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The Transparency That Public Pensions Need.

Pension investments are increasingly complex, but disclosure standards have not kept pace.

The stock market's recent volatility is a continuation of the bumpy ride investors have experienced since the Great Recession. Such swings used to have little direct effect on public pension plans, but that has changed.

That's because over the past four decades public pensions, in hopes of boosting investment returns, have shifted funds away from fixed-income investments such as government and high-quality corporate bonds. Today they hold, on average, about half of their assets in stocks and another quarter in alternative investments such as private equity, real estate and hedge funds. Between 2006 and 2013, the percentage of their funds invested in alternative assets more than doubled.

Not surprisingly, the collective returns of public fund investments over the last few years have been volatile, ranging from a high of 21 percent in fiscal year 2011 to a low of 1 percent in fiscal 2013. Returns for calendar 2015 are expected to be essentially flat.

Rules governing disclosure and transparency haven't kept pace with these trends. While some individual funds and states have made changes, more work must be done to increase transparency and present a clear picture of funds' bottom-line performance and costs.

Alternative investments can be complex. Most, including private equity and real estate, can be challenging to accurately value because there is no public exchange. They also often come with higher management costs. The total cost of managing pension assets has increased by more than 30 percent over the past decade, reducing returns on alternatives by as much as 10 to 20 percent for some plans.

Current disclosure standards were designed for much simpler investments and do not provide enough transparency for these complex and costly alternatives. Beneficiaries, taxpayers and policymakers need better information about the investment performance of public pension plans because investment returns account for an estimated 60 percent of the money paid out in the form of pension benefits.

Insufficient transparency affects the ability to discern how much is being paid in fees and the resulting impact on investment returns. Current accounting standards allow public pension plans to report investment returns without deducting the cost of fees paid to investment managers, known as "gross of fees." More than a quarter of the largest plans take this route. Some additional costs, such as carried interest and some performance fees, also can go unreported.

There are some exceptions. One of the few plans to comprehensively report performance fees is the Missouri State Employees' Retirement System. In 2014, the plan reported that performance fees paid to investment managers accounted for about half of its overall fees.

And last July the nation's largest public retirement plan, the California Public Employees' Retirement

System (CalPERS), raised the bar on investment-fee transparency by announcing that it would disclose the full amount it pays to invest in private equity. In November, CalPERS' new policy of providing additional reporting on carried interest for private equity and other performance fees showed that external investment partners realized $700 million from profit-sharing agreements in fiscal 2015 — information the public would not have had without the new reporting policy.

Movement toward stronger reporting and greater transparency on the costs associated with alternative investments appears to be gaining momentum. The Institutional Limited Partners Association's Fee Transparency Initiative, a widely supported industry effort to establish comprehensive standards for fee and expense reporting among institutional investors and fund managers, is advocating total fee reporting by private equity managers and their investors. And in a recent letter to the Securities and Exchange Commission, 13 state and municipal treasurers and comptrollers — many of them members of the Fee Transparency Initiative — appealed for industrywide standards on private equity fee disclosure, including carried interest.

There's no one-size-fits-all approach to successful investing, but there is a uniform need for full disclosure on investment performance and fees. This will help ensure that risks, returns and costs are balanced in ways that follow best practices and that public pension plans accurately disclose the fees that are paid.

State pension plans are entrusted with $3 trillion in public funds and face the challenge of a $1 trillion gap in the amount needed to pay for pension promises. With the dramatic shift toward more complex alternative investments, government workers and taxpayers deserve more complete information on both the cost of managing pension investments and the bottom-line results of these riskier investment strategies.

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BY SUSAN K. URAHN | FEBRUARY 16, 2016