Pennsylvania's Wolf Targets Wall Street Fees in Tackling Pension.

(Bloomberg) — To ease Pennsylvania's pension obligation, Governor Tom Wolf isn't targeting public workers, the focus in neighboring New Jersey and around the country. He's eyeing payments to Wall Street.

The first-term Democrat is calling for Pennsylvania's two pension systems to reduce investment-manager fees that are higher than the average U.S. public plan. He's also counting on Wall Street banks to market bonds the state would use to bolster one of the funds.

As retirement costs consume a growing share of municipal budgets, pension boards are scrutinizing payments to money managers. California Public Employees' Retirement System plans to liquidate its hedge-fund program, while Pennsylvania's Montgomery County moved most of its holdings to cheaper, passively managed funds, which track indexes. Wolf wants to adopt lower-cost approaches that may save $200 million annually.

"We're not talking about suddenly overnight going to a 100 percent passive investment strategy," said Randy Albright, Wolf's budget secretary. "We're talking about strategically re-evaluating the mix and trying to look at ways that they can reduce risk and reduce fees."

Taxpayer Dollars

Pennsylvania ranked second-to-last after New Jersey among states by the percentage of the required pension contribution that it made from 2001 to 2013, according to a March report from the National Association of State Retirement Administrators. Ratings companies cite the pension burden in giving Pennsylvania a grade two steps below the average for U.S. states. Standard & Poor's and Fitch Ratings cut their marks in September to AA-, fourth-highest. Moody's Investors Service lowered it to an equivalent Aa3 in July.

In his first budget address this month, Wolf said Pennsylvania "has been wasting hundreds of millions of taxpayer dollars on Wall Street managers."

Across the country, pension funds are examining their relationships with investment firms, said Greg Mennis, director of the states' public-sector retirement systems project at the Pew Charitable Trusts. They're reconsidering their strategies after expanding higher-cost alternative investments, such as hedge funds, he said.

County Shift

California's retirement system, the biggest state pension fund, said this month it expects to pay 8 percent less for money managers as it drops hedge funds. In Montgomery County northwest of Philadelphia, shifting most assets to Valley Forge-based Vanguard Group Inc. cut expenses by more than two-thirds, Josh Shapiro, county board of commissioners chairman, wrote in the Philadelphia Inquirer this month.

Pennsylvania administers two plans covering about 700,000 people. The funds had 62 percent of assets needed to cover promised benefits in 2013, down from 75 percent in 2010, for a combined unfunded liability of about $53 billion.

The largest system, the Public School Employees' Retirement System, paid 1.14 percent of assets in fees in 2013, compared with the 0.42 percent average for U.S. public plans, according to the Center for Retirement Research at Boston College. The Pennsylvania State Employees' Retirement System also exceeded the average, paying 0.66 percent.

Fee Sideshow

Officials are asking the retirement boards to lower fees to about 0.6 percent, said Albright, the budget secretary.

The call to reduce payments represents a "distraction" and a "sideshow" that won't reverse years of underfunding and the costs of a system that guarantees worker payments, said Paul Mansour, head of municipal research at Conning.

"You really need to attack the benefit levels either for existing employees, or certainly for new ones," said Mansour, whose Hartford, Connecticut-based company oversees $11 billion in munis. "Otherwise, it's going to be a continued problem."

Public pension officials can't just look at savings — they have a responsibility to do what's best for their funds and beneficiaries, said Keith Brainard, research director for the state retirement administrators' group.

"You're not investing the money to save money," he said from Georgetown, Texas. "You're investing the money in order to generate investment earnings within an acceptable level of risk."

Liability Focus

Albright said he's confident the funds would achieve the same return target. Yet Evelyn Williams, a spokeswoman for the school workers' pension, said a strategy involving lower fees would probably produce a lower assumed rate of return.

"The unfunded liability is too large for any significant impact, even if there were no management fees at all," she said in an e-mail.

Williams and Pamela Hile, a spokeswoman for the state workers' system, said the management fees resulted from investment strategies that propelled their funds to earnings above indexes while meeting risk standards.

Over the past 15 years, the school workers' fund paid managers $4.96 billion and generated a net $11.5 billion in returns above indexes, Williams said. The fund for state employees earned $19.7 billion net of fees while paying $2.4 billion in fees in the past decade, Hile said.

Savings Quest

The state workers' system "constantly looks for cost savings and aggressively negotiates fees, and that focus has reduced total investment costs by $70 million over the past five years," Hile said in an e-mail.

Wolf, a 66-year-old former businessman, also wants to sell $3 billion of pension bonds and direct the proceeds into the school workers' fund, which has the greater unfunded liability at $35 billion. The move would pay off if the pension's investment earnings are greater than the borrowing costs on the debt, underscoring the significance of any changes in the system's asset managers.

Pennsylvania's projected contributions to the systems rise to a combined $6 billion annually in 2035, from about $3 billion next fiscal year.

Unlike Illinois, which is fighting a court battle to cut worker benefits, and New Jersey, where Governor Chris Christie wants teachers to freeze current pension benefits, in Pennsylvania, Wolf isn't seeking givebacks from employees.

Pennsylvania's task is to make up for years of underfunding rather than trim benefits, Albright said. Legislation enacted in 2010 already raised retirement ages and cut costs, he said.

"We already have restructured our current employee benefit plan to a relatively inexpensive one," he said.

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