Concerns About Commingling SURS' Pension Trust Funds

January 2009

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Two separate subjects are included in the Treasurer's bill proposal: commingling trust fund assets and ethics.[1]/ The two subjects should be addressed in separate bills.

The SURS Board has long supported strong ethics standards and transparency. The SURS Board has serious questions and reservations about combining SURS investment functions with other, unrelated retirement systems.

Many concerns about combining trust fund assets are universal. For example, the Treasurer's cost analysis is unjustified and incomplete. Cost of investment is only a small part of the picture. The real issue is net return on risk-appropriate investments. To date, the analysis of the Treasurer's proposal has failed to address meaningfully the issues of investment return and risk (such as diversification and asset/liability appropriateness of investment).

SURS' unique position as a low cost, high performing, and ethically untainted retirement system causes distinct concerns about commingling assets with other retirement systems. Mixing trust fund assets with other retirement systems produces **no advantage for SURS** and many real and potential disadvantages.

Finally, SURS is the only retirement system which has a Defined Contribution (DC) plan. In a DC plan, each plan member chooses his/her own investments from a menu chosen and monitored by the SURS Board. The Treasurer's proposal doesn't address the SURS DC plan at all and doesn't account for the investment expenditures attributable to that plan.

For these reasons, SURS respectfully suggests:

- **Two bills.** The Treasurer's proposed legislation should be contained in two separate bills, one bill addressing ethics and a separate proposal to mix trust fund assets and combine investment functions. Each subject should rise or fall on its own merits. Good ethics provisions should not be endangered by controversial commingling provisions.
- **Exclude SURS Investments.** Any proposal to mix trust fund assets should exclude SURS. SURS' proven record of low cost, high performance, risk appropriate investment should not be ignored in favor of an untried, untested notion. Also, SURS will still have unique DC plan investment functions not handled by ILPERS. Of course the ethics provisions should still apply to SURS.

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[1]/ The bill proposal also includes authorization for investment for the Illinois Bank Examiners' Education Foundation (IBEEF) by the newly created "Illinois Public Employees' Retirement System". IBEEF is not a public employee retirement system.

The concerns are essentially the same as when this proposal was first proposed by Governor Blagojevich six years ago. Some of the concerns are:

1. Commingling Assets Increases Risk of Improper Conduct.

A. Pooling Assets Increases Danger of Improper Control.

The current system of having the separate retirement system assets managed by separate boards of trustees makes it more difficult for any person with criminal intent to reach all of the state's pension assets. Separation of the investment functions for the three funds minimizes the chances that any person or group with criminal intent could get access to the combined pension investment portfolio. [2]/

B. Combining Assets Decreases Review of Investment Transactions.

Twenty-nine Board members now have fiduciary responsibility for retirement system investment transactions.[3]/ ILPERS will have 13 Board members, at least two of which will have built-in conflicts of interest as elected officials.[4]/ The "Oversight Board" does not correct the deficiency, as the Oversight Board members, who only provide "advice, consultation,

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[2]/ Putting all your livestock in one pen just insures an easier meal for the wolves. Documents filed by the U.S. Attorney's office in the Rezko case indicated Rezko and Levine discussed that they did not have any control over SURS, even though they considered the Illinois State Board of Investment (ISBI) under their influence. United States v. Rezko, Case No. 05 CR 691-4, Northern District of Illinois (December 21, 2007), pp. 39-40, 44. Had a consolidated investment board existed, one bad actor could have exercised the same control over all pension funds as those criminals exercised over some of them.

[3]/ Currently 9 Board members review each SURS investment transaction. The Illinois State Board of Investment (ISBI) is governed by a 9 member Board; the Teachers' Retirement System (TRS) is governed by an 11 member Board.

[4]/ The bill proposal apparently recognizes the ethical conflict of interest for elected officials (who must run for election every four years versus the long term investment horizon appropriate for a retirement system Board member; who must represent broader constituencies versus the retirement system mandate of administration for the exclusive benefit of the members and beneficiaries; and who must raise campaign contributions versus the investment decisions that must be made solely to benefit the retirement system) but allows an elected state Treasurer and an elected state Comptroller to serve on the ILPERS investment board without restriction. The bill proposal provides, "The appointees [to ILPERS] shall not hold any other public office, nor run for public office during their term on the Board." Appointees to the board are appropriately restricted; specified elected officials (the Treasurer and Comptroller) are not.

To reduce the effect of the inherent conflict of interest for elected officials, a more logical consolidation would be to transfer the investment authority held by an elected official only, such as a state Treasurer's authority, to a state investment board, such as the current structure of ISBI (where a state Treasurer's authority is diluted).

and expertise," do not have fiduciary responsibility for the investment decisions and cannot be held responsible for improper investment decisions made by ILPERS, under civil or criminal law.

2. Commingling Assets Will Not Result in Savings for SURS.

The rationale for the asset commingling proposal accounts for too little and assumes too much. The rationale accounts for too little by not analyzing investment risk and returns (as opposed to investment fees). The rationale assumes too much by assuming investment expenses without knowing the asset categories that would be in an ILPERS investment portfolio.

But even on the overly simplistic basis used to justify ILPERS – investment fees only – ILPERS would cost more than the current SURS structure.

A. ILPERS Cost Savings Are Unsubstantiated.

The rationale for the Treasurer's proposal is the investment management cost savings. But even by the Treasurer's calculations, the hoped for savings from the commingled fund is only insignificantly less than the SURS actual, proven investment management fees (an illusory savings of 8/1000th of a percent, less than one basis point).

But even those supposed cost savings are based on assumptions that are unsupported. For example, the explanation of the cost savings assumes "the appropriate amount of total expenses for a $65 billion portfolio [the presumed size of ILPERS] is 26 basis points". That assumption is an unwarranted supposition.[5]/

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[5]/ The basis for all cost savings assumptions by the Treasurer is "a study by the Investment Company Institute" which is purported to contain an assumed appropriate total expense figure of 26 basis points for a retirement system with assets of the size assumed for ILPERS.

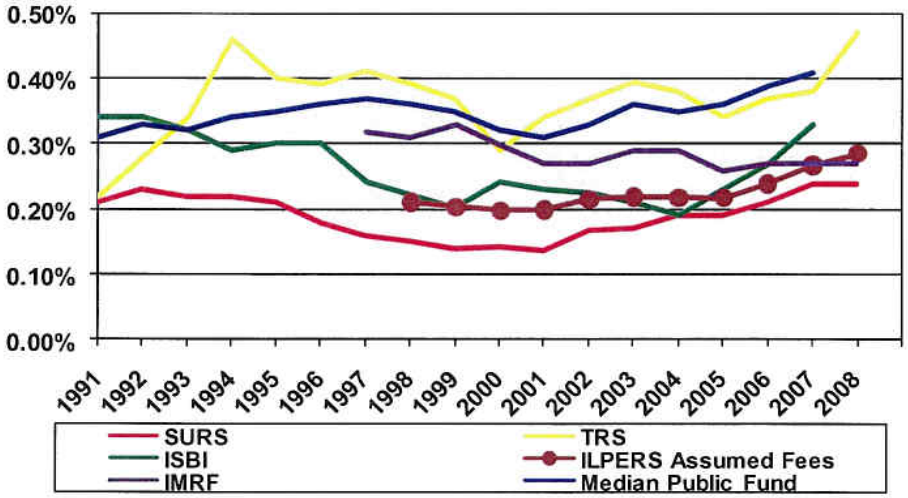
The Treasurer fails to point out the 1998 date of the survey (which was not done by ICI but is only later referenced in an ICI report). Not only would inflation have increased the operations expenses (salaries, rent, etc.), but the last decade has seen a general increase in investment management fees associated with the increased use of alternative investments (with potentially higher rates of return) and international investments (used for diversification and risk reduction).

As examples, SURS had a total operating expense of 25 basis points in 1998 (less than the 26 basis points assumed in 1998 for a fund the size of the proposed ILPERS fund), which increased to 31 basis points in 2008, despite assets increasing by about 63%. Similarly, ISBI had a total operating expense of 32 basis points in 1998, which increased to 41 basis points in 2007, despite assets increasing by about 73%.

As to investment expenses for a fund the size of SURS or larger, the size of the fund is trumped by other factors, such as the asset allocation. The ILPERS investment expense level will depend on which investments would be considered appropriate by the ILPERS Board, which is pure speculation.

The following chart depicts the investment fees paid by SURS, ISBI, TRS, IMRF, the median public pension fund, and the Treasurer's speculative investment expenses for ILPERS. SURS does not want to combine with other retirement systems in an attempt to lower the average fees. SURS is the low cost provider. [6]/

Investment Expenses as a % of Assets



*2008 investment expense information is not yet available for ISBI or the Median Public Fund.
** ILPERS Assumed Fees were calculated using the ILPERS source date (1998) information, adjusting each year by the percentage change reflecting the average percentage change of the Illinois retirement systems.

As the chart indicates, the fees paid by SURS historically have been lower than the other Illinois Funds and the median public fund. Factors contributing to this comparatively lower rate are SURS use of index funds, performance-based investment management fees, and continual monitoring of investment manager fee schedules.

The amount of SURS' assets under management is sufficient to allow SURS to obtain very favorable fee schedules; adding more assets is unlikely to produce more attractive fee schedules than already exist.[7]

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[6]/ SURS also has had a successful emerging manager program, bringing in above-benchmark returns on a net-of-fees basis. As of June 30, 2008, 13.4% of SURS investments were placed with emerging managers, well above the ILPERS proposed 12% goal.

[7]/ An Investment Company Institute report noted the limits to economies of scale. "Research has shown that economies of scale tend to dissipate quickly as the assets expand. * * * This is important because it indicates that the influence of economies of scale on a fund's expense ratio is not limitless, contrary to

B. **SURS Investment Return is Superior to ISBI's (the Current Combined Retirement System).**

SURS, making appropriate investments in consideration of SURS' asset-liability needs, has had superior investment return to ISBI, which is Illinois' current combined retirement system investment model. It makes no economic sense to move assets from a better-performing system to a worse-performing model.

From the most recently published CAFR (June 2007), SURS has higher returns than ISBI over the 3, 5, and 10 year periods.

	3 year	5 year	10 year
SURS	13.4	11.9	8.5
ISBI	12.6	10.8	8.0

Survey data collected from the retirement systems by the Illinois Municipal Retirement Fund shows that SURS' 10 year return has exceeded ISBI's in each quarter reported since June 2003 through September 2008 (17 quarters are reported by ISBI). The average excess performance of 10 year returns over these quarters is 68 basis points. Applied to SURS' average monthly market value from June 30, 2003 through September 30, 2008, SURS excess performance amounted to nearly $95 million each year.

Again, it makes no economic sense to move assets from a better-performing system to a worse-performing model. Note also that ISBI has higher investment expenses and operating expenses than SURS (see graph on page 4 and footnote 5, respectively).

3. The Commingling Proposal Ignores SURS' Responsibilities for the Self-Managed Plan (SMP).

Unlike the other retirement systems, SURS has a defined contribution plan (the SMP) that requires investments be made by the plan members.

Currently 16,052 SURS members are members of the SMP defined contribution plan. These SMP accounts total $562.1 million.

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opinions sometimes expressed. **Indeed, because economies of scale dissipate as a firm's assets expand, asset growth may reduce the expense ratios of already large funds relatively little.**"

ICI Perspective, Vol. 9, No. 6, page 11 (December 2003) (bold added for emphasis). The retirement system trust funds that would be combined by the Treasurer's proposal are already large (in the 8th to 9th decile of fund size). Combining the assets of already large funds "will reduce the expense ratios ... relatively little".

The plan administrator, SURS, is responsible for selecting investment alternatives in which the members can choose to invest. Since this responsibility is not transferred to ILPERS, it would remain with SURS.

However, the bill proposal requires "all employees performing investment functions for SURS shall be transferred to" ILPERS. Section 25-110. This would leave SURS without the expertise to choose and monitor investment alternatives for SMP members.

The bill proposal further requires that "all investments of the assets of the system shall be made by ILPERS". This directly conflicts with the SMP investment structure.

At the very least, if the bill proposal were amended properly, to allow SURS SMP members to choose their own investments from options selected by and administered by SURS, the supposed ILPERS cost savings would need to be adjusted to reflect investment responsibilities retained by SURS and not assumed by ILPERS.

CONCLUSION

For the reasons provided:

1) The Treasurer's proposed legislation should be contained in two bills, one bill containing ethics provisions and the other bill containing the controversial provisions that would commingle the assets of several pension trust funds.

2) Any bill that would commingle the assets of some Illinois pension trust funds should exclude the SURS' lower cost defined benefit plan pension trust funds and the SURS Self-Managed Plan pension trust funds.