

House Committee on Financial Services

Nov 19, 2019 Hearing: America for Sale? An Examination of the Practices of Private Equity
Written Testimony from Wayne Moore, Trustee, Los Angeles County Employee Retirement Association

Protecting public pension plan assets requires open and transparent relationships between all fiduciaries responsible for managing and investing these assets. Provisions of HR 3848 the Stop Wall Street Looting Act (SWLA) are designed to promote full disclosure of fees and returns from private equity funds to all intents and purposes to control and reduce the costs of investing for private equity fund investors. While percentage fees are relatively small, the billions of dollars transferred from pension fund assets to the financial services industry every year has a consequential impact on the long term health of pension funds and the benefits plan participants expect to receive. Strategies to reduce the cost of investing, especially in the high cost asset classes such as private equity is a top priority for trustees, pension plan administrators and investment managers.

I was appointed a public pension fund trustee ten years ago. Over time and after doing my own research and analysis, I have come to believe the interests of the financial services industry and the interests of our public pension plans are not properly aligned. I am especially apprehensive about the asset based management fee construct and its lack of correlation with the services provided and the level of performance achieved in asset management. Given the significant amounts of money at stake, better industrywide information from private equity firms on fees, expenses and returns is needed to ensure the proper alignment of interests is realized.

The Fees as a Percent of Assets Management Construct

According to passive investing guru Charles D. Ellis, in a 2012 Financial Analysis Journal editorial, during the post WWII era most major banks managed pension fund assets as a customer accommodation for little, ¼ percent of assets under management, or no money at all. In a highly regulated financial system with fixed rate brokerage commissions, the banks exchanged commissions from brokers for agreed upon cash balances from pension funds. The brokers got “reciprocal” commission business, the banks got “free” balances they could lend at prevailing rates and pension funds got rebated back commissions and fees. Then in the late 1960’s someone at Morgan Bank recognized that charging a very small asset based fee with no rebate could become a growing profit center, much like current bank overdraft charges. Thus began a steady 50 year rise in investment management fees accruing to the financial services industry. In 1974, there was \$218 billion in public and private pension plans. Today, we have \$7.7 trillion and an industry with a mature business model built around a fee construct that was never explicitly correlated to services or performance. Mr. Ellis opined in the same 2012 editorial, that even as fees calculated as a percent of assets are relatively small, investors already own the assets that are the basis of the fee calculations, thus investment manager fees should really be based solely on incremental returns above the market index. Stated more accurately, investment manager fees as currently calculated are remarkable high. In addition to these high management fees, invisible costs such as trading and transaction costs; legal fees, custodial, administration costs and regulatory expenses all combine to shave significant sums off the top of pension

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fund assets. Activists and academics in the UK and the US have done extensive research and analysis on these costs and it would be fair to say that the invisible costs rival investment management costs in impact on pension fund assets.

The Macro View

As a trustee, I have taken a macro look at fees from a public plan perspective. According to the Investment Company Institute, at the end of the Q2 2019, state and local government pension plans held \$4.5 trillion in assets. Historically there's been a lack of full disclosure of the actual fees and expenses charged by investment managers across all asset classes and especially the high cost asset classes such as private equity. Typically, pension funds only report fees and expenses paid and recorded in their general ledgers based on an invoice. Consequently, and particularly in private equity and other alternative asset classes, fees and expenses that are netted out of distributions are not accounted for nor is "carried interest" received by investment firm partners recorded in general ledgers. Private equity firms characterize carried interest as profit sharing. These firms typically invest 2% or less of their own cash into the funding vehicles they manage but reap 20% of the profits while the other 80% is shared amongst the limited partners in the fund. My analysis includes carried interest as a performance fee because firms get a material return from a non-material investment. These and other factors make it difficult to estimate what the overall pension fund portfolio fees and expenses are. However, based on published data from financial reports and detailed independent analysis done by researchers and some local government pension funds, a conservative assumption would be that at least 1% of pension fund assets are being transferred to the financial services industry every year. Although 1% is a small percentage, \$45 billion (1% of the \$4.5 trillion in assets) is no small sum of money coming from public pension plans. Over the past 30 years at 1% of assets under management, approximately \$781 billion in nominal dollars has transferred from state and local government pension plans to the financial services industry in fees and expenses.

What This Means for Plan Participants and Sponsors

Consider the impact of just \$1 million dollars in savings from the cost of investing. In 2018 at the Los Angeles County Employees Retirement Association, the 3,787 general members who retired received an average annual pension benefit of \$45,448. \$1 million in savings invested at 6.25% would fund two average LA county retiree pensions for 20 years, including an annual 2.5% COLA.

Over the long term, reducing the costs of investment also increases net investment returns thus contributing to closing the gap between low return expectations and the required actuarial return objectives of our funds while marginally reducing overall portfolio investment risk taking. Further, the long term impact on total fund assets of reduced investment costs increases fund balances thus decreasing the unfunded

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actuarial accrued pension liabilities (UAAL) and the annual cost of fully amortizing these liabilities.

I recently reviewed a local government pension plan with \$33.9 billion in assets and a UAAL of \$7.1 billion. This government's annual budget to amortize that liability was \$658 million. These annual amortization costs are funded from the City's general fund which also funds local government services such as safety, sanitation and street maintenance services. Working with an outside consultant, we estimated and sensitivity tested the impact of their costs of investment management at 6 bps (10%) less than currently reported. The results were that over a 10 year period, this government could potentially increase total fund assets by \$413 to \$497 million, reduce unfunded liabilities by \$253 to \$300 million and reduce annual amortization costs by \$20 to \$25 million. Implementing investment manager cost savings strategies would require a deliberate and intentional contract negotiating strategies, operations and administration changes and comprehensive reviews of compensation structures and rationales. None of this would be possible however without full disclosure of fees, expenses, returns and performance measures.

Targeting more efficient resource management by lowering the cost of investing without sacrificing performance should be a major initiative for our pension plans. Full disclosure of fees and expenses however, is one component of transparency of public pension funds need to ensure the efficient, effective and efficacious use of its assets. In addition, pension fund managers and staff would be much better equipped to make investment recommendations to their Boards of they had more operational information from private equity firms.

What is Ahead for Us?

Over the next decade institutional investors face a low investment return environment. Horizon Actuarial Services, LLC surveyed 34 investment advisors whose capital market assumptions are included in their 2019 Survey of Capital Market Assumptions. The 10-year median annualized returns assumption for large cap equities was 6.03% and for small and mid-cap equities 6.55%. Private equity market assumptions were 8.97% in the survey. While these assumptions are not predictive, they still drive investors to accept higher risks and therefore increased costs in search of higher investment returns to meet their return objectives. Private equity firms are raising ever larger funds in the multi-billion dollar range and are holding assets for longer periods of time. These longer holding periods drive the necessity for greater transparency with pension fund managers and staff as they decide which companies and strategies they will recommend making these longer term commitments to. There will also be a need for more detailed and more frequent financial statement information from firms and the portfolio companies they are targeting and acquire. If the longer term relationships between private equity firms and investors is to be more successful, the private equity industry must be more willing to partner with and share information with their investors and partners.

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In a 2017 Preqin assessment of the top 100 private equity limited partners worldwide, 31 US public pension funds allocated \$292 billion or 36% of worldwide private equity allocations. Further, all pension funds - public, private, foreign, domestic – allocated \$441 billion or 56% of worldwide private equity allocations. In other words most of the money allocated for private equity investments worldwide came from workers' retirement funds. Pension funds have long term investment horizons. The short term gains on investments generated by the financial engineering of some private equity firm strategies put at risk the future value and sustainability of many companies. Some private equity transactions end up putting at risk the jobs, local tax bases and investment portfolios of the workers whose money fuels their activities. Many of these companies become public and end up in passive indexed public equities portfolios of pension funds. Consequently, these financial risks should be considered when investment decisions are being made. This is where transparency comes into play.

First, limited partners, especially pension funds, have an interest beyond short term returns in private equity investment decision making, however, limited partners have a severely restricted role in that process. The California Public Employee Retirement System has proposed a new private equity business model that emphasizes more collaborative and strategic relationships with private equity firms. These relationships focus on cost efficiency and long term sustainable growth. More operational transparency must also be included in these new relationships. For example, full details on costs and expenses, periodic meetings with investment officers and detailed investment pipeline information would be critical components of the model. Given the significant role pension plans play in financing private equity activities, these are changes that must be addressed either voluntarily or through a more tightly prescribed regulatory regime.

Secondly, the Employee Retirement Income Security Act of 1974 (ERISA) protects pension plan assets by requiring fiduciaries to operate and administer plans solely in the interest of participants and beneficiaries and for the exclusive purpose of providing benefits and paying plan expenses. Fiduciaries have operationalized this responsibility over the past 45 years by making annual returns on investments – profits – the primary and almost exclusive objective of plans. Even after pension plans own assets were used to earn short term profits restructuring US manufacturing and helping to undermine long term economic growth for US workers, no rethinking of the primacy of profit has taken place. While the law does not necessarily need to change, how we protect the interests of our plan participants and beneficiaries is only partly driven by this year's profit and lost statements.

Conclusion

H.R. 3848, the Stop Wall Street Looting Act includes important provisions that will help protect the money that millions of workers have saved through deferred wages and payroll deductions to have a safe and secure retirement. Section 501 addresses full disclosure of fees, expenses and returns to ensure efficient and effective utilization is pension fund assets. Section 502 ensures that pension plan fiduciaries cannot waive or

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transfer their responsibilities. Section 503 requires more transparency from private equity firms about their past performance and how they managed their portfolio companies. All of these disclosures will help investors in private equity funds make sounder and more informed decisions when entrusting the future well-being of pension plan participants into the hands of the private equity industry. Congress plays a pivotal role through the legislative process ensuring the long term sustainability of public pension funds. I am certain that the public pension funds in your jurisdictions will be more than willing to provide you with facts about their systems that you will need to inform your decisions.