POLICY PIONEER PUBLIC BRIEF

Massachusetts Public-Pension Investment Reform

by Iliya Atanasov, PhD

Executive Summary

The overall underperformance in gross returns of Massachusetts's non-state public pension systems relative to the commonwealth's Pension Reserves Investment Management (PRIM) amounted to an estimated $2.9 billion loss for local taxpayers from 1986 to 2015. The shortfall would be much larger if the effects of compounding and PRIM's much lower investment expenses were factored in.

About $1.56 billion of this loss is attributable to the 2000-2015 period. This amounts to an unnecessary shortfall of about $97 million a year before fees and interest, which are likely to make the performance gap even bigger, given PRIM's pricing advantages.

In 2007, the Massachusetts General Court passed special legislation requiring underperforming public retirement systems to transfer their assets into PRIM's custody. Any system funded below 65 percent and trailing PRIM's average return over the prior decade by at least 2 percent was to be deemed underperforming. Alongside the subsequent financial crisis, this statute has helped double the number of systems participating in PRIM to more than 40. Only 9 out of 104 Massachusetts public-pension systems, with assets worth $6.7 billion, had no PRIM investments as of yearend 2015, according to the Public Employee Retirement Administration Commission (PERAC).

"The Massachusetts legislature has a responsibility to stop the bleeding and transfer all public pension assets to PRIM."

Despite the 2007 legislation, the investment decisions of local retirement boards continue to place undue burdens on cash-strapped communities across the commonwealth because it is local taxpayers who are ultimately liable for any pension underfunding. The statute has not had a transformative effect because it excludes systems funded above the 65 percent level, thereby allowing them to deliver mediocre results and become a drain on local budgets. Furthermore, real investment performance is captured by net returns, after all investment fees and expenses have been deducted. Local boards tend to underperform PRIM substantially on this metric as well. The statute also leaves a lot of leeway for regulators to extend the transfer schedules of underperforming boards or grant other exemptions through a murky appeals process.

The Massachusetts legislature has a responsibility to stop the bleeding and transfer all public pension assets to PRIM. Because the bill for underfunded local pensions falls on municipal budgets, local legislative bodies are the rightful arbiter of moving pension assets to PRIM even faster than the statutory schedule. Retirement boards should be given a lot of leeway in choosing an asset allocation for their needs under PRIM's segmentation program.

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Background

Statutorily, PRIM is the management authority for Massachusetts's state and teachers' retirement systems, the two of which held some $47.5 billion in assets as of yearend 2015[2] — about two thirds of all public pension assets in the state. However, the commonwealth is also home of 102 agency, local and regional public pension systems, which can make their own investment decisions. Many of these local boards have fallen on hard times through a combination of poor management practices, insufficient contributions and unsustainable benefits.

Chapter 68 of the Acts of 2007 created a special mandate requiring any system that falls behind on its funding level and investment performance to transfer its assets to PRIM. The legislation directed PERAC, the state's public-pension regulator, to conduct annual reviews of the investment performance and funded ratio of all systems. A system with a funded ratio below 65 percent and an average rate of return at least 2 percent less than PRIM's over the prior decade is deemed underperforming and required to move its assets to PRIM "in perpetuity".

For the affected systems, the potential direct benefits from the legislation could arrive in the form of:

- better asset allocation and cash management;
- lower investment-management fees and other costs;
- more attractive investment options due to PRIM's size and market power;
- decreased fiduciary risks from both the retirement system and its investment managers;
- enhanced board focus on operations.

Apart from the Chapter 68 mandate, systems can choose to join PRIM voluntarily. *Participating* systems are those which transfer their entire investment process to PRIM. They have an option to terminate the relationship, but no sooner than five years in. *Purchasing* systems only buy investment products offered by PRIM, typically an entire asset class within the fund. For example, a purchasing system can invest in PRIM's real-estate portfolio, largely as with a private investment manager. Unlike a participating system's, a purchasing system's decision-making authority is not materially constrained.

To be clear, that a system is legally designated "participating" does not always mean that in practice it is fully invested in PRIM. Nor does a system need to sign up as participating in order to move all its assets to PRIM. Chapter 68 provides an appeals process that could exempt a system from rolling its assets into PRIM. There is also significant leeway for PERAC to decide when and how affected systems should roll over their funds. In practice, this has meant that systems retain some assets with outside investment managers even if they fall within the purview of Chapter 68.[3]

A system may invest all its funds with PRIM without becoming a participating system and thus avoid the five-year minimum holding period. Originally, participation had the enticement of a bonus pension appropriation from the state, but the Massachusetts legislature has appropriated no such enticement funds for participating systems since 2000.[4] Purchasing systems can invest in any PRIM asset class except some timber and private equity funds, so there is little added benefit from locking in one's funds for five years by becoming a participating member. Thus, it is important to distinguish between systems participating in PRIM and those fully invested in it. What matters for investment returns and fees is not the member status but where the assets are actually held.

The most extensive public data that allow an assessment of the impact of the statutory mandate and the relative performance of PRIM are contained in PERAC's annual reports, which go back to 1985. All data presented in this policy brief are on calendar-year basis unless noted otherwise. PERAC's reports supply the annual gross returns and yearend market values of all systems, while PRIM's annual returns can be obtained from PRIM's own reports as well as PERAC's. However, PERAC's reports for 1997-1999 do not show the individual retirement systems' investment in PRIM, so certain comparisons for this period are not possible. In addition, due to the passage of time and statutory changes, regulations and reporting standards, earlier data may differ considerably in their quality and comparability from more recent information.

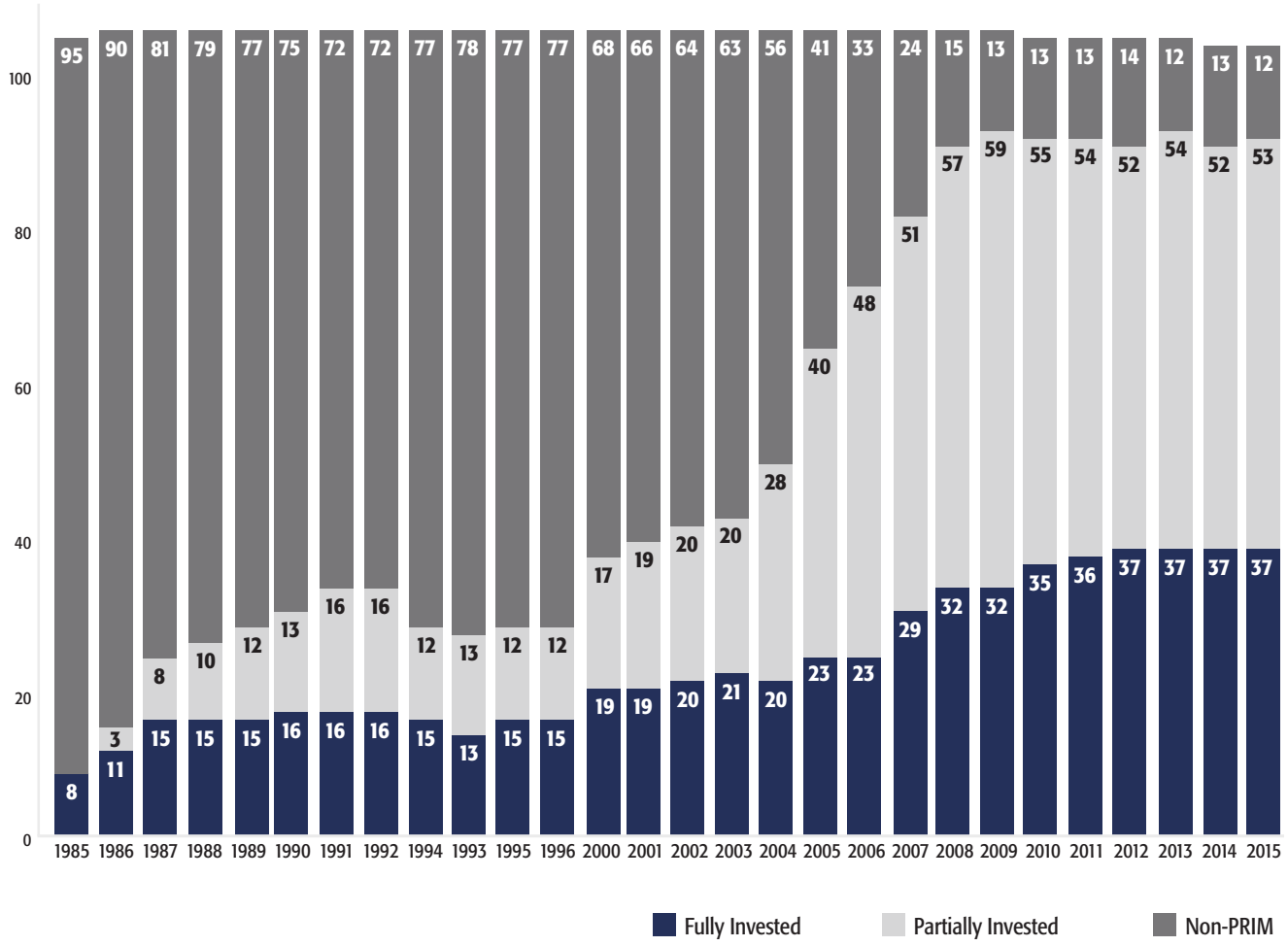
Because of these and other limitations in the available data, this report focuses primarily on the period 2000-2015. Whereas figures from earlier times are included in certain portions of the analysis, those should be interpreted with due caution.

Local Investment in PRIM and Chapter 68

Because Chapter 68 left the door open for systems to join PRIM voluntarily, it is not possible to directly assess the counterfactual of what they would have done had the statute not been passed. However, quite a bit can be gleaned by analyzing PRIM participation patterns as well as systems' performance relative to the statutory benchmark.

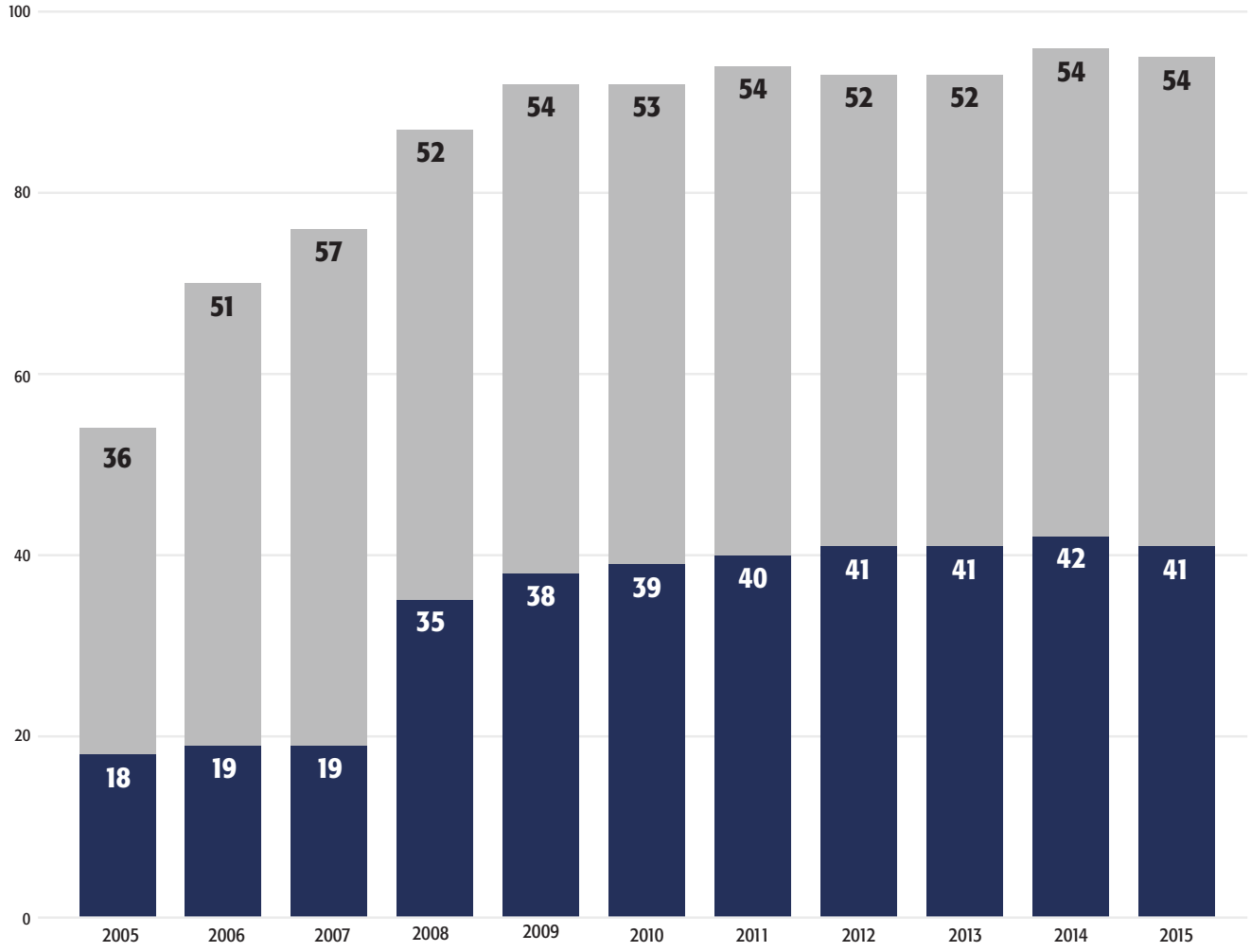
The big wave of systems joining or purchasing under PRIM's segmentation program was well underway long before the passage of Chapter 68 (Fig. 1). Systems moved assets aggressively into PRIM after the dotcom bubble burst (2000-2002) and continued to do so even as asset prices recovered during the housing bubble that preceded the 2008 financial crisis. From 2000 to 2015, the number of fully invested systems just about doubled, from 19 to 37, whereas the number of partially invested systems more than tripled, from 17 to 53.

Fig. 1. Local Pension Systems' Investment in PRIM 1985-1996, 2000-2015



Source: PERAC annual reports

Fig. 2. PRIM Purchasing and Participating Retirement Systems FY 2005-2015



Source: PRIM annual reports

The impact of Chapter 68 is more discernible in PRIM's own annual reports, which list the actual number of purchasing and participating systems (Fig. 2). The end of PRIM's fiscal 2007 almost perfectly coincides with the passage of the benchmarking legislation that summer. There were only 19 participating systems as of FY 2007, but that number doubled in the next two years. A more detailed examination of funded ratios and returns in the same period shows that a vast proportion of the joining systems at the time would fall under the statutory threshold of Chapter 68.

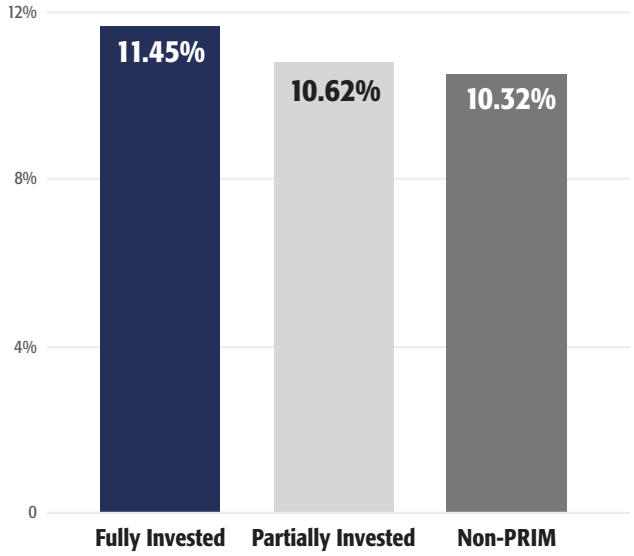
Gross Returns of PRIM and Non-PRIM Systems

The annual gross returns of local retirement systems published by PERAC provide one straightforward albeit crude avenue to quantify the impact of PRIM investment. The difference between PRIM's and the system's gross returns, as reported by PERAC, multiplied by pension assets at the beginning of the year implied an overall performance gap of $2.9 billion from 1986 to 2015. This is roughly equivalent to a taxpayer loss of $97 million a year. This loss could easily double if investment fees and the effects of compounding were included in the calculation.

Systems can be categorized as fully invested, partially invested and not invested in PRIM. To compare the investment returns of each group, it was necessary to estimate a composite return by weighting each local system's return on its assets at the beginning of the year. In the 11-year period 1986-1996, PRIM returned an annualized gross of 11.45 percent, whereas partially invested systems returned a composite gross return of 10.62 percent and non-PRIM systems returned 10.32 percent (Fig. 3). PRIM returned 113 basis points more than non-PRIM systems annually, a gap likely to be even larger if investment fees are taken into account.

In the 16-year period 2000-2015, the comparative picture is very similar although returns about halved for all groups. PRIM returned 5.8 percent annually, whereas partially invested

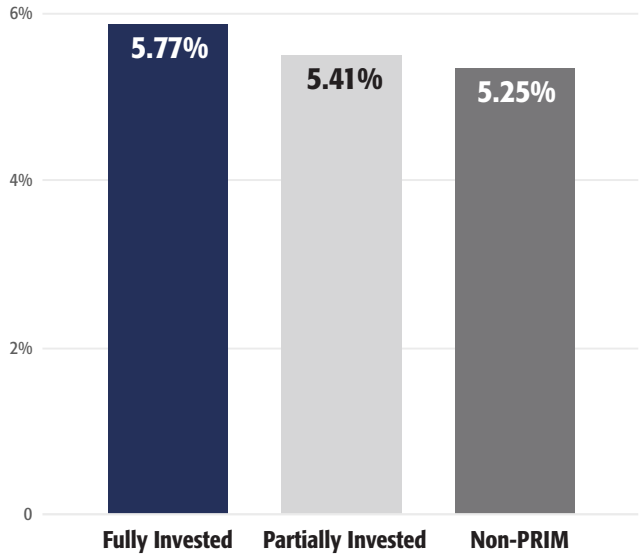
Fig. 3. Annualized Gross Returns of PRIM and Local Systems 1986-1996



Source: PERAC annual reports, own calculations

systems returned 5.4 percent and non-PRIM systems returned 5.3 percent (Fig. 4). The gap between PRIM and non-PRIM systems shrunk from 111 to 52 basis points from the previous period, scaling almost perfectly to the overall decline in market returns.[5]

Fig. 4. Annualized Gross Returns of PRIM and Local Systems

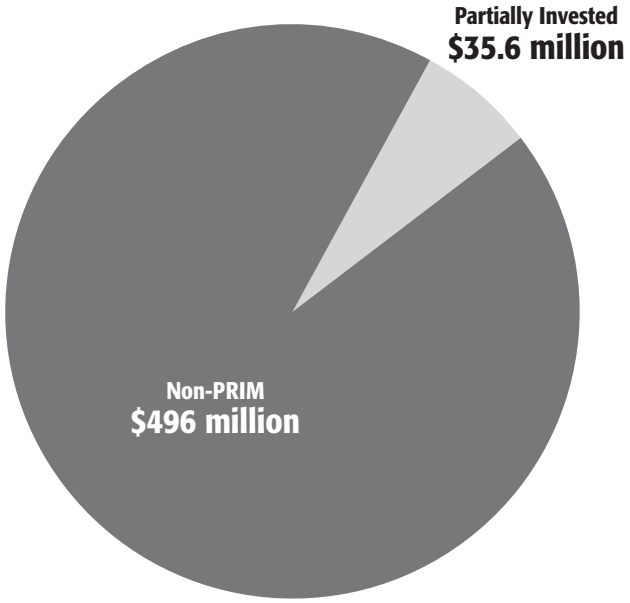


Source: PERAC annual reports, own calculations

Multiplying the difference between each system's annual return and PRIM's with the system's beginning assets for the year provides an approximate dollar value for the impact of (not) switching to PRIM. Because this approach omits intermittent cash flows during the year and the impact of investment fees, it likely underestimates the overall underperformance gap. In 1986-1996, non-PRIM systems would have generated nearly $496 million more had their assets been managed by PRIM, while partially invested systems would have gained another $36 million (Fig. 5). Not investing local pension assets with PRIM cost an estimated total of $532 million over the period 1986-1996, or about $48 million annually on average.

> " Overall, systems which were not fully invested in PRIM over the period 2000-2015 would have generated $1.56 billion more in gross returns if they had transferred all their assets to the fund full stop."

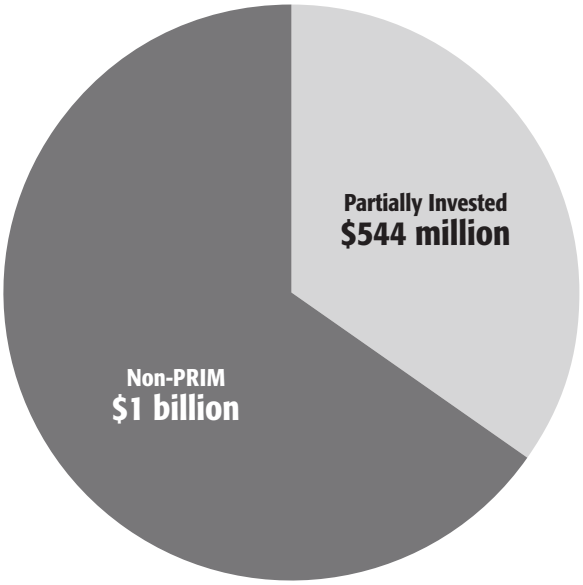
Fig. 5. Estimated Gross Underperformance of Non-PRIM and Partially Invested Systems 1986-1996



Source: PERAC annual reports, own calculations

The picture is even more dire during the period after the peak of the dotcom bubble. Partially invested systems underperformed by some $544 million, whereas non-PRIM systems missed additional returns of more than $1 billion (Fig. 6). Overall, systems which were not fully invested in PRIM over the period 2000-2015 would have generated an estimated $1.56 billion more in gross returns if they had transferred all their assets to the fund. This amounts to a gain of about $97 million a year before fees and interest, which are likely to make the performance gap even bigger, given PRIM's pricing advantages.

Fig. 6. Estimated Gross Underperformance of Non-PRIM and Partially Invested Systems 2000-2015



Source: PERAC annual reports, own calculations

Discussion

Over the 27 years for which fairly comprehensive data are available, Massachusetts public retirement systems forfeited an estimated total of $2.09 billion by not transferring all their assets to PRIM. This amount does not include the substantial compounded returns that would have accrued on much of these losses, nor does it take into account the excessive fees and expenses of many local retirement boards relative to PRIM's rock-bottom pricing.

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In light of these facts, the Massachusetts legislature appears to have moved in the right direction with the passage of Chapter 68. Reeling in all the systems would have generated even larger savings for cash-strapped municipal budgets. In the decade 2006-2015, the gross returns forfeited due to retirement systems' non-PRIM investments have averaged an estimated $80 million annually.[6]

The law still leaves far too many loopholes for boards to continue making bad decisions; the statutory benchmark for underperformance introduced by Chapter 68 is loose and ineffective. There are three strong reasons why:

1. The permitted 2-percentage-point margin below PRIM's return is huge. Over a decade, the cumulative effect of a 2-percentage-point underperformance can have disastrous effects. For example, a fund with an annualized return of 8 percent over a decade would return 20 percent more than a fund scoring 2 percentage points lower.

"In the decade 2006-2015, the gross returns forfeited due to retirement systems' non-PRIM investments have averaged an estimated $80 million annually."

2. The 10-year benchmark is based on average returns, which garble the effects of interest compounding. The real performance of an investment product is captured by annualized (or *geometric-average*) returns.
3. The benchmark does not take into account the management fees paid by the retirement systems. In the past decade, PRIM has cut its direct management fees to about 15 basis points. Meanwhile, local systems' investment costs can be several times higher than PRIM's. Alternatives such as hedge funds and private equity, which have become increasingly popular with retirement boards, also charge substantial indirect (hidden) fees, which are also unaccounted for by the performance benchmark.

The Massachusetts legislature can remedy the situation easily, with an almost immediate impact on local budgets. The options are many, but one stands out: legislators can simply set a five-year deadline for the transfer of all public pension assets into PRIM. State leaders can also tighten the performance standard by tracking the annualized return net of fees and applying this standard to boards funded at less than 90 percent. Most importantly, they can allow towns and cities, by vote of the legislative body, to compel retirement boards to move that locality's pension assets to PRIM, which will be particularly appropriate for smaller communities with little influence on the large regional retirement systems they have to put up with. Retirement boards should be given a wide range of allocation choices within PRIM's portfolio segmentation program to find the best solution for their system's risk profile and fiscal condition.

Conclusion

Despite some problems, investing with PRIM appears to have been a generally good idea since 1985. PRIM outperformed most retirement boards in the commonwealth on a gross-return basis. The performance gap would likely increase if investment expenses were factored in because PRIM tends to charge much lower fees while benefitting from operational economies of scale.

Allowing retirement boards to impair the investment returns of the systems in their custody is manifestly unjustified for the communities which ultimately have to foot the pension bill. When investments fall short, cash-strapped

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municipalities across the state have to squeeze their fiscal belts and raise taxes to make up for the difference. This unfair situation can be remedied easily by giving towns and cities the authority to compel retirement boards to invest their public pension accounts with PRIM. The Massachusetts legislature has a responsibility to stop the multimillion-dollar bloodletting.

> " The law left too many loopholes for boards to continue making bad decisions; the statutory benchmark for underperformance is loose and ineffective."

The need for such a legislative solution is particularly great in the smallest communities, which are enrolled in large — and largely unaccountable — regional systems covering dozens of local employers. To ensure the proper disposal of public funds, the very best of best practices is to put the decision making as close as possible to the taxpayer. A town meeting or a board of selectmen is therefore a much more appropriate authority than an unaccountable retirement board many miles away. The Massachusetts legislature has the responsibility to put the power of the purse where it belongs — with taxpayers.

Endnotes

1. Available data did not permit estimating this differential for 1996-1999.
2. Public Employee Retirement Administration Commission, "Commonwealth Actuarial Valuation Report," August 17, 2016, 15, http://www.mass.gov/perac/docs/forms-pub/reports/valuation-reports/2016commonwealth.pdf.
3. There may be some legitimate reasons to do so, such as prohibitive liquidation costs for certain products and investments.
4. Pension Reserves Investment Trust Fund, "Comprehensive Annual Financial Report for Fiscal Year Ended June 30, 2015" (Boston, MA, December 1, 2015), 31.
5. PRIM's annualized return of 1,145 bps over the prior period was about 10.9 percent higher than the non-PRIM composite of 1,032 bps. After 2000, the analogous gap was 9.79 percent.
6. This estimate uses the same methodology as other dollar estimates.

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