

State Retirement Agency

Response to Questions Received from DLS

November 14, 2012

DLS recommends that State Retirement Agency (SRA) and board discuss their expectations for the Terra Maria program going forward, and particularly whether the size of the program should be capped now that it appears to have reached a stable level.

The focus of the Terra Maria program* is on investment performance with an alignment of interests. The Program Managers, as well as the underlying investment managers, are regularly evaluated based on performance relative to agreed-upon benchmarks.

As noted by DLS, the performance of Terra Maria varies by underlying investment manager, Program Manager and asset class. Based on demonstrated performance of the underlying managers, the allocation of the public market Terra Maria program is adjusted by the Investment Division and Program Managers toward successful managers and strategies.

Terra Maria managers have experienced similar performance challenges as the broader active management arena in domestic equity management. As a result, the Terra Maria program has contracted slightly in domestic public equity management, even as it has become a larger share (at least 90%) of total active domestic equity for SRPS.

While smaller managers are less numerous in asset classes other than domestic equity, there has been significant success by the Terra Maria managers with international equity, fixed income and real return portfolios.

Current plans are to incrementally build on the successes of the Terra Maria program to date, focusing on the asset classes that have outperformed, while maintaining the Terra Maria domestic equity program with those managers that have demonstrated potential for outperformance. Additionally, starting in late 2010, the Terra Maria program was expanded to include smaller private equity managers who satisfy the due diligence and investment case requirements of the System.

Over time, the Terra Maria program should be allowed to shift to managers and asset classes where it can be most successful. This evolution is preferred to an imposed 'cap' on the program or any of its constituent parts.

*For a full description of the Terra Maria program:

<http://www.sra.state.md.us/Agency/Investment/Downloads/TerraMariaDevelopingManagerProgram-Description.pdf>

DLS recommends that the board and State Retirement Agency discuss their overall asset allocation strategy, particularly the role of alternative asset classes, in achieving the system's funding goals. Also, the discussion should address the advisability of continuing to expand the credit asset class as economic conditions improve. It should also discuss the relationship between the assumed rate of return and the asset allocation.

Over the last several years, the System's exposure to alternative assets has expanded as assets have been gradually transitioned from traditional asset classes, like stocks and bonds, to non-traditional strategies such as private equity and debt, absolute return and hedge funds and commodities. These alternative assets provide attractive characteristics that improve the overall expected risk/return profile of the fund. Alternative assets serve various roles in the portfolio in addition to the broad diversification benefits provided by investing in more asset classes, including excess performance generation, risk reduction and inflation protection.

1) Generate Returns

The primary role of private equity is to generate returns in excess of the public equity market over time. This performance premium should be expected as compensation for taking on the liquidity risk associated with private equity. If private equity were not expected to outperform public equity, the System would avoid the asset class. In fact, private equity is expected to be the System's highest performing asset class. Even though the MSRPS private equity program is relatively young, the performance has been strong, as shown in the following table.

**Performance Comparison
Cumulative Periods Ending June 30, 2012**

	1 Year	3 Years	5 Years	10 Years
Maryland Private Equity Program	7.49%	15.16%	6.03%	8.56%
S&P 500 Index	5.45%	16.40%	0.22%	5.33%

Currently, private equity accounts for just under 6% of total fund assets. In order to maintain vintage year diversification and to spread the investments of the private equity program over time, the System is gradually increasing the funds dedicated to private equity according to a multi-year plan. As the private equity portion of the fund grows to its long-term allocation of 10% of total fund assets, the total fund impact of the higher expected returns of private funds will expand.

2) Reduce Volatility

Absolute return strategies and hedge funds are expected to serve a different purpose in the portfolio. While private equity is expected to be a performance driver, the role of the hedge funds in the portfolio is to reduce risk relative to public equity. The return volatility associated with public equity accounts for the vast majority of the System's total risk. Hedge funds are expected to reduce this volatility by providing some downside risk protection. This can be illustrated by comparing the performance of hedge funds and public equity for fiscal year 2009, a period marked by extreme volatility associated with the financial crisis.

Performance Comparison Fiscal Year Ending June 30, 2009

	FY 2009
Maryland Absolute Return Program	-6.36%
HFRI Fund of Funds Index	-15.22%
S&P 500 Index	-26.22%

Though the absolute return program, at a combined return of -6.36%, failed to provide positive returns in FY 2009, their performance was impressive relative to public equity as represented by the S&P 500 at -26.22% on the year. The HFRI Fund of Funds index performed a full 10 percentage points higher than US equity, demonstrating to many investors the downside protection hedge funds can provide, relative to public equity. However, the Maryland program also outperformed the HFRI Fund of Funds index, magnifying the protective effect on the portfolio.

While hedge funds are expected to provide some protection and outperform public equity in down markets, that outperformance will not persist in strong bull markets. Over a complete market cycle, however, hedge funds can be expected to achieve returns comparable to public equity, with less volatility. As seen in FY 2009, this tendency toward counter-cyclicality is valuable in providing balance to the portfolio and curbing the effect of market downturns.

3) Protect Against Inflation

Alternative strategies are also used by the System for inflation protection and income generation. The System invests in real assets such as real estate, commodities, energy, infrastructure, credit and timber to serve this role. In high inflationary environments,

traditional asset classes like stocks and bonds typically do not perform well, as inflation erodes the values of current holdings. The inclusion of alternative inflation-linked strategies results in a more balanced portfolio that should provide some protection as the asset values underlying these strategies tend to rise with inflation. Some of these strategies are relatively new for the Maryland fund, but real estate is a long-standing asset class in our portfolio that has historically provided inflation protection and solid long-term returns (8.22% net annualized over ten years). These returns were supported by property incomes even as asset values fluctuated.

Because inflation can accelerate unexpectedly, some of these protective strategies are put in place during periods of low inflation as a protection against future price level increases. Currently, the Real Return portion of the MSRPS fund, which contains the various inflation-linked strategies, totals about 10% of the total fund, but is planned to increase to 15% of the total fund.

The Credit/Debt asset class was established to take advantage of the dislocation in the capital markets following the financial crises of 2008-2009. While capital markets have stabilized somewhat since then, there continues to be attractive opportunities to generate equity-like returns with lower volatility in this area. Given this, the continued expansion of the Credit/Debt asset class is warranted.

In summary, the alternative asset classes have been put in place to provide return generation, volatility reduction and inflation protection for the total plan. Alternatives play an important role in the long-term return expectations for the portfolio. The return expectation is calculated annually by the board's general investment consultant, based on the asset allocation and capital market expectations (return, risk and correlations) for each asset class. As of May 2012, the expected annualized long-term return was 8.3% assuming 3% annual inflation. The actuarial long-term assumed rate of return, currently 7.75% annualized, is adopted by the board in its annual actuarial review.

DLS recommends that SRA and the board brief the committee on the steps it has taken to restructure the program and the expected advantages and risks associated with its changes.

Across the market, the universe of active domestic and international public equity managers has increasingly failed to exceed the performance of stock indices. Two main reasons broadly recognized for this are: 1) the very high efficiency of the domestic and international developed equity markets, as well as increased efficiency of emerging equity markets; and 2) the challenge of choosing high-performing stocks using bottom-up, fundamental analysis in the alternating risk-on, risk-off environment that has dominated global markets over the last 5 years.

In the global equity arena (combining US and international investment mandates, measured by an index such as the MSCI ACWI), major active equity managers have experienced more success. This is in part due to the ability of global managers to adjust country and region exposures based on their views of the macro environment, as well as due to the broader opportunity set of investment options afforded by a global index.

The performance of the MSRPS active equity managers in great part mirrors the performance of the universe of managers as described above. This is true both in the failure of most of the domestic and international active managers to consistently outperform the Russell 3000 index and MSCI ACWI ex-US and in the success of most of the global active managers to consistently outperform the MSCI ACWI. As shown below, active management in global equity has been able to outperform the index over time.

**Performance Comparison
Cumulative Periods Ending June 30, 2012**

	1 Year	3 Years	5 Years	Since Inception
Maryland Global Equity	-6.64%	11.84%	-2.45%	3.15%
Global Equity Benchmark	-6.49%	11.23%	-2.47%	2.89%

Looking at the same series as of 9/30/12, the Maryland Global Equity portfolio outperformed the benchmark net of fees in every period. Public equity management, in any case, requires a long-term horizon to provide adequate perspective on the potential for consistent performance. Three years is generally seen as a minimum period for judging an active equity strategy.

Fiscal year 2012 was a pivotal point for the MSRPS public equity portfolio in that several portfolios had accumulated a three-year history. After a comprehensive review of the overall portfolio in terms of risk and return characteristics and future expectations, a number of changes have been implemented by the Investment Division, including:

- 1) Reallocation of some domestic portfolios to increase the share of global equity to roughly 35% of all public equity. The purpose is to increase the exposure to global active managers who have been successful. This has resulted in the termination of two domestic equity mandates and major reductions in two others, totaling roughly \$800 million in reduction of active domestic equity management.
- 2) Four terminations and a major reduction of international active mandates resulted in over \$1.2 billion shifting to passive management in the international equity portfolio.

As of June 30, 2012, the resulting domestic equity portfolio was 60% passive or enhanced passive while the passive share of the international equity portfolio was increased to 50%. Outside of the Terra Maria program only \$490 million or 10% of the domestic equity portfolio was actively managed. Since then, further reductions have been made. This shift toward passive domestic and international management, as well as the shift toward more global (combined US and international) mandates, were consistent with recommendations made by the System's general investment consultant, Hewitt EnnisKnupp.

DLS recommends that SRA and the board comment on the analysis of management fees contained in the MPPI report and discuss appropriate criteria for gauging the appropriateness of fees paid to external asset managers.

The State Retirement Agency reports current investment performance net of fees and inclusive of all investment management fees and performance-based incentive fees to all managers. This provides a transparent and comprehensive view of fees paid by the fund on a regular basis, including to the Maryland General Assembly and in the Comprehensive Annual Financial Report. It should be noted, however, that not all states are consistent in how their funds' fees are calculated and reported.

A recent Maryland Public Policy Institute (MPPI) and Maryland Tax Education Foundation (MTEF) report has been circulated which includes information that is incorrect and arguments that are misinformed. The following points are provided to clarify the issues and provide correct information.

The MPPI/MTEF report is substantially flawed and does not take into account the differences among states in reporting practices. Several important errors have been discovered in the MPPI/MTEF report. For example, in several cases fees paid for alternative investment strategies were overlooked by MPPI/MTEF when totaling the fees paid by some states. MSRPS investment staff reviewed the fee reports of several states which were incorrectly or only partially reported by MPPI/MTEF.

For example, the MPPI/MTEF authors reported that New Jersey state funds paid a total of \$13.4 million in investment management fees. This grossly understates the true amount. According to the 2011 annual report of the NJ State Investment Council, its total cost of management was \$205.9 million.

Similarly, the MPPI/MTEF reported that the Texas Employee Retirement System and Teacher Retirement System paid a combined total of \$247 million in investment management fees. However, a review of the Texas Teachers Retirement System's CAFR alone shows total fees of over \$550 million paid by the pension trust fund.

A review of documents from the other states examined shows similar understatements by MPPI/MTEF of those states' fee payments to investment managers.

Industry comparisons of fees often take into account the asset class and broad strategy (e.g. active or passive) of the managers in order to give an apples-to-apples comparison. The investment management report prepared annually by Greenwich Associates shows that in 2011 Maryland paid lower management fees than the state pension fund average for each asset class studied—active U.S. equity, active emerging market equity, active international/global equity and active fixed income. Data from the report is shown in the table below.

**Comparison of
Management Fees in Basis Points**

	Active U.S. Equity	Active International/Global Equity	Active Emerging Markets Equity	Active Fixed Income
Greenwich State Pension Fund Average	35	43	52	21
Maryland	29	41	41	17

Source: Greenwich Associates 2011 United States Investment Management Report. 100 basis points = 1%.

The MPPI/MTEF report refers to the full amount of fees paid by MSRPS as “Wall Street Fees.” While the MSRPS endeavors to minimize fees for comparable services, it should be noted that the professional investment management firms servicing the MSRPS are located in geographically diverse areas. Only 18% of assets is managed by firms headquartered in NY State. Eighty-two percent is managed by firms located elsewhere, including 7% by Maryland firms.

In summary, the State Retirement Agency has taken measures to ensure that fees paid for passively- and actively- managed assets do not exceed industry standards. Alternative investment strategies, such as private equity and absolute return strategies typically cost more than traditional asset classes and will tend to increase the average cost of management as alternatives gain greater weight in the fund. However, it is important to remember that performance of the SRPS fund is routinely reported net of all fees, in order to provide an accurate and transparent view of plan performance. As of June 30, 2012, the System’s net total fund performance exceeded its benchmark over a one-, three- and five-year period.