Retirement News Highlights

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Table of Contents

How Maryland's pension became a billion-dollar business for Wall Street

By Giacomo Bologna
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Public pension systems once invested nearly all their all funds in stocks and bonds. Then, the Great Recession hit in late 2007. Stock prices walked off a cliff, bond yields plummeted, and public pension funds across the country lost hundreds of billions of dollars.

For the first time, many pension systems began looking beyond stocks and bonds — the bread and butter of most retirement accounts — and started to make high-cost, actively managed "alternative investments" a part of their portfolios. These investments, such as private equity, promised alluring returns.

A few years before the downturn, the Maryland State Retirement and Pension System had dipped its toe into private equity funds, which buy, overhaul and sell companies. Under pressure to bolster the flagging pension fund at the time, the system took the plunge, putting more and more money into private equity and other high-cost investments.

The pension system is now at its healthiest funding level in a decade and it has grown most years since the Great Recession. The system's assets more than doubled from $27 billion 20 years ago to $64 billion now. But what it pays to Wall Street to manage those investments has increased much more rapidly. The system now pays money managers about $1 billion a year in fees and incentives, 25 times the $40 million it paid two decades ago.

Andrew Palmer, the fund's chief investment officer, said focusing on fees and incentives is like looking at a landscape painting through a straw. The bigger picture, he said, is that the fund's investments — including the high-cost ones — have been profitable.

"We look at the return net of fees. We want to make sure that we're not paying fees for something that's just a market return that doesn't help us," Palmer said. "We are cognizant of the fees."

Much of those fees and incentives come from investments in private equity. Generally speaking, private equity firms buy companies, make aggressive changes, then sell them, hopefully for a profit. These firms generally promise higher returns than more traditional investments.

Before 2005, Maryland's pension system had never invested in private equity. In 2007, on the cusp of the financial crisis, the pension system was aiming to put 2% of its portfolio in private equity. Over the next two years, the pension system lost about $9 billion in value, and the pension's managers took a hard turn toward private equity and upped that target allocation to 15%. As of last year, more than 21% of the pension's value was in private equity.

This move to private equity mirrors those of other public pension funds across the country.

When the Great Recession decimated investment portfolios of pensions nationwide, there was suddenly a lot more pressure to increase the size of their funds or struggle with shortfalls as a growing number of teachers, firefighters, police and other civil servants retired. The number of retirees and beneficiaries drawing money from Maryland's pension system nearly doubled over the past two decades to 172,000, but the active employee count has stayed roughly the same at 194,000.

In response, states kicked in more money for their pension systems, cut benefits and required employees to chip in more from their paychecks. Meanwhile, many pension fund managers put more money into private equity and other "alternative investments" that typically require active management and higher fees.

In Maryland, these decisions appear to be working. The health of a pension system is generally measured by its "funding ratio." A funding ratio of 100% means a pension system has enough money to cover pension benefits for current and future members. Very few public pension plans are 100% funded, but Maryland's was over 90% in the early 2000s.

According to financial reports, the funded ratio of Maryland's pension system has been increasing steadily since hitting a low point of 64% in 2010 to 77% last year.

Some of that success, Palmer said, is attributable to private equity investments.

"You do get what you pay for in those markets," Palmer said. "The long-term history [of private equity] is that it has been productive and we expect it to continue to be productive relative to public markets over the next decade."

That could be true for Maryland's pension system, but there is a broader discussion nationally about how pension funds should approach private equity and whether the fees charged by Wall Street are worth it.

"The answers to these questions are not very clear," said Gang Chen, co-director of the University of Albany's State and Local Government Finance Project. "It's complicated."

The upside to private equity is that it can diversify a pension's portfolio and raise the expected annual return of the fund, Chen said. Even slight percentage changes in these returns can have big impacts on the growth of a pension fund.

On the other hand, the value of private equity investments is not transparent, Chen said. Anyone can look up Ford Motor Co. on their smartphone and see the car manufacturer's stock price instantly, but that's not how private equity works.

Without more public data, Chen said it's hard to draw strong conclusions on the performance of pension funds as well as the fees they pay to manage their investments. One of the places he does look for data is the Center for Retirement Research at Boston College, which collects and publishes information about pension systems.

Jean-Pierre Aubry, the center's associate director, published a paper last fall on whether alternative investments — meaning private equity, hedge funds, real estate and more — have helped or hurt public pension systems over the past two decades.

Compared with the stock market, it's basically a wash, Aubry said, but pension systems had to try something different to meet the aggressive returns that many states wanted.

Still, some economists like Eileen Appelbaum have much deeper concerns about private equity. Applebaum is the co-director of the Center for Economic and Policy Research in Washington, D.C.

Wall Street managers have a financial incentive to overstate their success, she said, because the more money they manage, the more fees they earn. Appelbaum believes many private equity funds overestimate the value of the companies in their portfolios, and if a recession comes, these funds will be caught with their pants around their ankles.

"If you're the pension fund manager … what's your incentive to calling their bluff?" Appelbaum said. "Being a cynic is bad for your career in the pension fund world. Even raising questions is bad for your career."

Not every public pension plan has embraced such a high-cost, active investment strategy. Nevada's retirement system has become famous for its passivity.

Maryland's pension system is slightly bigger than Nevada's — yet pays eight times more in fees. Despite paying far less to Wall Street investment managers, Nevada's pension system has had a better rate of return than Maryland's in nine of the past 10 years.

It doesn't get any clearer than that for Jeff Hooke, one of the harshest critics of Maryland's pension system. Hooke is a lecturer at the Johns Hopkins Carey Business School and a former investment banker who has worked on private equity deals.

Hooke was always skeptical of private equity, he said, but his skepticism has since turned into a "full-time hobby" that includes writing books on the subject. His thesis boils down to this: It's really hard to consistently beat the returns of the stock market, especially when investment managers tack on fees.

"I use my knowledge on a pro bono basis to publicize it," Hooke said. "All I get is rotten tomatoes thrown at me by the industry."

Hooke has made some headway. He has testified before state lawmakers, and in 2019 the General Assembly passed a law that makes Maryland one of just a few states where the pension system must disclose incentives paid to outside investment managers.

In 2021, those Wall Street investment managers made more than $370 million from the Maryland pension system through such profit-sharing agreements. While the pension system gets the lion's share of any profit, the managers also get a cut to incentivize their performance.

This legislative session, Del. Robin Grammer, a Republican from Baltimore County, introduced another bill championed by Hooke. The bill would have forced Maryland's pension system to blow up its current investment strategy and adopt a low-cost strategy like Nevada's. The bill died, and Grammer did not respond to a request for comment.

Palmer is glad the bill died. He knows that Nevada had a great run of returns recently, but said it's not just about the returns. It's also about controlling volatility, reducing risk and diversifying the portfolio.

If it were all about the rate of return, Palmer said, then look at the state of Washington. Washington's pension system invested even more aggressively in private equity and other high-cost investments — and also outperformed Maryland's pension system.

According to Palmer, the point is not that Nevada or Washington has the best investment strategy. The point is that Maryland has a strategy that matches the risk tolerance, diversification goals and investment targets of its pension board and beneficiaries.

"One of the things I've found in this business is that there's a thousand ways to do this and be successful," Palmer said. "What really matters is finding the way that works for the organization that you're engaged with."

Back to top

Crisfield PD calls new pension plan passed by lawmakers a 'Game Changer' for recruitment

By Rob Flaks
WMDT TV
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CRISFIELD, Md – Crisfield Police are celebrating a higher-scale pension plan which they say will help with recruitment and retention efforts.

The changeover is made possible by a bill recently passed in the Maryland general assembly, allowing Crisfield police officers to enroll in the Law Enforcement Officer Pension System, or LEOPS.

Chief Rick Taylor says this could even help attract talent from other departments, who would have had to forego their retirement to come to the department in the past.

Chief Taylor says it's not just about new talent, but also rewarding the efforts of those who have dedicated decades to the department.

"We have an officer that's been here with Crisfield for 24 years and under the current pension system if he were to retire today his pension would be 1,100 a month however under LEOPS his new pension would be over 3,000 a month, big difference," he said.

All current staff will be able to roll over onto the new system as well as new hires.

Chief Taylor says he expects to see better response times – and less turnover in the department thanks to the more generous pension program saying he is thankful to the Eastern Shore Delegation, and Crisfield Mayor Darlene Taylor for their work to give officers have a better way to plan for their futures

Back to top