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MPERS
Investment Management Fees

MPERS Philosophy: Expected net-of-fees returns and investment risk drive the investment decision-making process

The most important elements used in determining investment selection are expected net-of-fees returns and investment risk. As such, the investment staff does not select a particular investment service provider (or asset class) based on low fees. Instead, the staff makes investment selection decisions that are expected to provide the best net-of-fees return for a particular investment mandate at an acceptable level of risk. The assessment of investment risk includes not only the underlying risk associated with each investment and how that risk influences the total portfolio, but also legal protections afforded the system in investment contracts and partnership agreements.

From an institutional investor perspective, risk is defined as the system's volatility of returns. Volatility is measured by the standard deviation. This definition of risk may be different than what many individuals use to define risk when considering their own investment choices.

MPERS Practice: Negotiate the lowest fees possible

The investment staff is responsible for enlisting the services of qualified providers at fee levels that are reasonable, competitive, and within industry standards for the type of investment. The staff works diligently to assure the most favorable fee arrangements for the system. Accordingly, staff considers several different fee structures or terms when appropriate and works diligently to secure the best overall fee arrangement, recognizing that as a smaller institutional investor MPERS is often a term taker not a term maker.

The system has negotiated competitive fees (compared to industry standards) for most traditional managers that invest in stocks and bonds. For example, the system pays 29 basis points (0.29%) on over one billion invested in fixed income and global equity strategies while MPERS' peers in the eVestment Alliance Universe pay 53 basis points (.53%). A significant advantage MPERS has with the expenses for these asset classes relative to the peer universe is that much of the fixed income portfolio is managed internally and not subject to outside manager fees.

As a general rule, MPERS pays higher fees only for: skill-based investment returns, diversification that is not available through lower cost alternatives, and for access to hard-to-obtain asset exposures. These exposures include hedged assets, opportunistic debt, real assets and private equity. With higher fee investment classes where fee structures are less negotiable, the system works diligently to ensure that the fund does not pay more than other similar investors.

MPERS Fee Disclosure: Most conservative approach in which all fees are disclosed

MPERS' practice is to disclose all investment management fees at all levels, including the split of the investment profits within alternative asset classes that is commonly referred to as carry (or carried interest) or performance fees. The fees are fully disclosed each year in the Comprehensive Annual Financial Report (CAFR).

MPERS regularly receives inquiries from other systems on how MPERS discloses fees. Several systems question whether they should be disclosing more and are looking to their peers for advice. Some systems only disclose investment management fees that are paid through the accounts payable process. Other systems include management fees paid within funds (deducted or netted from the investment return) but not the performance or carry fees. Finally, fewer systems, like MPERS, utilize full disclosure and also include performance/carry fees.

For example, during Fiscal Year 2018, MPERS paid one manager $276,100 in total fees. Within that total, $93,000 represented management fees and $183,100 represented profit participation (performance fees). This fee could have been reported in several different ways in the CAFR:

- Retirement systems that have a policy to only reflect fees paid through the accounts payable process would have reflected management fees of $0 in the CAFR.
- Retirement systems that have a policy to only include management fees and not incentive fees would have reflected $93,000 in the CAFR.
- Retirement systems that adhere to a full disclosure policy, similar to MPERS, would have reflected fees of $276,100 ($93,000 in management fees and $183,100 in performance fees) in the CAFR.

All three systems realized the same actual amount in fees and were the recipients of the same net of fees returns, however the reporting and disclosure for such varied greatly. All three methods also meet the minimum reporting requirements for the Governmental Accounting Standards Board (GASB) and the Government Finance Officers Association (GFOA). MPERS has simply chosen to take the most conservative and transparent approach in recognizing these fees and expenses in our reporting process.

MPERS' Fees Compared to Other Public Funds: Difficult to compare

It is very difficult to compare investment management fees among public pension plans because there is no industry standard regarding fee disclosure. As described above, each system provides varying levels of disclosure. The Institutional Limited Partners Association (ILPA) (of which MPERS is a member) has worked diligently in recent years to have all stakeholders adopt a more consistent reporting and disclosure process. ILPA has had some success with its fee disclosure and reporting initiative but full adoption by investors and the firms they do business with will not occur in the near term.

The *Maryland Public Policy Institute* issued a report entitled "Wall Street Fees and Investment

Returns for 33 Pension Funds" on July 28, 2015 indicating that the Missouri retirement systems (inclusive of PSRS/PEERS, MOSERS and LAGERS) had the highest fees in the nation at 1.70% (ratio of expenses to total assets). The calculation is correct if a full fee disclosure process is utilized. However, most of the other state retirement systems (outside of Missouri) in the study do not fully disclose all investment management fees. In fact, the report notes, "the data prepared by the authors is not commonly calculated in a comparative way" and "we conclude that a number of states are not reporting fees properly." Since the 2015 report, there have been many other articles and reports published questioning the investment management fees paid by pension funds and other institutional investors. The *Maryland Public Policy Institute* updated its report in 2018 with an abbreviated study that supported conclusions from the 2015 report.

In Fiscal Year 2018, the *total* of MPERS management fees was 1.35% (1.29%). However, if MPERS utilized a policy to only reflect those fees paid through the accounts payable process, the total fees reported would have been 0.25% (.18%). If MPERS utilized a policy to include all fees but no carry, the total fees reported would have been 0.96% (.89%).

For systems similar to MPERS that disclose all investment management fees, the investment expense ratio will vary significantly each year based on a number of factors. For example, as the chart below indicates, the investment expense ratio will be higher in years where performance is strong relative to years where performance is more subdued. This is usually a result of the incentive/performance fees associated with higher cost investments. These additional fees are very much like the increases in pay that a college coach receives when the team's record meets certain criteria, when the team wins conference titles, bowl games, or a national championship. If those benchmarks are recognized, pay goes up proportionately.

	As Reported in CAFR			
	FY18	FY17	FY16	FY15
Investment Expense*	$ 31,280,333	$ 30,734,675	$ 23,869,686	$ 22,798,148
Invested Assets	$ 2,312,973,240	$ 2,163,726,971	$ 1,984,989,058	$ 1,991,396,298
Investment Expense Ratio	1.35%	1.42%	1.20%	1.14%
Net Investment Income (Loss)*	$ 197,619,367	$ 220,301,127	$ 21,432,090	$ 92,645,423

*inclusive of consultant, custodial, securities lending, and other professional fees asociated with investment policy

Higher Fee Products Do Not Mean Lower Investment Returns

Various reports have indicated that "states" that pay higher fees have lower investment performance than "states" that pay lower fees. There are three problems with this conclusion. First, the authors compare states, not funds. For example, in Missouri, it is inclusive of three or four retirement systems (PSRS/PEERS, MOSERS, MPERS, and LAGERS). The investment returns and fees are different for each fund. Second, as stated previously, most of the other state retirement systems in the study do not fully disclose all investment management fees. In fact, the report states "the data prepared by the authors is not commonly calculated in a comparative way" and "we conclude that a number of states are not reporting fees properly." And third, actual return data does not support the conclusion. For example, the MPERS investment return for the five-year period ending September 30, 2018, was in the top three percent for all public funds reported in the InvestorForce universe. This performance was supported in large part by alternative investments that include higher fee products. Over longer time periods, alternative investment returns, net of fees, outperform lower cost traditional asset classes. MPERS generated this investment return while taking less risk (as measured by standard deviation) than 81% of comparable public funds as measured by the InvestorForce universe.

Alternative Investment Fees Have Not Contributed to Underfunding

There have been reports issued by policy institutes over the last several years that indicate alternative investments are not worth the fees and may be too risky. For example, in an undated white paper from the American Federation of Teachers entitled "The Big Squeeze," concludes "our analysis suggests that a significant contributing factor to the underfunding of pensions is the excessive fees charged to pension funds by managers of alternative investments." While this certainly could be the case in a specific pension fund, it is definitely not the case for MPERS. High cost alternative assets represent roughly half of the assets in MPERS' portfolio while almost 90% of the expense. However, as stated in the MPERS fee philosophy above, the system is most concerned with net-of-fee investment returns. Over the last 15 fiscal years, MPERS' asset allocation, heavily weighted to expensive alternative asset classes, out performed an inexpensive, passively invested 60/40 allocation significantly on a net-of-fees basis. As noted in the table below, had these assets been invested in a passive 60/40 portfolio for that same period of time, the system would have given up over $329 million in returns.

FY ending June 30	Market Value (B)	Total Plan Return (C)	60%/40% Return* (D)	= B x C	= B x D	MPERS Excess Return
FY03	$1,237,513,224					
FY04	$1,349,531,516	14.93%	14.74%	$ 184,760,724.34	$182,462,369.71	$2,298,354.63
FY05	$1,435,962,316	10.98%	9.42%	$148,178,560.46	$127,137,593.51	$21,040,966.95
FY06	$1,593,889,243	14.95%	10.50%	$214,676,366.24	$150,724,541.02	$63,951,825.23
FY07	$1,821,213,548	18.09%	17.59%	$288,334,564.06	$280,344,416.91	$7,990,147.15
FY08	$1,713,975,398	-2.41%	-2.71%	$(43,891,246.51)	$(49,366,925.71)	$5,475,679.20
FY09	$1,221,219,306	-24.70%	-15.18%	$(423,351,923.31)	$(260,103,723.68)	($163,248,199.62)
FY10	$1,303,536,373	12.92%	10.86%	$157,781,534.34	$132,579,951.12	$25,201,583.21
FY11	$1,544,387,723	21.75%	19.64%	$283,519,161.13	$256,075,269.55	$27,443,891.57
FY12	$1,528,065,232	2.74%	-0.90%	$42,316,223.61	$(13,946,622.08)	$56,262,845.69
FY13	$1,674,921,460	13.42%	9.66%	$205,066,354.13	$147,685,431.48	$57,380,922.65
FY14	$1,917,976,458	17.59%	15.52%	$294,618,684.81	$259,981,920.35	$34,636,764.46
FY15	$2,003,769,229	6.62%	1.17%	$126,970,041.52	$22,427,971.81	$104,542,069.71
FY16	$1,984,989,056	1.01%	0.16%	$20,238,069.21	$3,293,554.74	$16,944,514.48
FY17	$2,163,726,897	11.22%	11.14%	$222,715,772.08	$221,207,559.97	$1,508,212.11
FY18	$2,312,972,908	9.42%	6.28%	$ 203,823,073.70	$135,832,251.02	$67,990,822.68
					Excess Return Over 15 Years	$329,420,400.09
	15-year Annualized	7.930%	6.802%			

* 60% MSCI ACWI / 40% Barclays Aggregate

Summary

Managing the investment portfolio of a multi-billion dollar pension system is a complicated task not driven by a single point of emphasis such as investment fees. Fees are an important piece of the analysis but only present a portion of the whole picture when identifying an investment service provider or asset class that supports the best return profile within acceptable risk parameters. For the most recent MPERS investment news, visit us on the web at www.mpers.org.