

PENNSYLVANIA STATE EMPLOYEES' RETIREMENT SYSTEM

TESTIMONY TO THE

PUBLIC PENSION MANAGEMENT & ASSET INVESTMENT REVIEW COMMISSION

THURSDAY, OCTOBER 25, 2018

Thank you, Mr. Chairman, and members of the Commission for inviting the State Employees' Retirement System here to provide testimony today.

My name is Terri Sanchez, and I am the Executive Director of the State Employees' Retirement System. Joining me today to testify is Mr. Bryan Lewis, Chief Investment Officer for the State Employees' Retirement System. Bryan has been with SERS since 2016. I have been with SERS since May of this year, and I can't think of a better time to be with this organization. For SERS, it's a time of tremendous change on many fronts. Change, that as one who stands as a fiduciary to the 240,000 members of this system, I am proud to be a part of.

The State Employees' Retirement Board is in the process of enhancing board governance by adopting leading governance policies and practices that improve the effectiveness of the Board to better serve the needs of the

Retirement System's members and employers, with corresponding benefits for the taxpayers of Pennsylvania.

We also are implementing one of the most comprehensive pieces of pension legislation in the 95-year history of this organization – Act 5 of 2017 – and evaluating how we can capitalize on this opportunity to better serve all members. In addition, we have stepped up our efforts to pursue quality investments at reasonable costs.

We stand strongly behind our steadfast dedication to honesty and integrity, and we are working hard to further advance our strong commitment towards providing as much transparency as possible, without breaching our standard of care and fiduciary duties.

I hope you will come to realize that the goals of this commission and those of the State Employees' Retirement Board are more alike than different.

We are here today to respond to the Commission's request to receive the benefit of our perspective on specific workable actions that can be taken to reduce investment expenses and improve investment and investment-related

operations, and generate actuarial savings of \$1.5 billion over 30 years from the effective date of the legislation that created this Commission, Act 5 of 2017.

SERS has been committed to finding and implementing positive, practical approaches to strengthen the operational efficiencies and oversight processes of the system – with the ultimate goal of maximizing results for its members and paying promised benefits – benefits that were earned.

These are responsibilities we do not take lightly. Last year, the system paid approximately \$3.3 billion in benefits to its members. Of that, more than 90 percent, about \$3 billion, was paid to members who live right here in Pennsylvania.

These three-plus billion dollars represent actual lifelines – providing important means of support and even survival, not only for SERS members, but for the thousands of small businesses across Pennsylvania that rely on them as valued customers.

To put this in a long-term perspective, over the past 25 years, the SERS fund has earned over \$50 billion and paid \$48 billion in retirement benefits. The SERS Board and team of investment professionals made difficult investment decisions

in the best interest of its members through multiple market environments, cycles of suppressed employer contributions, unfunded benefit enhancements, legislative changes, and challenging political headwinds. In spite of these challenges, SERS returned 8.4% and outperformed a 60/40 index portfolio, net of fees, over the same time period.¹

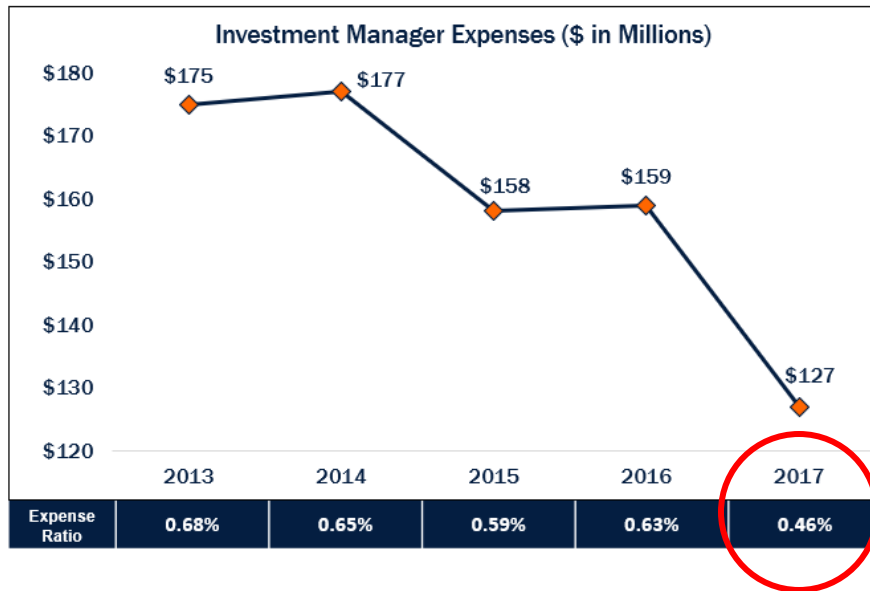
Returns as of Dec. 31, 2017, net of fees, annualized¹

	25-YRS
SERS' Total Fund	8.4%
60/40 Index	7.3%

In short, we take our responsibilities as legal and fiduciary protectors of our members' retirement funds very seriously. And I think that will become evident through our testimony.

The fact is, seeking relief from investment fees is a way of life at SERS. The system has been reducing investment manager expenses over the past several years, and in the past year has reduced annual investment manager expenses by \$32 million to 46 basis points (0.46%).

¹ Source: RVK, Inc. Performance is shown net of fees, annualized. The 60/40 Index consists of 60% MSCI ACWI (USD) (Net) and 40% Bloomberg Barclays US Aggregate TR Value Unhedged Index (USD). Prior to 12/31/1998, the 60/40 Index consisted of 60% MSCI World TR (Net) and 40% Bloomberg Barclays US Aggregate TR Value Unhedged Index (USD). The fee used for the 60/40 index is 6 basis points.



We are happy to have the opportunity to share our plans and perspectives, and even some of the accomplishments that have been realized since the beginning of 2016.

Before we get to those cost-saving items, however, I would like to take just a moment to assure the Commission, our members, and the public, that the State Employees' Retirement Board has an ongoing commitment to demonstrate transparency in its reporting of fees and investment expenses, while working within our legal and fiduciary framework.

Each year, SERS reports investment and investment-related expenses, including ongoing management fees and performance/incentive fees, to the

general public in two reports, our ***Supplemental Budget Book*** and our ***Comprehensive Annual Financial Report***.

Although SERS reports management fees and expenses paid to private partnerships, these amounts are typically returned to SERS later in the investment life cycle. These returned amounts, however, are not retroactively adjusted in SERS' fee reporting. So, if anything, these management fees and expenses are **overstated**.

In an effort to ensure that all management fees and expenses are calculated and audited in a consistent ongoing manner, SERS' Office of Finance and Administration (OFA) has created and implemented internal controls that comprise very detailed processes and methodologies.

It is a multi-step process designed to ensure that all relevant financial data reconciles and that management fees are calculated accurately and reported properly, so we don't pay more than the contractually negotiated amount.

Where the confusion comes in is with the term **"Profit Sharing" – (what the industry refers to as "Carried Interest")**. It is our opinion and the opinion of some

of the previous testifiers, as well as others in the industry, that carried interest is not a fee.

In exchange for providing the capital for an investment, SERS is entitled to the majority (typically 80%) of the partnership profits. The General partner then receives its share of the profits (typically 20% of profits, minus fees and expenses, as noted). These General partner profits are determined only after: 1) all prior management fees and expenses paid by SERS are returned to SERS; and 2) capital contributed by SERS also is returned to SERS.

While we understand that the General partner's 20% share of the profits of a successful investment could be a significant amount, this type of compensation structure works very well to align the interests of the General partner with those of SERS. When the General partner succeeds, SERS succeeds; typically, for every dollar of profit the General partner receives, SERS receives four dollars.

That being said, because SERS and others in the industry do not consider carried interest as a "fee," it isn't something that historically has been reported or tracked by SERS. It was never "hidden" and there is nothing shady going on here. It simply wasn't something that was reported or tracked – and there is a very big difference between one and the other.

We are working in the midst of a maturing industry where new standards are emerging, and SERS is open to these standards.

In fact, State Employees' Retirement Board Motion 2018-15, passed in April, specifically directed SERS' staff to request general partners of new investment opportunities in private markets to begin adopting and completing the Institutional Limited Partners Association (ILPA) fee disclosure template, effective immediately. Similar requests are being made of general partners of existing investments in private markets, effective January 1, 2019.

So, we are well underway in our efforts. Thank you for your indulgence in letting me “shine some light” on this important matter.

I will now turn the microphone over to Bryan to discuss our ideas for cost savings.

Bryan Lewis

Let me first say that SERS believes the established benchmark of \$1.5 billion in actuarial savings is an achievable goal. To arrive at this conclusion, we worked closely with our actuarial partners at Korn Ferry to perform projections as to what it would take to reach that \$1.5 billion mark.

Based upon the projected assets for each of the 30 years, we estimate that, if the fund were to reduce investment costs by 4.5 basis points, and sustain that reduction in each of those 30 years, it will be sufficient to create an estimated actuarial savings of \$1.5 billion, as of June 2047.

For the record, we were working diligently on ways to trim investment manager expenses even before Act 5 became law. Since the beginning of 2016, SERS implemented a number of measures to reduce costs:

- Transferred \$2.5 billion of active public stock strategies into low-cost index strategies. Nearly 80% of SERS' public stock portfolio is invested in index strategies.
- Negotiated lower fee structures with public stock and fixed income managers.
- Liquidated eight hedge fund strategies and transferred nearly \$900 million from these hedge fund strategies into low cost index strategies.
- Consolidated fixed income portfolios to take advantage of more favorable fee structures.

- Negotiated a private equity fund with a supplemental component (side car) that charges no fees, thereby reducing the management fee of that total investment.
- Invested in a private equity co-investment vehicle with no fees charged on committed capital, a 35% reduction on invested capital management fee, and a 50% reduction in the General partner's profit sharing.
- Reduced the number of private equity managers in which SERS has invested, while increasing the size of SERS' commitment amount – thereby hitting certain investment size thresholds to reduce management fees.
- Worked closely with PSERS, so that the two agencies invested in the same investment opportunity can benefit from reduced fees as a result of the combined investment size in the strategy.

Naturally we're proud of what we've accomplished thus far, but we're not finished yet. At the direction of SERS' board, we continue to work with our

consultants to pursue cost savings wherever feasible and beneficial to fund investment risk/return outcomes.

One key cost reduction tactic is to participate in no fee/no carry or reduced fee/reduced carry co-investments alongside General partners with whom SERS has made primary fund commitments. These co-investments help reduce the aggregate fee burden on dollars deployed with General partners. As noted, we already are working with several General partners who offer co-investments to SERS and have expressed further interest in completing co-investments.

Another key cost reduction SERS has begun implementing is negotiating management fee reductions with an eye to founder's and/or first close terms. Private Equity and Real Estate funds sometimes offer incentives to first (or early) closers by offering management fee discounts. Where possible, SERS can achieve these discounts by committing to General partners in a first close. The resulting management fee discounts can range from five to 25 basis points.

Another way we continue to reduce investment expenses related to management fees is through building strategic partnerships with managers that invest across various fund products. The formation of strategic partnerships typically involves large commitments to managers that are divided, at an agreed-

on ratio, among various strategies in which the manager actively invests. Such partnerships are often diversified across sub-strategies, geographies, and investment types, thereby creating diversification with the broader portfolio.

SERS is also researching internal asset management opportunities for public and private markets that are designed to reduce the amount of fees paid to external managers.

To ensure that SERS is implementing a best-in-class framework, we plan to contract with a consultant to assess SERS' existing systems and processes; identify operational risk, gaps in current infrastructure, and human resources requirements; and then present a viable solution that details the pros and cons of various options, systems, portfolio management, trading, middle and back office functions, and compliance and risk management. We also will ask the consultant to help evaluate costs to successfully implement internal asset management objectives.

Now I'll turn this back to Terri.

Terri Sanchez

Thank you, Bryan, and thank you to the Commission for asking us for our perspective on what the General Assembly can do to help us improve efficiencies and reduce costs.

The State Employees' Retirement Board and staff stand in direct fiduciary status to the fund. All of the requests that follow are absolutely consistent with the fiduciary duties and responsibilities of the Board and staff in administering the fund for the exclusive benefit of the members, and with the skill and care that a person familiar with such matters would exercise.

Specifically, we ask that:

- The board be given the decision-making authority for organization, position complement, and compensation for management employees in place of the Commonwealth's Executive Board.
 - Having maximum flexibility in the ability to increase our staffing complement will allow us to continue with the cost-saving improvements that are already underway. The addition of high quality, specialized staff in the investment and investment accounting areas will help us to improve our investment and financial operations and audit capabilities, and to reduce costs.

- Increasing our staffing complement will also enhance our ongoing effort to implement and grow our internal asset management capabilities. We've seen the promise that this effort holds – from our own experience, and in learning about the actions taken by some elite public pension funds.
- Having control over the ability to set compensation levels allows the board to attract high quality expertise.
- The board be given greater flexibility to more efficiently procure goods and services.
- The board be given the ability to determine its budget, without having the Office of the Budget approve, or alter the board's budget requests.

There is no entity better positioned to make the necessary fiduciary decisions regarding the investments and disbursement of any of the monies of the fund, than the board. In addition to the specific items listed above, I ask the General Assembly to remember that administrative limitations imposed upon the ability of the board to efficiently administer the fund and manage SERS operations, and substantive restrictions on how the board can invest the assets of the fund have consequences. Administrative burdens or substantive restrictions can, to a

greater or lesser degree, increase costs or reduce the ability of the board to achieve desired investment returns. This applies to both current statutory regimes or future statutory changes. The board must be given maximum administrative flexibility and investment authority in its ability to satisfy its fiduciary duties and obligations.

The items just stated are all important and achievable goals. But there is one more area that holds even greater promise and would go a long way toward demonstrating that Pennsylvania is serious about its commitment to public pension fund reform. This is by far our biggest “ask” if you will.

I would ask the Commission to consider the benefits to the fund, the members, and to the Commonwealth of consistently paying the actuarially required contributions to the fund year after year, as this administration and the General Assembly have done for what is now the third year in a row. An amount, that when combined with investment earnings, would be sufficient to pay promised benefits in full, in a cost-effective manner.

We have seen, first-hand, how persistent underfunding can jeopardize a plan’s sustainability, eating away at the asset base, forcing decisions to liquidate investments at the most inopportune times, and pushing a retirement board to

reach for returns that it otherwise may not need to. Returns that are often reached through expensive investment alternatives.

At a previous hearing we heard testimony from other systems who had more passive, less expensive investment strategies than SERS. It is important to note that these systems acknowledged that had they not been in the healthy financial position that they were, their investment approach would **not** be possible.

After years of suppressed contribution rates, SERS is not in that position. And, given our position, alternative types of investments are critical to meeting the assumed rate of return so that we can continue to pay promised benefits in perpetuity. None of us want to take unnecessary risk. And, quite frankly, as fiduciaries, we cannot and should not take unnecessary risk.

But perhaps this commission can help position us so that we can, in good conscience, move towards an asset allocation where we not only look to get the best return for the risk we take, but where we also take less risk overall, and pay promised benefits cost-effectively.

So how might you do that? One way would be to recommend consideration of an amendment to the constitution that requires the legislature to incorporate into the State Employees' Retirement Code, a dedicated funding source and a contribution payment amount that is based on sound actuarial methods and assumptions consistent with generally accepted actuarial standards of practice. Ensuring funding at an amount that cannot be impaired by the changing priorities of elected officials, insulating it from the unpredictability of the appropriations process, and preventing the manipulation of amortization methods and other funding deferral mechanisms that have cost the system approximately \$8 billion through 2017. Those assets could have offset the unfunded liability and provided more investment flexibility to the Retirement Board – flexibility that may well have included an asset allocation with more lower cost investments.

What has been suggested here is a heavy lift, no doubt, but it is a lift that several states have already made; some in reaction to situations much more dire than ours. But Pennsylvania has an opportunity to be *proactive* and attempt to implement elements of the Government Finance Officers Association (*GFOA*) funding policy best practices and of the Conference of Consulting Actuaries

funding policies and practices guidance now. Preserving the good that this administration and General Assembly have accomplished and ensuring that future administrations and General Assemblies do the same.

Thank you for your time and attention to this critical issue. We are happy to take your questions.