Government Finance Officers Association

Investment Fee Policies for Retirement Systems

BEST PRACTICE

BACKGROUND:

Investment management fees can have a major effect on a retirement system's net investment returns. Historically, retirement systems have tried to minimize fees by: 1) using a competitive selection process that makes fee negotiation a key factor in the procurement decision; 2) using low-cost passive index investment strategies; and 3) exploring opportunities for achieving economies of scale. As retirement systems make increasing use of alternative investments such as hedge funds, private equity, and real estate, procedures to identify, quantify, and negotiate all forms of investment manager compensation are needed to minimize the effect these premium-priced investment strategies can have on the retirement system's total returns.

RECOMMENDATION:

To minimize the impact of investment management fees on portfolio returns, the GFOA recommends that retirement systems, especially those that use alternative investment strategies, adopt an investment management fee policy that will allow the retirement system to negotiate the lowest competitive fee possible while looking out for the system's long-term earning potential.
To achieve this goal, an investment management fee policy should adhere to the following guidelines:

1. Staff and consultants should negotiate the lowest competitive fees using measures and techniques such as:

- Determining what fees similar investors are paying and making these peer comparisons part of the negotiation process.
- Including a "most favored nation" clause (ensuring that the type and size of fees are at the level that is being made available to other similar investors) in the agreement.
- Leveraging the consultant's knowledge of the marketplace to minimize fees for contracted services, keeping in mind that fees are a key component of the competitive procurement process.

2. Give a specific individual or group of employees explicit responsibility for negotiating fees, and require that they report on the status of negotiations before the management agreement is executed. Consult with retirement system trustees to determine their interest in alternate fee structures (e.g., a fixed fee versus a performance fee that may have a higher or lower expected cost, based on performance).

3. Identify where the importance of competitive fees ranks among the multiple factors analyzed when selecting investment managers:

- The primary factors to consider are demonstrated track records, proven investment talent, repeatable investment processes, competitive and strategic investment advantages, and other qualitative factors.[1]
- When screening investment managers, make sure fees are reasonable. Future returns are uncertain, while fees can be determined in advance. When one manager's fees are higher than another's, analyze the track record to determine whether the additional cost is necessary and appropriate.
- Because fees for active management can be dramatically higher than fees for passive management, examine the fees, the investment process, and historical performance of active managers to determine the likelihood that their performance will be better than the index return, after fees.[2]

4. When investing in traditional investments, ensure that the pension system is paying a reasonable, competitive fee by implementing the following strategies:

- When using a separate account structure (whereby professional investors manage a portfolio solely for the system), establish fee break points as the manager's mandate grows.[3]
- Explore the possibility of excluding uninvested cash from management fees, where possible. If exclusions aren't possible, consider a refunding arrangement.
- When investing in commingled and mutual funds (investment vehicles that pool assets of multiple investors), ask the manager to identify and quantify all levels of fees.
    - Any fees that aren't directly related to the management of the portfolio should be considered for elimination.
    - Seek access to the lowest-cost share class and require that any fees related to services provided to retail investors be refunded to the retirement system.
    - Ask the investment manager to consider all the accounts it handles for your organization when determining fees.

5. When investing in alternatives, ensure that the retirement system is not paying excessive fees by implementing the following additional strategies:

- Identify all fees. Paying a base fee is usually appropriate, but the fee policy should specify a preference for performance-based fees, where applicable. Focus on aligning the interests of the retirement system and the investment manager through the performance fee structure, potentially including fulcrum fees, hurdle rates, fee caps, and clawback provisions.[4]

- The fee policy should state a preference for performance fees that compensate the manager for alpha rather than beta, and it should include a hard hurdle.[5] Alternative investment managers commonly use "carried interest," or participation fees, which are expressed as a percentage of net returns over a specified minimum return.
- Rather than entering into direct partnerships with alternative investment managers, investigate the possibility of group purchasing arrangements such as an alternative investment fund of a P-share class.[6] These options allow retirement systems to realize pricing concessions based on their meaningful economies of scale and their long-term investment horizon.
- Look for ways to "piggyback" on other institutional investors to maximize economies of scale and increase negotiating leverage.[7] One way of piggybacking is through a cooperative pool, in which an investment manager makes available a separate pool

that provides lower pricing, based on the combined assets in the pool. Such "break points" are employed by mutual funds and commingled investment trusts and can be replicated through investment pools established for public pension funds.

- Hire an attorney to oversee alternative investment contracts.

Notes:

[1]*A repeatable investment processes* is one that is disciplined and consistent in strategy. *Competitive and strategic investment advantages* refer to an advantage that a firm has over its competitors, allowing it to generate greater sales or margins and/or retain more customers than its competition; this can include the firm's cost structure, product offerings, distribution network, and customer support. *Qualitative factors* refer to aspects of a firm's business such as its business model, competitive advantages, management, and corporate governance.

[2] In *active management*, an investment manager attempts to earn more than the average market return. In passive management, the manager simply attempts to replicate the average market return before fees.

[3]*Break point* refers to the investment amount that qualifies the investor for a reduced sales charge.

[4]*Performance fees* are paid when an investment manager achieves an investment return that beats a specified benchmark. *Fulcrum fees* are fees that are centered on a target, or "fulcrum," performance level, which are increased or decreased, depending on performance. *Hurdle rates* are the *minimum rate of return* required for payment of performance fees. *Clawbacks* are payments the retirement system has made that the investment manager needs to return because of special circumstances that are included in the contract, such as failure to meet a minimum investment return.

[5]*Alpha* refers to the portion of investment returns that is attributable to the manager's performance and skill, while *beta* is a measure of an investment's volatility, or systematic risk, when compared to the market as a whole. *A soft hurdle* calculates the manager's performance fee on all the fund's investment returns, if the hurdle rate is cleared. A *hard hurdle* is calculated only on returns above the hurdle rate. A hurdle is intended to ensure that a manager is rewarded only upon generating investment returns that are greater than what the investor would have earned elsewhere in the market.

[6] A P-share class is a special pricing structure established by some investment fund companies; it gives retirement systems access to lower fees than those paid by retail investors.

[7] Pension funds can also pursue collaborative procurement strategies and other methods of lawfully increasing the pension plan's bargaining and purchasing power. Each of the 50 states has enacted statutes permitting intergovernmental service and procurement arrangements.

References:

- Orange County Employees Retirement System Fee Policy.
- Girard Miller, "Managing Against Escalating Pension Investment Fees," *Government Finance Review*, February 2014.