

Options for Improving PERA Investment Governance

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Background

- Think New Mexico studied ways to improve public pension performance as part of our 2019 report on retirement security
- PERA oversees an \$18 billion trust fund on behalf of more than 90,000 state employees and retirees
- Concerns have been expressed by the State Auditor, LFC, PERA members, and legislators about current PERA board performance



Pension Governance Matters

- Poor governance can cost pensions 1-2% annually according to research presented to IPOC in 2019
- 1-2% of the PERA fund is \$180-\$360 million dollars each year
- Requiring pension board members to have relevant qualifications tends to improve pension fund investment performance

NM Pension Board Qualifications

- Currently, no member of the PERA board is required by statute to have any relevant qualifications
- By contrast, in 2011, the legislature added qualifications for a majority of ERB board members:
 - the two ERB members appointed by the governor must have “a background in investments, finance, or pension administration”
 - designees by the Treasurer and Secretaries of Public Education and Higher Education must “possess experience relevant to the financial or fiduciary aspects of pension or investment fund management”

Best Practices for Pension Board Composition

“Representation on pension fund boards by state officials—often determined by statute decades past—is negatively related to the performance of private equity investments made by the pension fund, despite state officials’ relatively strong financial education and experience.

Boards dominated by elected rank-and-file plan participants also underperform...due to these trustees’ lesser financial experience.”

Source: Joshua Rauh, et. al., *Political Representation and Governance: Evidence from the Investment Decisions of Public Pension Funds*. The Journal of the American Finance Association, October 5, 2018.

Option 1: Restructure the PERA Board

- Change the PERA board from a 12-member board with 10 elected members to a 9-member board with mostly appointed members
- All nine board members would be required to have “skill, knowledge and experience in financial matters” and two public members would have “skill, knowledge, and experience related to investing”
- Along with adding qualifications, this proposal tracks with other best practices for pension boards from the Center for Retirement Research:
 - Ideal pension size = 6-10 members
 - Should consist of no more than 70% active & retiree membership
 - Removes elected officials from the board

Proposed new PERA board membership:

- one active member of a state general coverage plan appointed by the state personnel board
- one active county employee appointed by New Mexico Counties
- one active municipal employee appointed by the New Mexico Municipal League
- one active member appointed by the unions
- one public representative who is not a member and has skill, knowledge and experience related to investing appointed by the Speaker of the House
- one public representative who is not a member and has skill, knowledge and experience related to investing appointed by the Senate President Pro Tem
- the Secretary of Finance and Administration, and
- two retired members appointed as follows (alternately, these could remain elected):
 - one appointed by the Retired Public Employees of New Mexico, and
 - one appointed by the unions

Why Appointed vs. Elected Board

- PERA board elections have extremely low participation
 - Around 10% turnout for state and municipal active member positions
 - Just 35% turnout for retiree positions
- The board tends to be dominated by members from Albuquerque and Santa Fe, where it is easier to campaign among concentrations of public employees
- An appointed board can better balance geographic and stakeholder representation, along with ensuring financial expertise

Option 2: Consolidated Investment Board for PERA & ERB

- PERA and ERB boards would remain as they are, but their responsibilities would be limited to plan and benefit administration
- A new, qualified investment board would oversee assets of both funds
- This would likely reduce fees and result in better investment deals because the consolidated board would have more assets under management

Proposed Consolidated Investment Board membership:

- the Executive Director of PERA
- the Executive Director of ERB
- one finance/investment expert appointed by the Governor
- one finance/investment expert appointed by the Senate Pro Tem
- one finance/investment expert appointed by the Senate Minority Leader
- one finance/investment expert appointed by the Speaker and
- one finance/investment expert appointed by the House Minority Leader

Other States with Consolidated Pension Investment Boards

- Florida
- Indiana
- Maine
- Nevada
- Tennessee
- Washington
- West Virginia
- Wisconsin

Challenges to the Pension Sustainability Formula

➤ Governance & Operating Model Built for the Past



- Short of Actuarial Required Contributions (ARC)
- Local Gov't Strained Budgets
- Employees unable to withstand lower take-home pay

- Poor Board Governance & Expertise
- Expected returns < 7%
- Uncertain Post-COVID Economy
- Attracting & Retaining Talent

- Demographic bulge- Retirees 2 to 1
- Over-promised
- Unfunded benefit enhancements

4 Pillars for Pension Success

Pillar #1: Good Governance

- Organizational Expertise & Focus
- Board Professionalization
- Delegation of Investment Authority to Staff

Pillar #2: Flexible Plan Design

- Cost Sharing

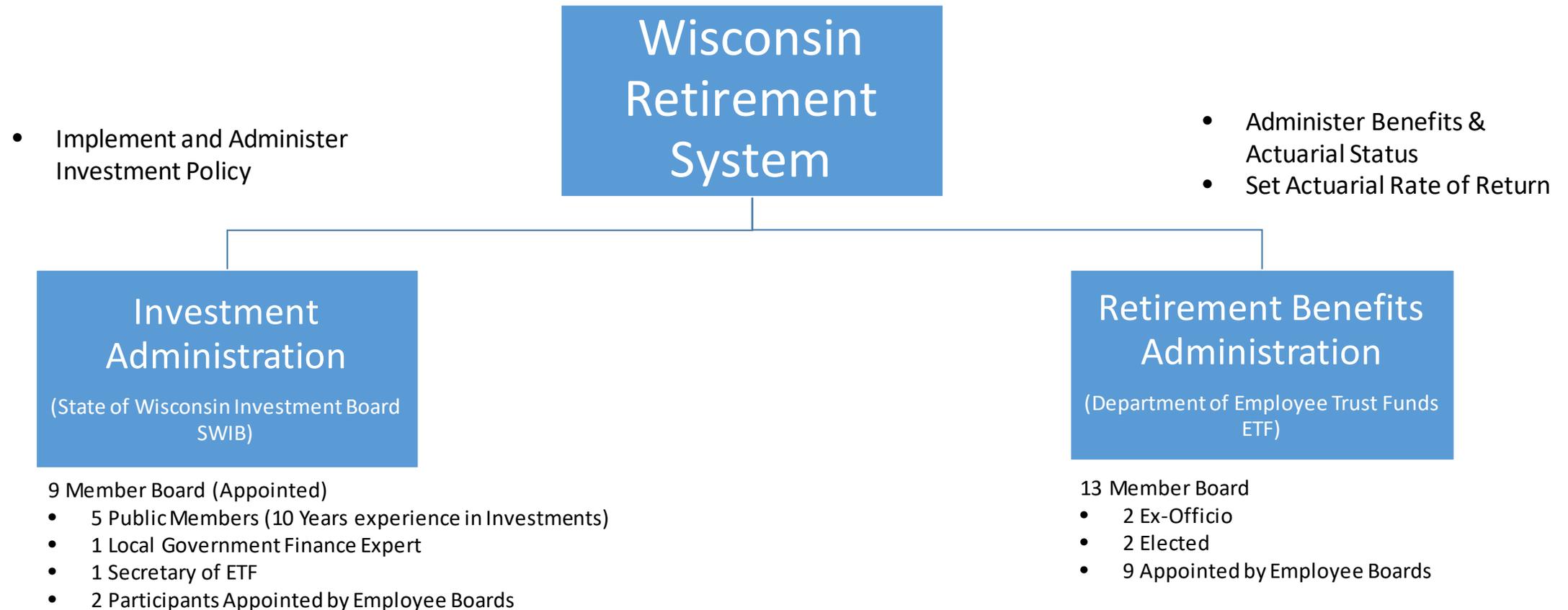
Pillar #3: Portfolio Best Practices

- Non-Traditional Investment Tools to Meet Hurdles

Pillar #4: Attract & Retain Talent

- Run Like a Business

Pillar #1: Good Governance Organizational Expertise & Focus



Pillar #1: Good Governance

Board Professionalization

1. Politically Affiliated

- Allocate higher proportion of assets to risky assets
- Use higher liability discount rates
- Lower risk-adjusted performance
- Private Market performance lower-due to more expensive investment vehicle use (fund of funds), over-weight in-state investments
- Higher political contributions to Board Members

2. Member Elected

- Allocate higher proportion of assets to risky assets
- Use higher liability discount rates
- Lower risk-adjusted performance
- Private Market performance lower-due to more expensive investment vehicle use (fund of funds)
- Tend to lack requisite business/financial expertise

3. Professional/General Public

- Professionalized Board typically are paid with required business/finance background
- Performance superior to model 1 and model 2
- Impact of good governance may be as much as 100-300 basis points each year.

Sources: Watson Wyatt, 2006; Ambachtsheer, 2007a; Ambachtsheer Dec. 2016; "Best Practice Pension Fund Governance" *Journal of Asset Management* vol 9, 1, 2-21; 2007

Pillar #1: Good Governance

Investment Delegation to Staff

	Decision Mode	*Area of Focus	* Best Practice Meeting
Board	Strategic	Strategic direction Asset allocation Approve plan risk tolerance and active risk budget Performance & program evaluation	Board 6-8 times per year
Investment Committee	Strategic	Recommend Asset Allocation Recommend Active Risk Budget Benchmarking	Staff Investment Committee (Monthly)
Staff	Implementation	Asset allocation implementation Active risk budget implementation (manager selection, diligence, monitoring) Education	N/A
Consultant- Board	Strategic	Strategic direction Asset allocation Active risk budget Benchmarking Advising on program evaluation Education	N/A
Consultant-Staff	Implementation	Manager selection, diligence, monitoring	N/A

“Research suggests impact of good governance may be as much as 100-300 basis points each year.”

Source: Ambachtsheer, 2007a; Watson Wyatt, 2006

“Canadian Model funds were more successful at generating positive [net value add] over the 2006-2015 period than most of the 132 other funds.”

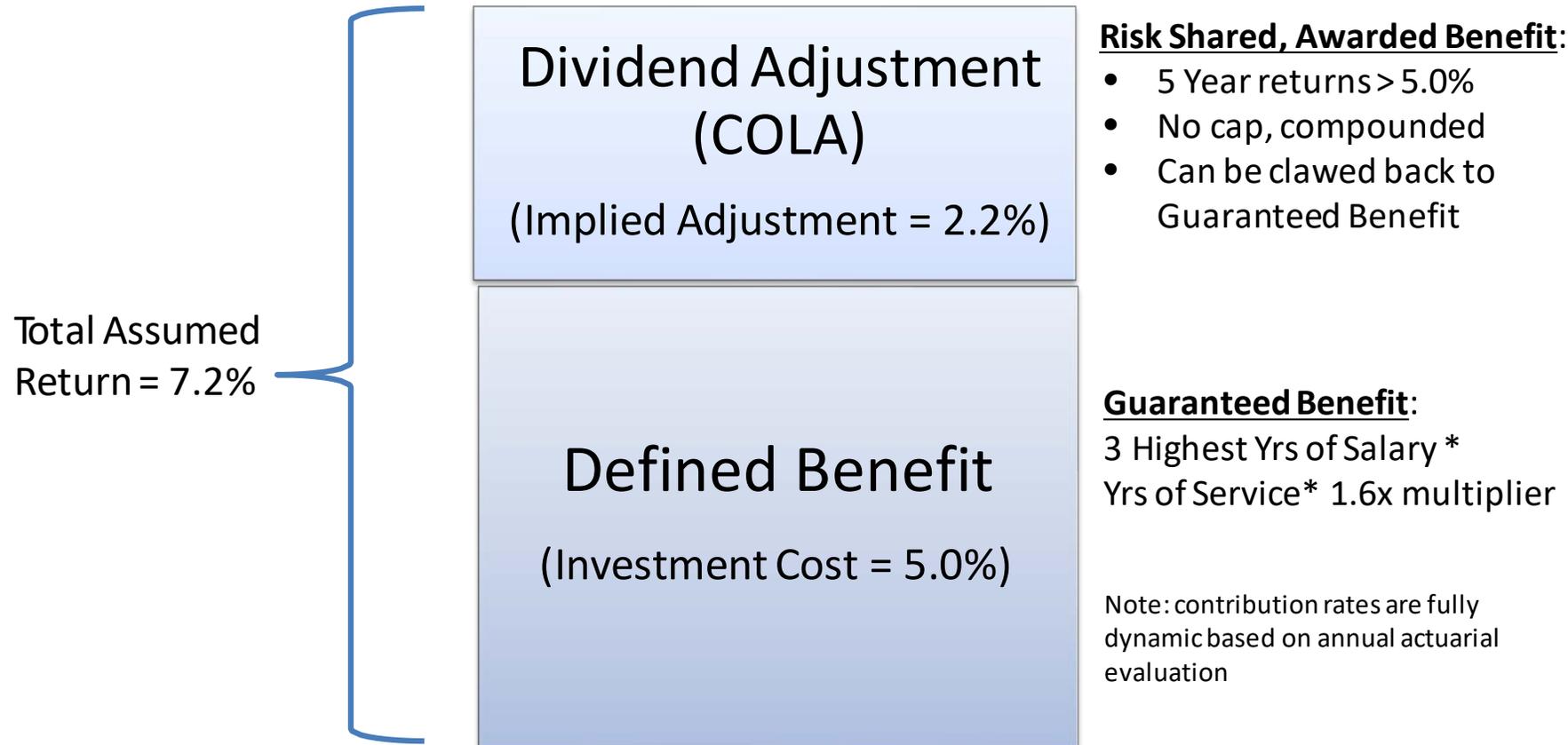
Source: Ambachtsheer Letter, August 2017

Source: Clark and Irwin. “Best-practice.”

Journal of Asset Management Vol.91, 2-21 pension fund governance

Pillar # 2: Flexible Pension Design: Wisconsin Cost Sharing Example

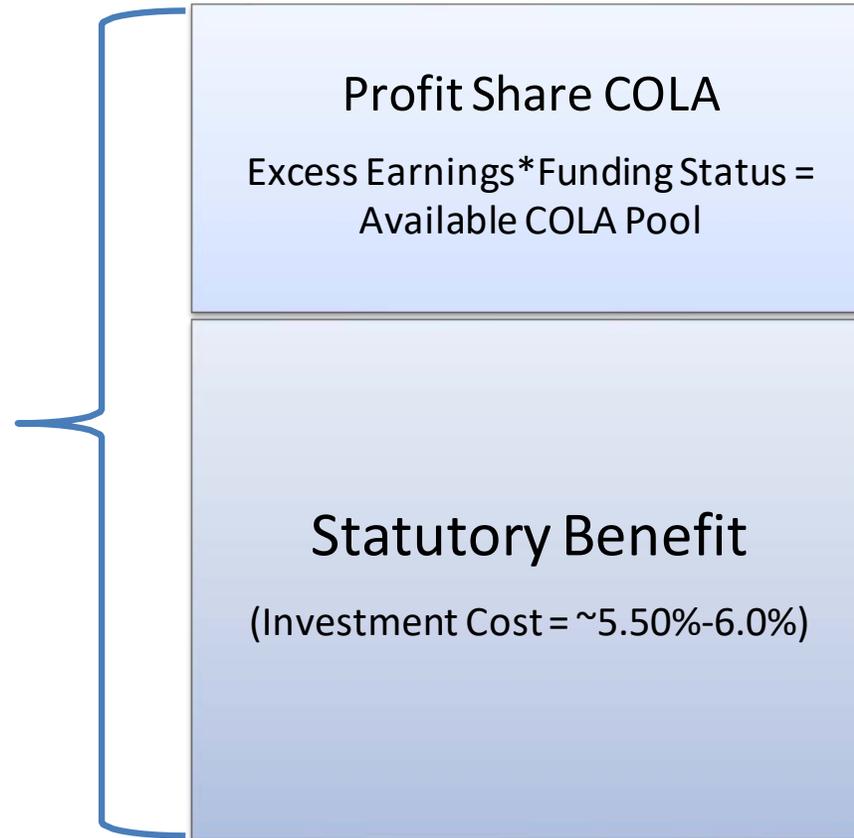
Total Benefit = Defined Benefit + Dividend (COLA)



Pillar #2: Flexible Pension Design: New Mexico Cost Sharing Example

Total Benefit = Defined Benefit + Profit Share COLA

Total
Assumed
Return
= 7.25%



Additional, Awarded Benefit:

- Profit Share COLA shared based on earnings
- COLA 0.5% to 3.0% up to 5%
- 1 year after retirement
- No age limit

Guaranteed Benefit:

Tier 1
Tier 2

Note: contribution rates are dynamic to the downside with triggers based on funding ratio

Pillar #3: Portfolio Best Practices

Non-Traditional Methods

Alpha

- Embrace **active management** from everywhere...**Long Biased, Hedge Funds, Private Assets**
- Use **Portable Alpha** to unleash impact of Hedge Funds
- Use Excess Value to Separate Alpha & Beta in **Private Assets**

Beta

- Invest via **Ratio**. Get your **Ratio** Up.
- Two efficient frontiers: Levered and Un-levered
- Lever to increase risk of diversifying assets.
- Truly extract a diversification bonus.

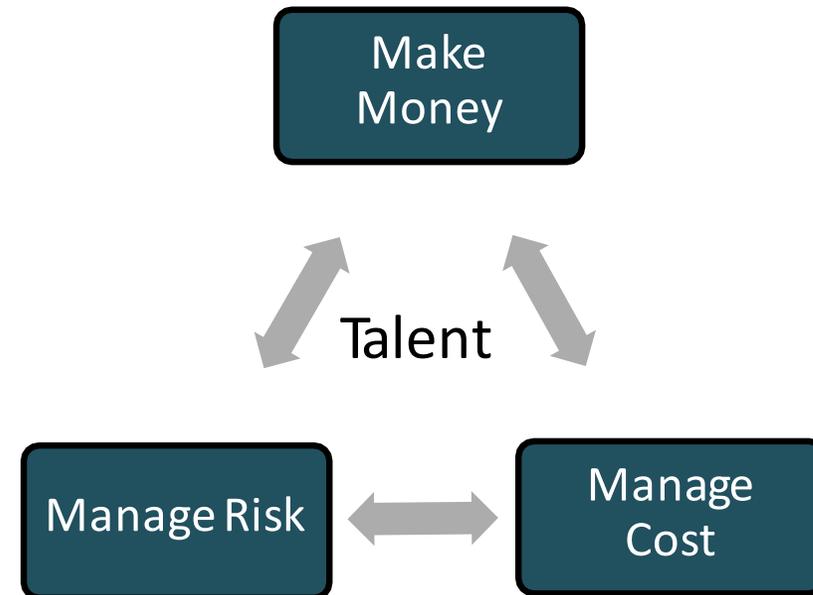
Cash

- Near zero. Controlled by Central Bank.
- Foundation of all returns

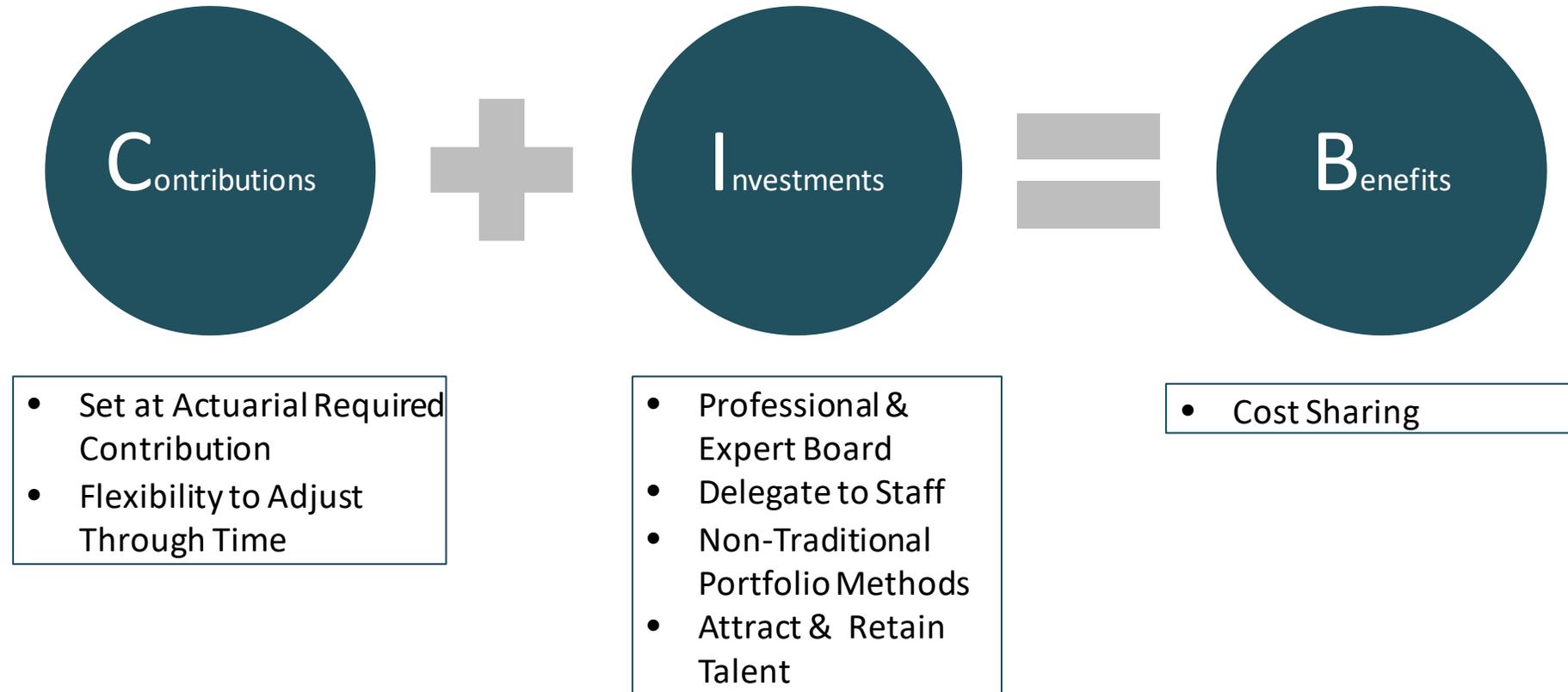
- Embrace Active Management
- Use Leverage at the Total Plan
- Set Risk Budgets
- Use Internal Management to Reduce Cost
- Separate Active and Passive Returns

Pillar #4: Attract and Retain Talent

- Manage like a business: budget flexibility & human resource policies
- To manage non-traditional portfolios: you need good people
- Incentivize and produce value added creation
- Market competitive salary + Pay for Performance
- Hold staff accountable
- Compensation consultant & committee



Best Practices Summary: Pension Sustainability Formula



Conclusion

We encourage IPOC to endorse one of the reform options presented here for the 2022 legislative session.

The PERA board urgently needs to be fixed for the sake of state taxpayers and the current and future retirees who depend on it.

Speaker biographies



Kristina G. Fisher, Associate Director, Think New Mexico

Kristina has served as Think New Mexico's Associate Director since 2008. A lifelong New Mexican, she graduated first in her class from the University of New Mexico School of Law, where she was Editor-in-Chief of the *Natural Resources Journal*. Kristina is a recipient of the national Harry S. Truman Fellowship for Leadership and Public Service and the Morris K. and Stewart L. Udall Award for Excellence in Environmental Studies. She is the co-author of Think New Mexico's 2019 report, "Solving the Hidden Crisis: Achieving Retirement Security for All New Mexicans."

Speaker biographies



Dominic Garcia, Managing Director, Chief Pension Investment Strategist

Dominic is responsible for structuring mission-based investment and funding solutions for U.S. Pension Plans for CBRE Investment Management, U.S. Infrastructure Partners, a \$129 bn asset management firm. Dominic has over 15 years of experience in asset management.

Prior to launching U.S. Infrastructure Partners, Dominic was the Chief Investment Officer at New Mexico PERA, where he oversaw an investment portfolio of more than \$16bn. Previously, Dominic was Senior Funds Alpha Manager at the \$144bn State of Wisconsin Investment Board.

Dominic is a recognized industry thought leader and selected as a Global Power 100 CIO and as a Global Innovative Voice by *Institutional Investor*. Dominic serves on the research and advisory boards for EDHEC Infrastructure Institute, UNC-Kenan Institute for Private Markets, AIF Global, the University of Chicago, Center for Municipal Finance, and Milken Institute, Center for Public Finance. Dominic is a Trustee for the Santa Fe Preparatory School, United World College-USA and for Cliffwater Corporate Lending Funds.

Dominic is a native of New Mexico and graduated from the University of New Mexico with a BA in Political Science and Spanish and the University of Chicago with Master of Public Policy in Public Finance.