managers, and such payments are off-budget. In political speak, “off-budget” means the payments do not appear anywhere in the state budget, nor do such payments require legislative approval.

Designed to keep retirees’ savings depoliticized, the fund’s independence comes at the cost of accountability. Being hands-off, the legislature and executive branch don’t say much about pension investments, even though almost $750 million in fees sounds like a lot of money. Most other states, unfortunately, have similar arrangements.

The investment underperformance problem that is evident at Maryland and other public pension plans is a bipartisan affair, with plan trustee boards typically composed of elected officials, political appointees and union leaders. Traditionally, public plan trustees have had limited financial expertise and, in the pre-2000 days, focused the portfolio on blue-chip stocks and bonds. Nowadays, the in-house staffs have become enamored with exotic, complex investments such as hedge funds, private equity and illiquid real estate. Many public plans have 30 percent or more of their portfolios in such assets. These investments carry sizable fees, long-term contracts and opaque information disclosures. They promise but do not guarantee higher yields. In an attempt to boost plan returns and to forestall greater employee and taxpayer contributions, plan trustees in Maryland and elsewhere have approved these costly alternatives in lieu of proven, low-cost 60/40 indexing. Between the persistent fees and mediocre returns, these exotic investment choices produce a drainage of $30 billion per year from public plans.

This drainage damages the financial security of public workers in Maryland and other states, and it forces greater taxpayer contributions to the plans. The ongoing situation has a secondary effect as well: The massive wealth transfer — from public workers and average taxpayers — to a small coterie of Wall Street money managers fosters a new plutocracy, successful at obscuring the problem and blocking reform.

The obvious fix for public plans is to shift from expensive fee investments to low-fee indexing, a tactic endorsed by none other than Warren Buffett, the noted value investor and philanthropist. For large public plans, including Maryland's, this shift, if implemented, would be gradual. Extricating the fund from its long-term contractual commitments and replacing them with passive investments is going to take time.

Back to top

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