



















In 1992 then State Auditor Mark Dayton, concerned about the lack of transparency and oversight in pension fund management and performance, launched an effort to have Minnesota adopt value added performance auditing. A consultant<sup>60</sup> was hired to conduct a value added analysis for the three first class city teachers funds for the 1982-1992 time period.

According to a report by the St. Paul Pioneer Press, the study concluded “the investments of the Minneapolis, St. Paul, and Duluth teacher’s pension funds didn’t perform as well as the securities markets in which they were invested from 1982-1992 costing those funds millions of dollars in potential income.”<sup>61</sup>

Based on the initial 1994 report, State Auditor Dayton argued for a bill to broaden disclosure requirements for all pension funds based on value added performance reporting. The controversial bill was enacted in 1994 that strengthened the oversight rules to hold pension boards accountable for both their investment policies and their selection of fund managers to carry out these policies.

In July, 1995 the State Auditor issued its initial report on pension fund management under the 1994 law. For this report, funds with assets exceeding \$300,000 were required to submit investment data. In all, 135 pension funds were required to report, and the results were disappointing. Of the 135 associations reporting, only 12 had investment policies in place prior to 1989. Four had policies in place but lacked specific asset allocations making comparisons to indices impossible. Forty-eight relief associations had policies in place but did not know when they were in effect—again making comparisons to indices impossible. Other relief associations submitted data, but an alleged problem with computer software made assessment of their investment performance impossible. At least one relief association did not submit any data at all, while remaining funds were granted a waiver from submitting data.<sup>62</sup>

Midway through 1994, substantial progress had been made to institutionalize value added reporting requirements through the Office of the State Auditor. State Auditor Dayton declined to run for reelection in 1994, and he was replaced in January of 1995 by Judith Dutcher. A contract dispute later arose between the consultant and the Office of the State Auditor and with approximately 75% of the work completed on the value added reporting system, State Auditor Dutcher cancelled the project.

### **Resistance to Value Added Performance Auditing**

There is considerable resistance to value added auditing among fund administrators. The aborted implementation of value added performance auditing in 1995 offers insights into reasons behind the resistance to implementing such a system:

***Loss of local control***—The nearly 700 hundred local firefighter pension funds and the handful of locally-administered police and fire pension funds in the state have been resistant to consolidating into larger centrally-managed plans. Such consolidation would

---

<sup>60</sup> By way of disclosure, the consultant referenced above was Asset Allocation, Incorporated, the same consultant hired by MCPFR to provide technical assistance with this report.

<sup>61</sup> *Pension Funds Are Criticized; Public Plans Miss Chances to Achieve Higher Returns*, by Dave Beal, *St. Paul Pioneer Press*, March 13, 1994.

<sup>62</sup> *Public Pensions in Minnesota: Issues of Taxpayer Accountability*, Minnesota Taxpayers Association, February, 1997, p. 24.

## Improving Accountability in Public Pension Asset Management

---

likely appear prudent as more complete return-on-investment information is made available. When a 1994 proposal related to greater investment of firefighter relief association assets in the SBI-operated Minnesota Supplemental Investment Fund was being debated, Representative Phyllis Kahn, a supporter of the bill, noted that she received hundreds of letters from volunteer firefighters from across the state. Commenting on local reaction she stated, “you would think the dome went off the Capitol.”<sup>63</sup>

Much of this reaction is understandable since local pension management decisions have never been fully exposed to taxpayer and beneficiary scrutiny. Ironically, local firefighters and police officers have a vested interest in seeing this type of analysis implemented to ensure that their retirement funds are well-managed.

**Cost of data management and administration**—In 1994, the executive director of the State Board of Investment projected that value added performance auditing could cost from \$200,000 to \$300,000 in administrative expenses. State Auditor Dayton considered that figure “wildly exaggerated” and said “I don’t see this as expensive at all.”<sup>64</sup>

In the course of preparing this report, both the MTRFA and the SBI (also approached for data) emphasized significant administrative time and cost challenges of gathering the data needed to perform this analysis. However, the statutory reporting requirements already require the reporting of most of the necessary data to the State Auditor already, including the most challenging element, each fund’s benchmark rates of return. Necessary data requirements for value added performance auditing should already be in place:

- An investment policy (currently required)
- Fund values (already reported monthly)
- Net cash flow data— required but usually missing from reports now. It consists of deposits into and disbursement from the fund. This is uncomplicated and straightforward information for any fund to maintain.

Cost concerns should be honestly addressed, but the overall benefits of the additional disclosures from value added performance auditing should easily outweigh cost considerations. This type of performance auditing provides more complete pension fund financial information by tracking and evaluating the decision-making process as well as the overall returns on investment.

**Passive versus active investment management**—Some fund managers are concerned that value added analysis would force pension fund administrators into passive, index-based investments instead of active management that is believed to generate better returns. The value added auditing system is “investment neutral”, however, in that it is simply designed to report the results of investment decisions, positive or negative, active or passive.

A highly visible and accountable pension reporting system may indirectly drive managers into more passive investment practices simply because citizens will become more aware of failed attempts to beat the market and the costs associated with those attempts.

“The value added auditing system is ‘investment neutral’, however, in that it is simply designed to report the results of investment decisions, positive or negative, active or passive.”

<sup>63</sup> *Pension Funds Are Criticized; Public Plans Miss Chances to Achieve Higher Returns*, by Dave Beal, St. Paul Pioneer Press, March 13, 1994.

<sup>64</sup> *ibid.*

Estimates are that only about a third of professional money managers typically beat the market in any given year, and that ratio declines as managers are compared to indices over longer periods of time. According to Morningstar, over the ten years ending in December 2005, only 7.6 percent of all actively managed domestic stock funds were able to outperform the S&P 500.<sup>65</sup>

These tough odds are implicitly acknowledged and reflected in the compensation system for pension fund money managers. Investment managers hired by pension funds are paid on a percentage of assets managed, not on performance. A properly designed system of compensation based upon value added by money managers would increase the potential earnings of those managers if they are able to add value to the investment portfolios.

When active attempts to beat the market chronically fail, taxpayers and pension beneficiaries still pay for under-performance. Value added performance auditing brings this to light. As Mark Dayton commented in 1994, “any good money manager is willing to be evaluated.”<sup>66</sup>

It is essential that investment authorities’ policies and strategies be more comprehensively evaluated before any efforts are made to improve fund health via larger employee or taxpayer contributions. Value added performance auditing provides the mechanism to do this. If the changes in the reporting requirements discussed in this section are made, taxpayers will have an excellent means to assess how effective investment authorities are in managing funds under their control.

History suggests it may be necessary to transfer this auditing responsibility to a state agency less subject to political pressures that come to those who are elected officials. As quarterly information is processed by an appropriate and independent state agency, pension boards’ investment policies and strategies will then become more visible to their plans’ retirees and active employees, as well as to legislators and taxpayers. At the same time, investment authorities will maintain the freedom to invest as they see fit.

*“History suggests it may be necessary to transfer this auditing responsibility to a state agency less subject to political pressures that come to those who are elected officials.”*

### **Beating the Market in the Future—The Growth of Alternative Investments**

The previous discussion focused on performance evaluation relative to fund benchmarks. An underlying issue involves determining what specific investments are appropriate for the investment policy. Investments are tailored to the particular needs of each fund based on investment objectives and risk tolerance.

State law prescribes what types of investments Minnesota’s public pension funds may invest in. There is some variation in allowable investments between SBI-managed funds and other funds, but the general universe of pension investments consists of the following<sup>67</sup>:

- Government obligations—which includes bonds, notes, and other debt instruments. Obligations must be ranked in the top four quality rating categories of rating agencies and include the obligations of other states and municipalities as well as that of Canada and other United States sponsored international organizations such as the Asian development bank.

---

<sup>65</sup> “Value investing: a thing of the past -- or future?” Barbara Whelehan, Bankrate.com

<sup>66</sup> March 13, 1994 St. Paul Pioneer Press article previously cited.

<sup>67</sup> M.S. 346A.06

## Improving Accountability in Public Pension Asset Management

---

- Corporate obligations—which includes bonds, notes, and debentures of a corporation organized in the U.S. or Canada
- Other obligations such as commercial paper, certificates of deposit, asset backed securities, subject to various rating and insurance requirements
- Corporate stocks—which include U.S. foreign and emerging market equities subject to size of ownership restriction
- Mutual and index funds
- Real estate investment trusts
- Exchange traded funds

In order to meet growing obligations, pension funds have tolerated greater risk over time. Asset allocation strategies in public pension funds have changed dramatically over the past 25 years. In 1980, state and local pension funds placed just 22% of their assets in equities, while 70% of the fund portfolio was dedicated to bonds. Today more weight is placed on stocks.<sup>68</sup> Minnesota's large public pension plans invest around 60% of their assets in the equity markets. Although the transition is motivated by the record of historically higher returns that stocks provide, it is also somewhat "forced" due to growth in public pension benefit commitments and a population that is living longer.

The trend toward higher risk investments continues today across the country, and is illustrated by the growth of a pension asset category called "alternative investments." Alternative investments are investments that do not trade publicly on an organized exchange. Examples include, but are not limited to, partnership funds that focus on private equity, venture capital, buyout, mezzanine financing (see description below), natural resources, and hedge funds.

In Minnesota the universe of allowable "alternative investments" includes private equity funds and investments in natural resource and real estate limited partnerships. Minnesota has a history with alternative investments that dates back to the mid-1970s. Unlike many other states, Minnesota's pension funds cannot invest in hedge funds. State law prohibits alternative investments from exceeding 35% of the fund's total market value<sup>69</sup>. For the fiscal year ending June 30, 2005, the State Board of Investment had \$3.4 billion of assets in alternative investments, or about 9% of assets.

Alternative investments typically comprise a small but growing percent of public pension fund assets because they offer potential for superior returns. For example, one type of alternative investment—a mezzanine investment—consists of a debt or debt-like instrument, paired with an equity "kicker." The equity component of the investment gives the mezzanine lender upside potential, while the debt component—which generates steady interest payments to the pension fund—provides a measure of downside risk protection. The prospect of good returns exist even in bearish markets.

The promise of these investment instruments does not come without potential pitfalls.

---

<sup>68</sup> "Holders of the Purse Strings: Governance and Performance of Public Retirement Systems," Michael Useem and Olivia Mitchell, *Pension Research Council, Wharton School, University of Pennsylvania*, p.4. While bond yields in these inflationary times were one important reason for this different investment mix, it is also important to note that actuarial rates of return at that time were also lower than today making reliance on higher risk equity markets less necessary in order to achieve full funding.

<sup>69</sup> M.S. 356A.06, Subdivision 7, paragraph (g); and M.S. 11A.2, Subdivision 6.

- *Performance comes at the expense of transparency*—A crucial reason why private equity instruments beat the market is that their success is largely influenced by proprietary information unknown to the market. Private equity firms strongly resist public disclosure of how individual investments are valued for competitive reasons. Private equity firms worry that proprietary information about a company’s strategy, technology, profit or losses will reach competitors. Yet transparency is critical to stakeholders in the public pension system and especially to taxpayers who are at risk if the underlying business ventures fail.
- *Risk in Asset Valuation*—Politicians and taxpayers should know the value of the entire pension fund at all times with reasonable accuracy, to determine if the fund can cover future payments to retirees. It’s easy to know what one million shares of a particular company’s stock are worth on any given day. But “alternative” investment managers don’t price their assets as often—and most importantly only they know if that pricing is accurate. Quite often, the valuations are merely estimates. This valuation problem also makes direct performance benchmarking more difficult. Performance can only be benchmarked by using standard, less representative indices.
- *Diversification into alternatives can be expensive*—Investments into these alternatives may carry a minimum annual flat fee, plus an additional fee consisting of a percentage of each year’s investment gains.
- *Multi-year commitment*—With alternative investments, the pension fund must commit or dedicate a sum of money, which may be tens of millions of dollars, to the investment fund over a period of many years. In many private equity funds, there may also be a callable feature requiring the pension fund to provide additional money for the investment should the underlying business ventures be struggling and in need of an injection of capital.

“... ‘alternative’ investment managers don’t price their assets as often—and most importantly only they know if that pricing is accurate.”

Alternative investments have been successful for many public pension funds around the country including the State Board of Investment. Growing pension obligations are likely to continue to make this investment option appealing in the future. But even if pension fund administrators can successfully navigate the shoals of higher risk associated with these investments, managers’ growing reliance on them points to the frequent challenges of meeting actuarial assumed returns in today’s investment markets. As the Director of the Arizona State Retirement System noted, “If you don’t think you can make your 8 percent a year, you look anywhere you can to add value.”<sup>70</sup>

---

<sup>70</sup> “Pension Plans Turn to Hedge Funds”, *Arizona Republic*, February 12, 2006