Bond Case Briefs

Municipal Finance Law Since 1971

Pensions Are Shelling Out Billions in Fees -- and It's Not Paying Off

SPEED READ:

- According to a new report by the Pew Charitable Trusts, pension plans spend at least $2 billion a year on investment fees.
- Over the past decade, pension plans have devoted more of their assets to alternative investments, such as hedge and private equity funds.
- The shift means that pensions are more vulnerable to stock market swings and are paying far more in fees than ever.
- The report recommends pension plans to change their reporting requirements.

Public pension plans spend at least $2 billion a year on investment fees to high-priced Wall Street firms to boost their returns. But, according to a new report, it doesn't appear to be paying off.

The report, released Wednesday by the Pew Charitable Trusts, attributes the steep bill to the fact that more and more pension funds are putting money in alternative investments, such as hedge and private equity funds. Over the past decade, the average plan has gone from devoting about 11 percent of its assets to those types of investments to 26 percent.

The uptick is part of a larger trend over the past 30 years of pensions reducing their reliance on stable, fixed income investments like bonds in favor of more volatile — but potentially more lucrative –investments like stocks and alternatives. Since 1986, the latter two have gone from representing roughly 38 percent of pension portfolios to 75 percent in 2016.

The shift means that pensions are more vulnerable to the swings of the stock market and are also paying far more in fees than they ever were before. Pew's Director of Public Sector Retirement Systems Greg Mennis estimates that, in addition to the $2 billion in fees pension plans do report, Wall Street fund managers are pocketing an additional $3 billion to $4 billion in fees each year. That's because the majority of funds don't disclose so-called performance fees, which allow investment fund managers to get a cut of the investment earnings if their returns hit a certain target.

Meanwhile, pension plan performance has waned over the past decade. Among the 44 funds that the Pew report studied, the average rate of return during that period was 5.5 percent, and no plan's average investment return met its target of 7.5 percent. (In general, plans tracked closer to their investment return goals when the years around the 2008 financial crisis are excluded.)

Among the plans studied, Mennis says that the ones that had more experience investing in alternative assets tended to do better. For example, South Dakota's pension, which has for more than a decade been investing up to 20 percent of its portfolio in alternatives, averaged a 6.8 annual rate of return. But Indiana's public employees fund, which has ramped up its alternative investments rapidly over the past five years to account for roughly 40 percent of its assets, averaged 3.8 percent over the 10-year period.

Pension plans' reporting requirements "haven't kept pace with the risk" they've opened themselves up to, according to Pew. To rectify that, it recommends that all plans disclose their net return after fees and include costs like performance fees. The report also suggests pensions implement stress-test reporting, which throws different economic loss scenarios at pension plans to see how each could affect a plan's fiscal health and funded status.

The report notes that many plans are lowering their assumed rate of return to prepare for a future with lower annual earnings. Over just a two year period, 33 states have done so. Still, Pew estimates that most plans should prepare for an average annual investment return of somewhere near 6.5 percent. Some — Kentucky and South Dakota — are at or below that mark, but most still have higher expectations.

GOVERNING.COM

BY LIZ FARMER | SEPTEMBER 26, 2018

Copyright © 2026 Bond Case Briefs | bondcasebriefs.com