Disadvantages of Consolidation

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PERA's position on consolidation

- PERA has historically opposed consolidation of the State's investment agencies
- Consolidation is not consistent with PERA's mission
- Consolidation has the potential to actually increase costs for the PERA Fund and PERA's 100,000 members
- Consolidation would be incompatible with PERA's need to invest in the context of its liabilities and done incorrectly could add to the liabilities

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Consolidation will create confusion in governance

- PERA, ERB and SIC will have
    - Different boards with various election/appointment criteria
    - Separate legal trust funds

- Each board is required to
    - Set asset allocation
    - Determine risk parameters
    - Identify acceptable investment mandates
    - Hire and fire money managers
    - Oversee investment performance
    - Oversee staff

- Conflicting goals and beliefs from various boards can impair performance

- Consolidated staff would be continuously meeting with and reporting to different boards

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Examples of confusion in governance

- No efficiencies of consolidation with disparate board structures
  - New York City $160B system
    - 5 boards of trustees, 1 consolidated staff and multiple general consultants
    - Cited by New York Times (8/3/14) as being hampered by antiquated and inefficient governing structure
  - San Jose, CA has similar issues with multiple boards and different consultants with 1 consolidated staff

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Asset allocation must match liability structure

- Every pension has a different liability structure
- Asset allocation is the primary responsibility of a plan's fiduciary
- Pensions and endowments have very different liquidity needs and investment mandates
- Asset allocation
  - Function of an organization's unique mission
  - Balances unique return expectations and risk tolerances
  - Biggest driver of returns

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Consolidation may lead to diseconomies of scale

- Larger portfolios have fewer investment options than smaller portfolios

- Larger portfolios may be limited to large asset categories by virtue of their size

- Example
    - Inefficient and immaterial for $50B pool to invest in early stage venture capital
    - Yet early stage venture capital has 30-year return of 21.88%
    - Larger capital private equity has 30-year return of 13.57%
    - Incremental cumulative 30-year return of 997% for smaller strategy
    - 10% of PERA's private equity portfolio invested in early stage venture capital

- Smaller portfolios can access less efficient, more capital constrained strategies

Wilshire TUCS Performance Comparison

According to the 6/30/2015 TUCS Report, as fund size increases median performance decreases over the long term.

Fund Size	Median Fund Size in Category	10 year return	15 year return	20 year return
> $1 billion	$10.7 billion	6.93%	5.92%	8.15%
> $5 billion	$25.3 billion	6.92%	5.77%	8.04%
>$10 billion	$33.2 billion	6.92%	5.69%	8.03%
>$50 billion	$70.0 billion	6.86%	5.62%	8.04%

* Wilshire Trust Universe Comparison Service (TUCS) 6/30/2015 median returns

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Consolidation may be more expensive

- States with more assets have larger staff with greater total compensation
- Wisconsin SWIB (~$100B),140 employees dedicated to investment program
- CIO compensation
  - Pension funds - CalPERS, CalSTRS, SWIB, Texas TRS compensation greater than $500,000
  - Public endowments - Cal Regents, Ohio State, U of Michigan, U of Texas compensation greater than $1M
- 2014 PERA total investment staff compensation less than $1M

- As separate legal entities, no savings on attorneys, accountants, consultants, custodians

- Example
  - Custody banking used to have a consolidated contract across agencies
  - PERA issued RFP for its own custody banking services
  - PERA's custody expenses decreased by 30+% and service level increased

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Fees in context- Investment Management Fees

- Larger asset pool does not necessarily equal lower cost structure

Agency	Assets ($B)	Investment Expense (bps)[3]
PERA[1]	14.5	42
CalPERS[2]	300	57
CEM Benchmark median[4]	(Range) 0.155 – 284	58

- Cost structure does not drive investment returns
- PERA reduced its pro forma investment manager fees in FY 2015 by over $10M
- PERA has a lower budget request for FY 2017 than FY 2016 as a result of fee savings

1) September 2015 Fee Presentation
2)April 2015 CALPERS Press Release
3)1 basis point (bp) = one hundredth of one percent
4)Excludes performance fees and includes administration expenses

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Fees in context- Administrative expenses

- Investment staff is one of the lowest relative expenses for all agencies

Agency	Assets ($B)	Admin Expense (bps) [3]
PERA[1]	14.5	4
Texas TRS[2]	130	4
U.S. DB Universe Range[4]	(Range) $155M - $283B	4.5

- Administrative expenses include staff, custody banks, consultants, legal fees, accounting fees, etc.

1) September 2015 Fee Presentation
2) FY2014 CAFR
3) 1 basis point (bp) = one hundredth of one percent
4) CEM 2013 Investment Benchmark Analysis (Benchmark DB)

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Operating challenges

- Each agency is its own legal entity and is funded by separate trust funds
  - Can create challenges in allocation of expenses
  - May make it difficult for LFC and DFA to provide budgetary oversight

- Each agency has its own budget– invoices and BARS would be complicated

- Each agency is required to maintain separate books and records
  - Would create financial statement and audit challenges for each agency
  - May impair ability for agencies to maintain adequate control environment

- Actuarial valuation more challenging to calculate

- Each agency has unique cash flow requirements
  - Differing liquidity needs may sub-optimize asset allocation
  - PERA might not be able to internally control cash for benefit payments

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Introduces new risks

- No agency in New Mexico has experience managing $50B
- Single agency risk – pay-to-play scandals
- Friendly competition from agencies is healthy and inures to the benefit of the State
- Agencies manage assets differently – some internally managed and others externally managed
- Time
  - Consolidation is timely and expensive
  - Existing money manager commitments can last up to 17 years
  - Negative motivation for staff and performance at each agency may suffer as a result

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No clear precedent

- All states with sovereign wealth funds greater than $5B (AK, TX and WY) have separate pension systems
- In states with consolidated structures (NE and WI) endowment assets are less than 3% of total
- Nearly all major public university endowments are managed separately from public pension systems
- Unlike New Mexico's agencies, states with consolidated investment agencies often
  - Consolidate boards to avoid the diseconomies from duplicative functions
  - Delegate money manager hire and fire decisions to staff

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Conclusion

- PERA has serious reservations about agency consolidation

- Consolidation is actually likely to
  - Increase PERA's expenses
  - Negatively impact PERA's investment portfolio
  - Put at risk PERA's tight control over liquidity
  - Introduce accounting and actuarial uncertainties
  - Undermine the fiduciary duties of the PERA Board

- Consolidation would require time consuming and expensive constitutional amendment process without any real benefit or cost savings to the State or PERA

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