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The Hidden Wall Street Fees That Could Be Costing Pensions $20 Billion a Year.

A new report says the fees pension plans pay private equity and hedge fund managers aren't worth it.

The fees public pension plans pay Wall Street money managers — some of which go unreported — have come under increasing scrutiny in recent years. It's estimated that disclosed and undisclosed fees cost public plans upwards of $20 billion annually, according to the author of a new study.

That's a big dollar amount when you consider that public pension plans' collective unfunded liability is a little over $1 trillion. So far, just a few state plans have been trying to get a handle on these fees. One of them, the California Public Employees Retirement System (CalPERS), reported late last year that it paid $3.4 billion in undisclosed fees over the past 25 years on $24 billion in total investment earnings. CalPERS is the nation's largest retirement system.

Jeff Hooke, a consultant for the right-leaning Maryland Public Policy Institute, estimates in the study that Maryland's public employees' plan paid $500 million in 2014 — twice as much as it reported for that year. Hooke said that if other states' hidden fees are similarly underreported, the total fees pensions actually pay could be as much as $20 billion annually. "And that's just for states — forget about all the counties and cities," he said, "which could easily add another 25 percent to that."

At issue are so-called performance fees, which private equity and hedge fund managers charge plans for any profits they generate. Pension plans generally disclose management fees but have avoided reporting performance payouts because they weren't required to under accounting rules and because they're hard to calculate.

Now states are looking to bring these fees under control. Kentucky took a step in that direction last year when it revised its reporting policy to include more transparency on private equity fees. In 2015, the first year of the policy, the Kentucky Retirement System estimated it spent $108.3 million in fees — a 75 percent increase over the amount reported in 2014.

Similarly, New Jersey and South Carolina also revamped their fee reporting. Since 2007, fees in South Carolina have gone from $39 million to $468 million, an increase the system attributes to better reporting. New Jersey's pension system recently announced it paid outside fund managers $328.4 million in performance bonuses last fiscal year, on top of nearly $400 million in management fees.

Rooting out the true cost of private equity and hedge funds isn't just about transparency. It's also about making sure the high costs are worth the investment. Hooke argues that, at least in Maryland's case, it isn't. According to data from Boston College's Center for Retirement Research, the Maryland public employees' plan has underperformed its peers over the past 10 years on its average annual rate of return. State officials, which have butted heads with the policy institute before, defend the fund's private equity investments, arguing it has earned double-digit returns over the past decade, well above the fund's total target rate of return.

In South Carolina, Treasurer Curtis Loftis has loudly criticized his state's pension system's high fees for similarly meager investment performance compared to other plans. In a report last year to the state legislature, Loftis estimated the pension system would have saved $7 billion in costs over 10 years if it had instead used that money to invest in index funds — low-fee portfolios that replicate the movements of a specific financial market.

One pension fund is actually testing this performance theory. In 2013, the $509-million Montgomery County Employees Retirement Plan in Pennsylvania shifted most of its investments to index funds. The county Board of Commissioners estimated at the time that the move could save up to $1.3 million in annual management fees while potentially improving performance. In 2014, the county fund reported a total 7.7 percent on its investments while paying less than 0.9 percent of its investment income in fees. By comparison, the state public employees' pension fund earned 6.4 percent on its investments and paid out 11.4 percent of its total investment earnings to money managers.

In Maryland, the policy institute estimates the state employees fund has spent a similar percentage of its investments on fees over the past five years. The institute's president, Christopher Summers, said he hopes his group's report will encourage better data in Maryland and elsewhere so that lower-cost investments like index funds might be considered as an alternative.

"There's still a learning curve on this for public and elected officials," he said, "so we're trying to get as many educated as we can."

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