State pension plans would be better off avoiding external management fees

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Recent research from North Carolina State University finds that state pension plans would be better off avoiding external asset managers when investing their plans' assets—and would carry substantially smaller unfunded liabilities if they simply invested in a conventional index fund.

"We set out to answer three questions about state pension plans, their external management fees and the return on their investments," says Jeff Diebold, an assistant professor of public administration at NC State and co-author of a paper on the work. "First, what influences the amount of money that state pension plans pay in external management fees? Second, do higher fees lead to better performance? And third, how would those pension plans have fared if they had taken the money spent on external management fees and invested it in a conventional portfolio, with 60 percent invested in the S&P 500 and 40 percent invested in an intermediate bond fund?"

To address these questions, the researchers turned to the Public Plans Database, where they were able to find data from 49 state-administered pension plans—spanning 30 states—regarding how much those plans spend each year on external management fees. Specifically, the researchers evaluated data on the performance of those 49 plans, spanning the years 2001-2014.

Their first finding was that if states had to begin paying more money into their pension plans, they became more likely to pay higher external management fees—though this was moderated by plan size. The effect was still seen in large pension plans, but it was less pronounced than was seen in smaller plans.

"This makes sense, in a way, because the pension plans are trying to achieve returns that outstrip the stock market as a whole," says Jerrell Coggburn, a professor of public administration at NC State and co-author of the paper. "And larger plans may be able to negotiate better fees with external managers."

"Unfortunately, higher fees did not lead to better performance," Diebold says. "There was no positive relationship between what plans paid in fees and how they performed. You don't always get what you pay for."

For the third research question, the researchers only evaluated 42 of the 49 plans, because the evaluation required at least 10 years of data. But for those 42 plans, the researchers found that the more a plan spent on external fees, the more it lost—relative to what it would have made investing in the conventional portfolio of the S&P 500 and intermediate bond funds.

For example, the plan that spent the fourth least amount of money on external fees would have cut 5 percent of its unfunded liability if it had invested in the conventional portfolio. The median plan would have eliminated 14 percent of its unfunded liability. And the plan with the fourth highest fees would actually have recouped 44 percent of its unfunded liability—approximately $4.2 billion—if it had invested its external fees in the S&P 500 and intermediate bond funds. In this context, an unfunded liability is the amount of the pension plan's obligation for which the plan has not set aside money.

"And the losses may actually be worse than that, because the study doesn't account for carried interest," Coggburn says. "Carried interest refers to a percentage of any returns that external managers earn, over and above the flat fees they take for their services. And carried interest can account for around 20 percent of earnings from an external manager's investments. We couldn't account for carried interest because almost no plans share that information publicly."

"This work suggests that the fees associated with external managers—and the dearth of corresponding benefits associated with those fees—contribute to an unnecessary risk of underfunding state pension plans," Diebold says.

The paper, "The Determinants and Opportunity Costs of External Management Fees for State-Administered Pension Plans," is published in the journal *Public Budgeting & Finance*.

More information: Jeffrey Diebold et al, The Determinants and Opportunity Costs of External Management Fees for State-Administered Pension Plans, *Public Budgeting & Finance* (2018). DOI: 10.1111/pbaf.12207

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