



The Reckless Cost of Investment Mismanagement at the MBTA Retirement Fund

by Iliya Atanasov

Executive Summary

The maintenance of a separate retirement system has been an expensive luxury for the Massachusetts Bay Transportation Authority (MBTA), its employees and Massachusetts taxpayers. Had MBTA Retirement Fund (MBTARF) assets been placed in the state pension fund since the beginning of 2001, their value would have been an estimated \$902 million higher by yearend 2014. Contractually, employees must cover a quarter, or \$225 million, of this unnecessary cost. The MBTA, which is heavily subsidized by taxpayer dollars, is responsible for the other three quarters of the loss, or \$676 million.

The dismal investment results are consistent with the MBTARF's troubled history. For many years, the fund has been plagued by scandals and resisted efforts to open its books to public scrutiny. The union representatives on the retirement board and the "independent" member aligned with them have opposed transparency about the fund's

dealings, including with investment managers.

Stiff opposition from union leaders has impeded pension reform at the T, allowing MBTARF governance to deteriorate further.

Stiff opposition from union leaders has made reform impossible and governance has deteriorated further.

Annual reports show a fund which veered into ever riskier, more expensive and more speculative asset classes as its performance lagged that of the state pension board. A steady stream of scandals did

not usher in more accountability and prudence. In recent years, the fund's investment expenses have averaged three times those of the state investment board. As the pension funding level tumbled below 65 percent, the MBTARF has doubled down on reckless risks.

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Forays into speculative debt generated massive losses during the 2008 financial crisis. The MBTARF later lost tens of millions of dollars on hedge-fund investments that have since been investigated for fraud, then failed to disclose the losses in its financial statements. Most recently, the fund has dug down into risky assets – venture capital, hedge funds and junk bonds – that have precipitated considerable losses in every significant market downturn.

If the pension assets had been invested by the state board, MBTA pensions would have been about fully funded as of 2014, allowing the authority to save \$119 million in contributions for fiscal 2014-2016. The expected savings for fiscal 2017 alone would have been about \$49 million, helping close the MBTA's budget gap, which has to be filled by taxpayers. The Massachusetts legislature can stem the bleeding by placing all MBTA pension assets and investment decisions in the hands of the state pension fund.

Background

The MBTARF was formed as a private pension fund in 1948 alongside the Metropolitan Transit Authority, predecessor of the MBTA. The fund has been embedded in the MBTA's union pension agreement, which includes an evergreen clause making it nearly impossible to drive change. Union leaders have supported the fund's compromised management and resisted transparency and accountability at the expense of the members whose interests they are supposed to represent.

In the first three decades of its existence, the MBTARF's assets were mostly invested in less risky bonds that targeted a modest return and preservation of capital. That changed after John Gallahue, a union chief, became board chairman in 1979 and pushed to terminate the blind trust which safeguarded retirees' money. In 1983, Gallahue became the fund's executive

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director. Subsequently, he shifted most pension assets into stocks, foreign securities and alternatives.¹

A 1992 state probe into Gallahue's relationships with investment managers did not find improprieties. Meanwhile, the MBTARF board fended off the press's public-record requests in the commonwealth's highest court. The executive director was finally forced out in 2001 amid a pay-to-play kickback scandal involving, among other things, a loan to a known associate of notorious murderer and racketeer James “Whitey” Bulger.² The board's chairman and another union appointee were quietly replaced as well.³ No charges were brought.

A two-member search committee selected Karl White, whose background included stints at Goldman Sachs and Putnam Investments, to replace Gallahue as executive director. The board also adopted strict internal rules against whistleblowers and against access to fund information.⁴ White quit in 2006 to become the chief investment officer of Fletcher Asset Management, a “hedge” fund. After his departure, he encouraged the MBTARF to invest \$25 million with Fletcher. White's successor Michael Mulhern and the board obliged. The entire investment in what seems to have been a Ponzi scheme was later written off amid a criminal probe.

Mulhern's rags-to-riches story began as a bus driver at the T. Before being appointed executive director of the MBTARF in 2006, he had been a member of its board and later general manager of the MBTA. As general manager, he had negotiated a labor contract that provided additional benefit increases despite an already bloated pension liability. MBTA pension benefits are incomparably lavish relative to what other Massachusetts state employees can hope to receive.⁵

Mulhern left the MBTA with a sizable pension, which was nearly \$65,000 in 2014. He did not have experience in asset management when he was appointed executive director of the MBTARF, while his deputy, John Barry, had previously been a rail repairer.⁶ In 2014, Mulhern drew a salary of \$282,000, while Barry took in \$196,000.⁷

Shortly after Mulhern's appointment, substantial risk-related portions of the fund's annual report were

discontinued. So was the management discussion and analysis required by the Governmental Accounting Standards Board (GASB). Management failed to

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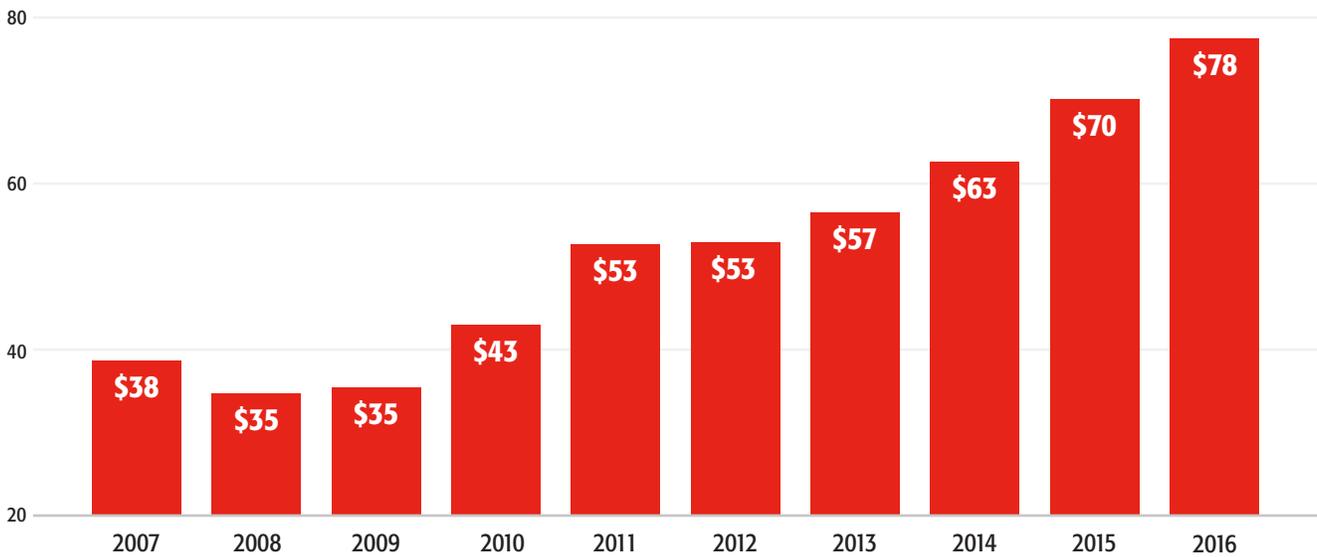
disclose the Fletcher loss for at least a year after learning that the money had gone missing.⁸ Among myriad missteps, the fund continued using actuarial

tables from decades earlier and even hiked its assumed rate of return to 8 percent from 7.5 percent at a time when pension systems across the country were lowering that target.

According to the most recent version of the MBTA pension agreement, the authority is responsible for three quarters of the contributions necessary to keep the plan going. The MBTARF therefore has a very direct impact on T finances.

The MBTA’s contractual contributions to the fund have doubled to \$70 million in fiscal 2015 from \$35 million six years earlier (Fig. 1). They were budgeted at \$78 million for fiscal 2016, as both employer and employee contributions were required to rise yet again. The authority’s contribution is expected to grow further, to \$84 million, in fiscal 2017.⁹

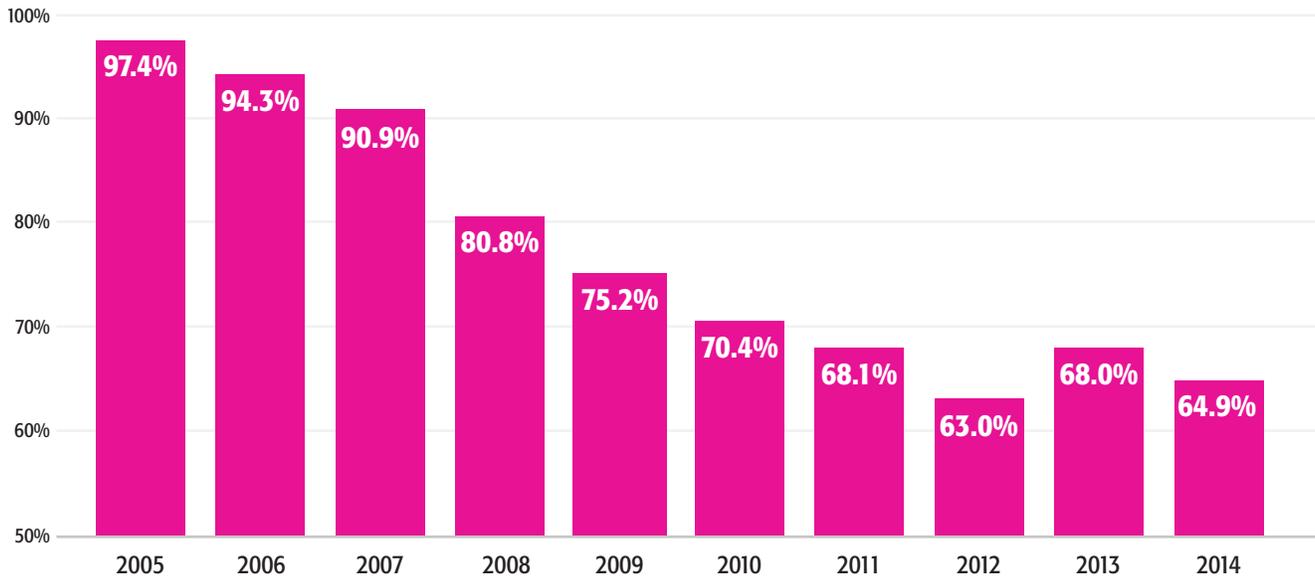
Fig. 1. MBTA Pension Contributions by Fiscal Year (\$mn)



Source: MBTA

Although contributions have skyrocketed, the plan’s funding level has continued to deteriorate (Fig. 2). In 2013, the MBTARF used a number of actuarial tactics to inflate its funded ratio. Increasing the assumed return to 8 percent and a one-time booking of unrecognized portfolio gains from the prior five years provided a temporary boost. However, the funding level resumed its decline in 2014, when net position (the total net amount of assets available for pension payments) sank as well. The fund reported having less than 65 percent of the assets it needed to pay benefits earned.

Fig. 2. MBTARF Funding Level by Calendar Year



Source: MBTARF

Because of the rigid pension agreement, the MBTA’s budget is hostage to decisions made by the MBTARF, a private entity. The authority is contractually obliged to contribute whatever amount is required by the funding schedule adopted by the retirement board. That schedule is not constrained by governmental accounting standards or any other independent authority; it is at the mercy of the board’s momentary disposition. The MBTA has no real say in investment decisions either, even though it appoints three of the seven board members. The tie-breaking “independent” member is a lawyer whose firm specializes in labor disputes. She has typically sided with union leaders, including to prevent disclosure of fund records in defiance of Massachusetts law.¹⁰

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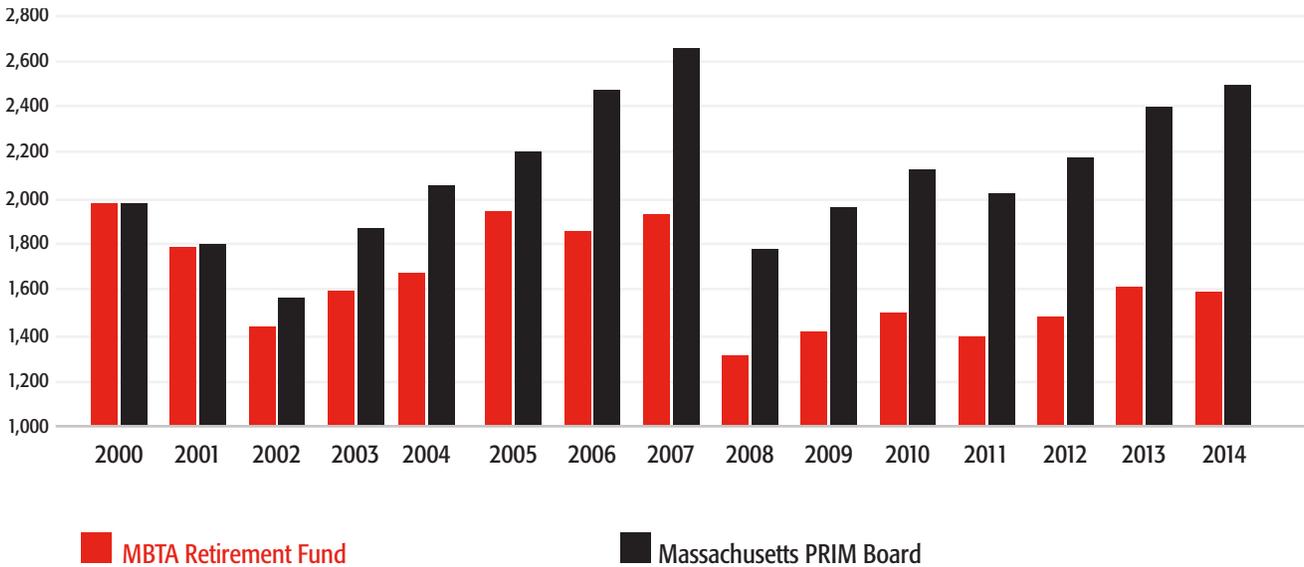
Investment Returns

The MBTARF’s investment performance is a grim reflection of its governance. Using fund data for 2001-2014, it is possible to determine what the fund’s value would be if its assets had been managed by the Pension Reserves Investment Management (PRIM) Board, the state’s pension fund. The hypothetical assumes that the \$1.98 billion of MBTARF assets at the end of 2000 are transferred to PRIM at that time. Original numbers for all fund flows such as benefit payments were used, apart from substituting PRIM’s investment return and investment expense ratio for MBTARF actuals.¹¹

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The MBTARF reported net pension assets of \$1.59 billion at yearend 2014. If PRIM had been in charge of investment management, the accumulated net position would have been \$2.49 billion (Fig. 3). Relative to the state pension fund’s performance, the MBTARF has generated a negative value added of \$902 million. Following the 1:3 contribution allocation of the MBTA’s pension agreement, this negative value translates into a \$225 million cumulative loss to MBTA employees and a \$676 million loss to the authority, which is funded by taxpayers.

Fig. 3. Yearend Market Value of Assets under MBTARF and PRIM Management (\$mn)



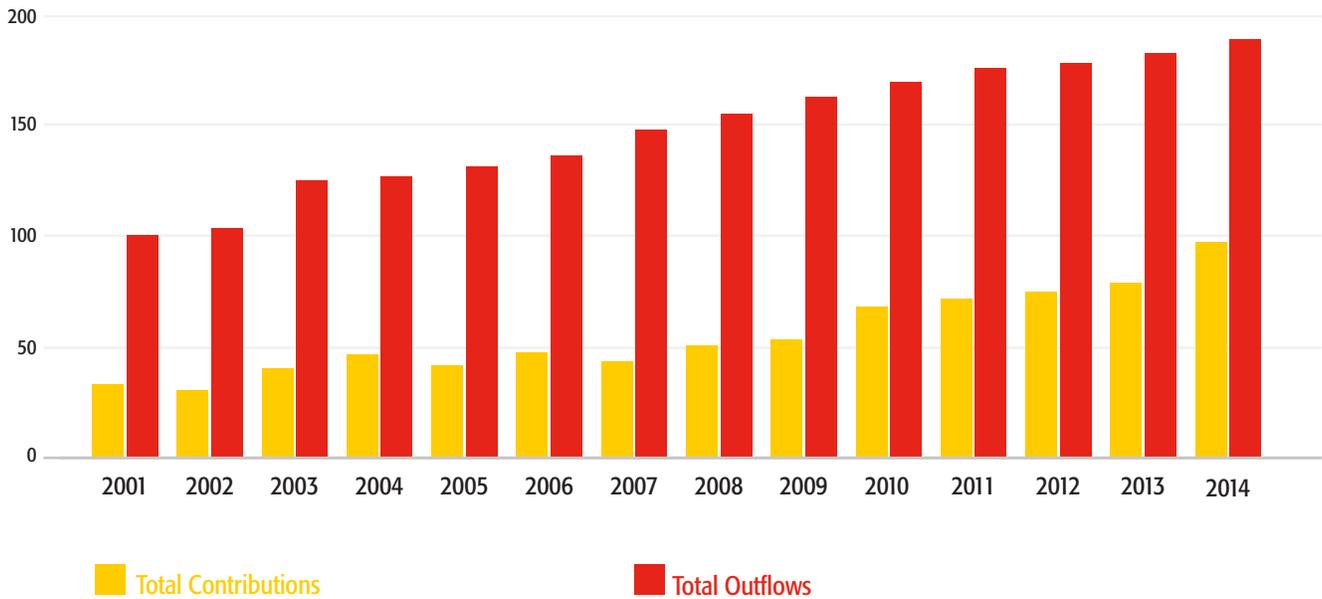
Source: MBTARF, PRIM, own calculations

If MBTA pension assets had been managed by PRIM, the MBTA’s retirement plan would have been about fully funded at yearend 2014. According to the 2014 actuarial valuation, about 57 percent of the MBTA’s pension payments go towards amortizing the unfunded liability. If PRIM had been in charge of pension assets, the MBTA would have saved some \$119 million in unnecessary pension contributions for fiscal 2014-2016. The savings would be \$49 million for the preliminary FY 2017 budget.

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Meanwhile, investment returns are essential to offsetting fund outflows such as benefits, refunds and administrative expenses. From 2001 to 2014, total contributions were sufficient to cover an average of 38 percent of annual fund outflows (Fig. 4). Investment returns had to cover the remaining 62 percent to avoid a decline in assets. In the decade ending in 2014, the MBTARF had to generate investment returns of about \$100 million annually to break even on a net asset basis.

Fig. 4. MBTARF Annual Contributions and Outflows (\$mn)



Source: MBTARF

Investment Expenses

Excessive overheads and management fees are a significant contributor to the MBTARF’s poor investment results. The MBTARF does not seem to report its investment expense ratios or indirect management fees. PRIM reports expense ratios with and without indirect investment fees, as well as returns gross of all fees. These rates are further broken down by portfolio segment in the supplementary sections of PRIM’s annual statements.

Available data allow a comparison of investment expense ratios based on direct fees over 11 calendar years (Fig. 5). An expense ratio for MBTARF can be

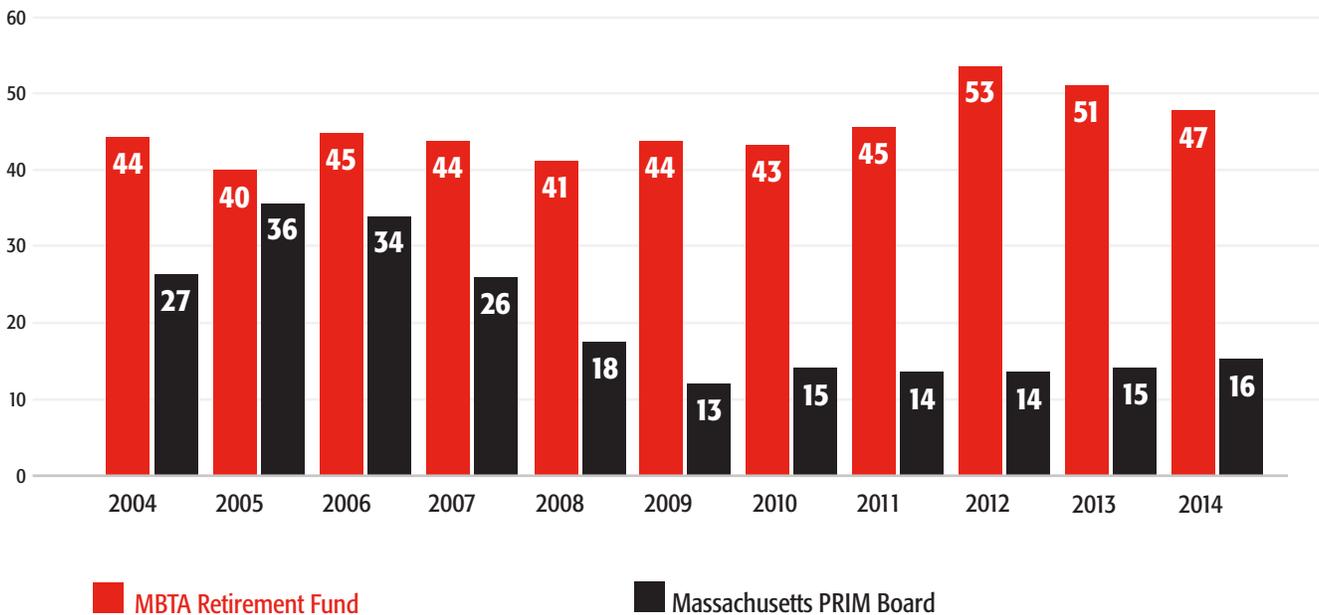
calculated using the line item for investment expenses from the income statement and the average net position for the year. PRIM’s fiscal-year data were converted to calendar-year by taking the average for the two corresponding fiscal years.

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Over the period, PRIM cut its costs substantially from already restrained levels. Meanwhile, the MBTARF’s investment expense ratio remained high.

In 2010-2014, PRIM’s average direct expense was less than 15 basis points, whereas the MBTARF’s was more than 48.

Fig 5. Investment Expense Ratios Excluding Indirect Fees (bps)



Source: PRIM, MBTARF, own calculations

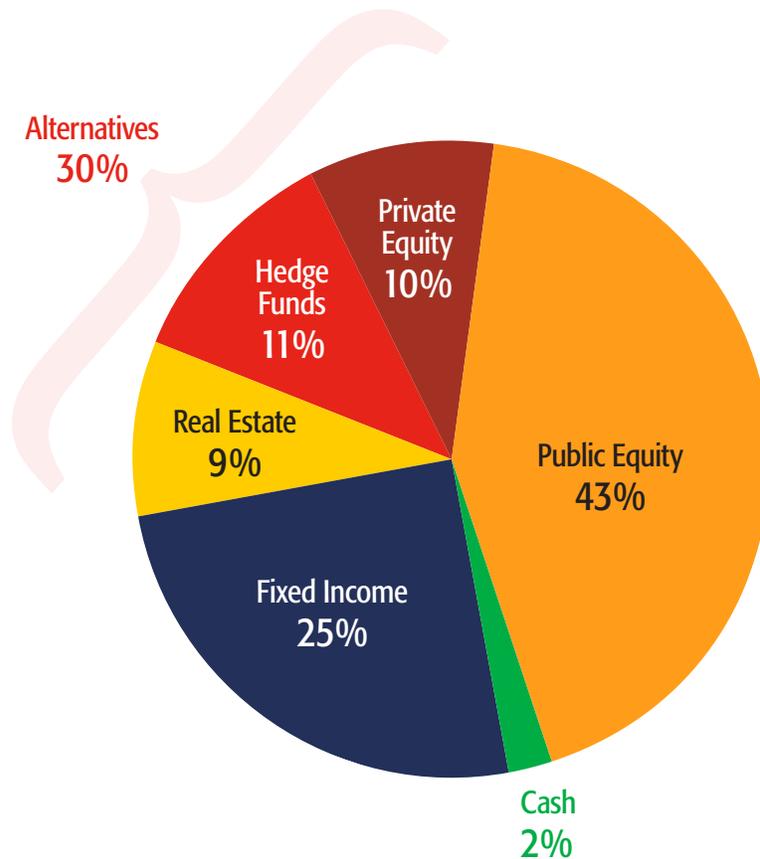
Portfolio Risk

Weak investment returns and high costs are the direct result of portfolio construction. The MBTARF has ratcheted up risk in the decade since Michael Mulhern became executive director at the fund. Massive losses during the 2008-2009 financial crisis do not appear to have had a sobering effect on the MBTARF's management.

As of 2014, the MBTARF's target asset allocation

included 73 percent equities and high-risk investments versus 27 percent in cash and fixed-income securities (Fig. 6). This is an enormous amount of risk at a time when equities and even bonds are near historic valuation highs.¹² Alternative investments accounted for 21 percent of the target allocation. So-called "hedge" funds, a market segment distinguished by dismal performance and exorbitant fees, made up 11 percent of the target portfolio.¹³

Fig. 6. MBTARF Target Asset Allocation (2014)



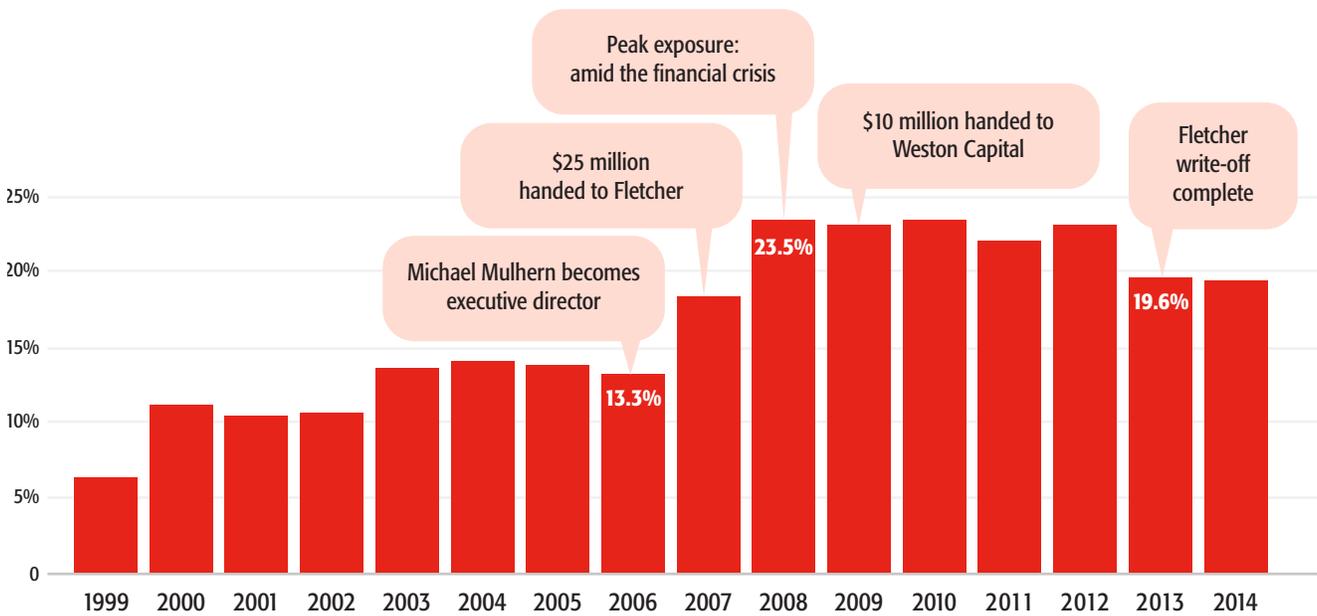
Source: MBTARF

The fund escalated its exposure to high-risk, high-cost, low-performance alternatives shortly after Mulhern’s appointment. During his first two years as executive director, a whopping 10 percent of the portfolio shifted to hedge funds and private equity, nearly doubling their share (Fig. 7). As of 2013, the \$25 million Fletcher investment had been completely written off

amid a federal fraud investigation.¹⁴ Weston Capital, another hedge fund in the MBTARF portfolio, was investigated by the Securities and Exchange Commission and the MBTARF was seeking to recover a \$10 million investment.¹⁵ Problems with neither fund manager were disclosed in financial statements promptly and appropriately.

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Fig. 7. Exposure to “Hedge” Funds and Private Equity



Source: MBTARF

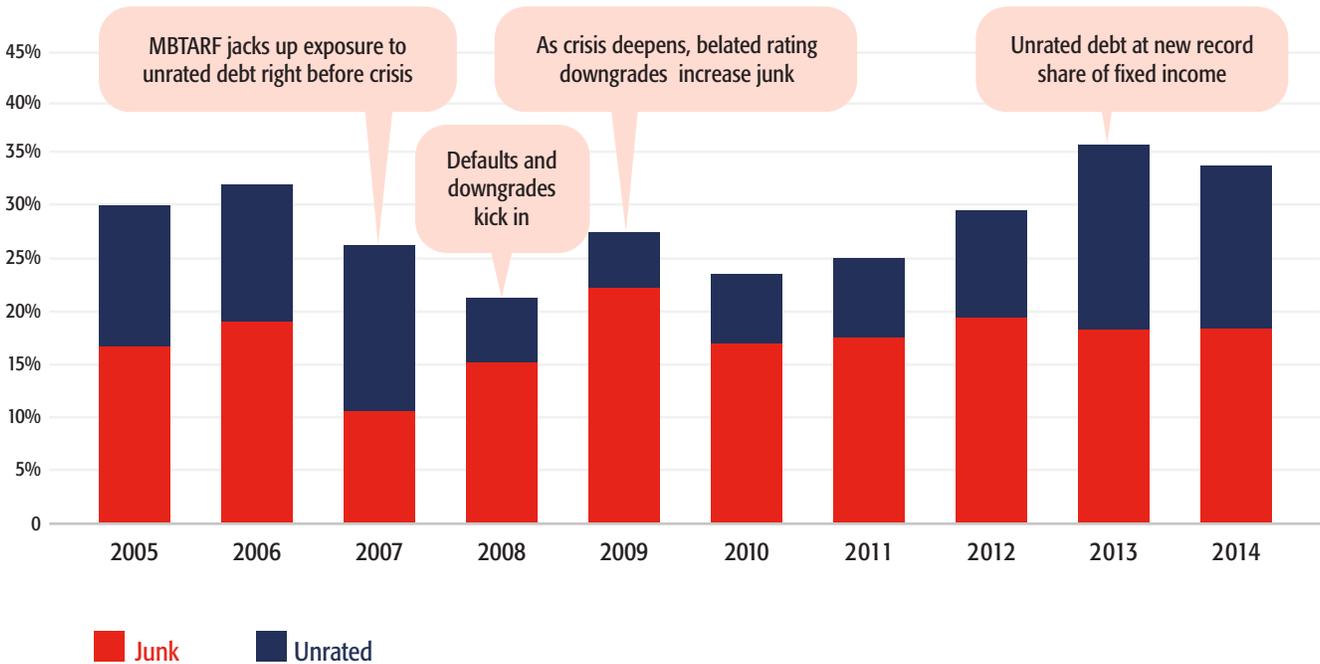
Excessive risk lurks in the fixed-income portfolio as well. Junk and unrated debt reached nearly 36 percent of the

MBTARF’s fixed-income positions in 2014 (Fig. 8). The fund had similarly racked up exposure to high-risk debt at the peak of the business cycle in 2007. As the financial crisis hit, there were massive losses due to defaults and rating downgrades. The fixed-income portfolio shrunk from \$429 million at yearend 2007 to \$323 million at yearend 2007 to \$323

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million two years later. The MBTARF has recently increased exposure to unrated debt while maintaining a large allocation of junk bonds, just as it did in 2007.

Fig. 8. Unrated and Junk Debt Exposure as Proportion of Fixed-Income Allocation



Source: MBTARF

Conclusion

Recklessness and lack of accountability put MBTA pensions in jeopardy. The MBTARF's investment mismanagement has cost taxpayers \$676 million in unnecessary liabilities. Employees have been shortchanged another \$225 million. The costs will mount with 2015 financial results, as the MBTARF reported to have underperformed PRIM yet again.¹⁶

There is little evidence that the MBTARF has benefitted from the lessons of the 2008-2009 financial crisis. In recent years, the fund has ratcheted up exposures to riskier, costlier and less profitable investments, just as it did on the eve of the housing bust. This time will not be different, and the pension portfolio will be gutted come the next downswing in the business cycle.

Placing MBTARF assets under PRIM's management will give MBTA pensions a chance of survival and help preserve retirees' savings. Unlike the secretive MBTARF, PRIM is subject to all state ethics and transparency standards. Transferring the assets to PRIM will save additional money for the transit agency by terminating the MBTARF's lavishly paid senior management.

Poor MBTARF management leaves pension assets at risk and the cash-strapped MBTA exposed to ever larger payments. Having the state fund manage the MBTARF's assets is the low-hanging fruit in solving the T's pension crisis. The Massachusetts legislature has the legal authority and the political responsibility to act.

Endnotes

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