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Opinion: Maryland is wasting its pensioners' money

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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.

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