



March 2015

Report No. 15-05

## FRS Pension Plan Investment Returns Are Similar to Other Public Pension Funds; SBA Continues to Increase Alternative Investments

### *at a glance*

The State Board of Administration (SBA) has exceeded market-based investment benchmarks for its largest funds, including the Florida Retirement System Pension Plan. In addition, the Pension Plan fund has generally met the SBA's overall investment objective over several long-term periods, and its performance was comparable to that of similarly sized funds in other states.

Alternative investments such as private equity funds remain a small proportion of the Pension Plan fund, although the SBA has increased the percentage of plan assets invested in alternatives; this larger investment has resulted in significant increases in external management fees. Because fees for alternative investments increase with the dollar amount invested, as more traditional assets are shifted toward alternative investments, investment fees will continue to rise. In addition, the board is continuing to implement additional oversight procedures for monitoring alternative investments.

### Scope

Section 215.44(6), *Florida Statutes*, requires OPPAGA to perform a biennial evaluation of the State Board of Administration's management of investments. This review examines the SBA's Fiscal Years 2012-13 and 2013-14 performance and answers two questions.

- In general, how well are the SBA's major mandate funds performing?
- What steps has the SBA taken to implement the legislatively authorized increase in alternative investments?

### Background

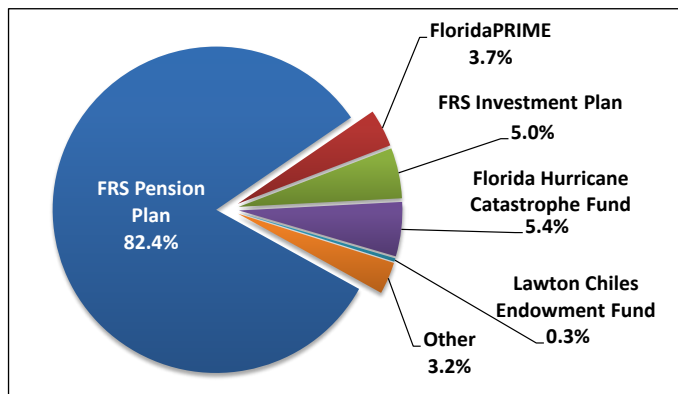
The State Board of Administration is primarily an asset management organization that invests funds contributed on behalf of state agencies, school boards, educational institutions, and units of local government.<sup>1</sup> The board is composed of the Governor, Chief Financial Officer, and Attorney General, who serve as trustees to the funds under board management. The trustees appoint the SBA's executive director, who oversees the general management of investments.

As of June 30, 2014, the board managed 38 funds with a total market value of \$181 billion. The SBA's major mandate investment funds are the Florida Retirement System (FRS) Pension Plan, the FRS Investment Plan, the Florida Hurricane Catastrophe Fund, the Florida PRIME Fund, and the Lawton Chiles Endowment Fund.<sup>2</sup> The largest fund is the FRS Pension Plan, which had net assets of \$149.1 billion and comprised 82.4% of the total assets managed by the board. (See Exhibit 1.)

<sup>1</sup>The SBA also invests funds on behalf of direct-support organizations of the state and political subdivisions.

<sup>2</sup>The SBA defines mandate investment funds as those for which board responsibilities are required by state law. The SBA refers to the five largest of these as "major" mandates. Other mandate funds include the Florida Lottery and the Florida Prepaid College Plan.

**Exhibit 1**  
**The Total Market Value of SBA Investments Was \$181 Billion as of June 30, 2014<sup>1</sup>**



<sup>1</sup> Total market value refers to the net value of SBA assets as of June 30, 2014. Source: OPPAGA analysis of State Board of Administration data.

SBA does not receive a legislative appropriation to support its activities. Instead, the board funds its operational and administrative expenses through fees derived from its investment management services (including those associated with investing assets of the FRS Trust Fund). To manage investment activities, in Fiscal Year 2013-14, the board had an operating budget of \$37.2 million and 190.25 authorized positions.<sup>3</sup>

## Questions and Answers

### *In general, how well are the SBA’s major mandate funds performing?*

The State Board of Administration uses several methods to evaluate fund performance. These methods include examining investment returns relative to market-based benchmarks, comparing the investment returns to those of other large investors, and comparing these returns to the board’s overall investment objective for each fund.

<sup>3</sup> The board also had 53 positions and budgeted \$41.6 million for the Florida Hurricane Catastrophe Fund, the Division of Bond Finance-Arbitrage Compliance, the Division of Bond Finance-Revenue Bond Fee, College Savings Program, Prepaid College Board, and the FRS Investment Plan/Office of Defined Contribution.

OPPAGA reviewed the SBA’s performance in investing fund assets and found that, in general,

- major mandate funds have exceeded their market-based benchmarks for a 10-year period;
- FRS Pension Plan returns have generally exceeded the SBA’s overall investment objective for most of a 25-year period; and
- FRS Pension Plan investment returns were similar to those of other state funds of a comparable size over multi-year terms.

Major mandate funds have exceeded market-based investment benchmarks. The board’s investment returns are important because the earnings help fund a range of state and local government efforts, including pension benefits. SBA investment returns for the five major mandate funds compare favorably to the funds’ benchmarks over 1-, 3-, 5-, and 10-year periods. (See Exhibit 2.) For example, the FRS Pension Plan had a 17.4% return for Fiscal Year 2013-14, which exceeded its 1-year benchmark by 0.4%. The SBA Board of Trustees generally sets these benchmarks at standard market indices.<sup>4</sup>

The SBA’s fund benchmarks vary widely based on the state’s goals for the individual funds. For example, for a fund used for emergencies or short-term goals, like the Hurricane Catastrophe Fund, assets must be easy to liquidate, so they can be distributed quickly in the event of a disaster. Generally, these investments have lower returns and lower associated benchmarks. Conversely, the SBA’s goal for investing FRS Pension Plan assets is to provide investment returns sufficient to ensure timely payment of promised benefits to current and future FRS Pension Plan participants. To obtain sufficient returns, the SBA invests FRS Pension Plan assets primarily in investment vehicles that potentially yield higher long-term returns than bonds and cash. As such, these investments generally have higher benchmarks.

<sup>4</sup> A market index tracks and measures changes in the performance of a specific group of stocks, bonds, or other investments from a specific starting date. As an example, the performance of domestic equities within the Pension Plan fund is measured against the Russell 3000 Index, which is an index measuring the performance of approximately 3,000 of the largest companies in U.S. stock markets.

## Exhibit 2

## As of June 30, 2014, SBA Fund Returns Exceeded Market-Based Investment Benchmarks for Periods up to 10 Years

	1-Year Trailing Return <sup>1</sup>	3-Year Trailing Return	5-Year Trailing Return	10-Year Trailing Return
<b>Florida Retirement System</b>				
<i>FRS Pension Plan</i>	17.4%	10.0%	13.1%	7.5%
Performance Benchmark	17.0%	9.3%	12.1%	7.0%
<i>FRS Investment Plan</i>	15.5%	8.7%	11.0%	6.6%
Performance Benchmark	15.1%	8.5%	10.5%	6.1%
<b>Hurricane Catastrophe Fund</b>				
<i>CAT Operating Fund</i>	0.2%	0.3%	0.6%	1.8%
Performance Benchmark	0.0%	0.1%	0.1%	1.7%
<i>CAT 2013A Fund</i>	0.2%	N/A	N/A	N/A
Performance Benchmark	0.0%	N/A	N/A	N/A
<b>Lawton Chiles Endowment</b>	20.8%	10.3%	13.8%	7.1%
Performance Benchmark	18.4%	9.0%	12.8%	6.4%
<b>Florida PRIME Fund</b>	0.2%	0.2%	0.3%	1.9%
Performance Benchmark	0.0%	0.1%	0.1%	1.7%

<sup>1</sup> A trailing return shows how a fund has performed over the period shown. For example, a 1-year trailing return as of June 30, 2014, would show a fund's performance from July 1, 2013, to June 30, 2014. A 10-year trailing return as of June 30, 2014, would show a fund's performance from July 1, 2003, to June 30, 2014.

Source: State Board of Administration.

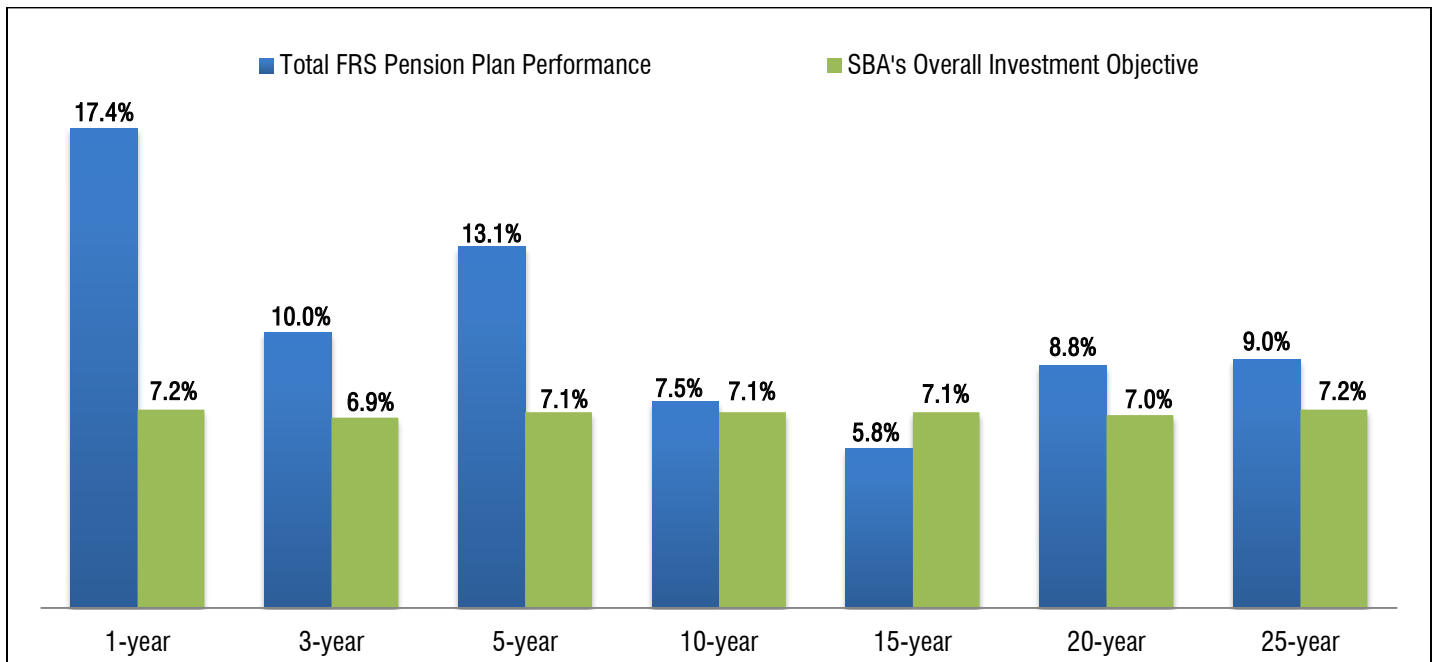
The SBA generally exceeded its overall investment objective for the FRS Pension Plan Fund over time. In addition to market-based benchmarks, the SBA also measures its investment performance relative to an overall investment objective. Specifically, the SBA's overall investment objective is for the FRS Pension Plan to achieve investment earnings of 5% over the annual rate of inflation.<sup>5</sup> As such, the objective varies slightly every year. This objective shows how the fund is performing over multiple market cycles (e.g., over 15 years).

<sup>5</sup> The SBA Board of Trustees sets the overall investment objective and the level of investment risk. The SBA reported that this objective is designed to closely track the investment return assumed by the FRS actuary. It is based on an analysis of expected benefit growth, contribution levels, market performance, and risk tolerance for the fund. The SBA uses the compounded U.S. Department of Labor Consumer Price Index to represent the inflation rate.

The SBA significantly exceeded its overall investment objective over the one-year term. (See Exhibit 3.) The board attributed this performance to high returns in the global equity asset class as well as strategic investments and real estate. In addition, the SBA has generally met its overall investment earnings objectives for the FRS Pension Plan Fund for the long-term (e.g., 20 years and greater), although returns did not meet this objective at the 15-year mark. The SBA reported that the lower return for the 15-year period likely reflects two extreme market events that occurred between Fiscal Years 1999-00 and 2013-14—the “technology bubble” bursting and the recent global financial crisis.

**Exhibit 3**

**SBA Pension Plan Investment Returns Generally Exceeded the Board's Overall Investment Objective for Periods Ending June 30, 2014**



<sup>1</sup> Annualized returns are net of fees.

Source: OPPAGA analysis of State Board of Administration data.

In general, FRS Pension Plan performance was similar to that of several large public pension funds. The SBA's one-year investment performance for FRS Pension Plan funds in Fiscal Year 2013-14 was 17.4%, which was slightly higher than four of seven other pension plans that OPPAGA examined. (See Exhibit 4.)

The SBA's FRS Pension Plan investment performance over other multi-year periods was also comparable to that of other large public pension funds. For example, the SBA's 10-year return on the FRS Pension Plan fund was 7.5%; the seven comparison state funds had 10-year returns that ranged from 6.9% to 8.0%.

**Exhibit 4**

**The FRS Pension Plan's Multi-Year Investment Returns Are Similar to Those of Other Large Public Retirement Plans<sup>1</sup>**

Fund	Overall Rate of Return				Net Market Value of Pension Assets (in Billions)
	10 Years	5 Years	3 Years	1 Year	
California Public Employees' Retirement System	7.2%	12.5%	10.4%	18.4%	\$301.8
California State Teachers' Retirement System	7.7%	13.7%	11.2%	18.7%	\$190.5
New York State and Local Retirement System	7.3%	13.8%	9.8%	13.0%	\$181.2
<b>FRS Pension Plan<sup>2</sup></b>	<b>7.5%</b>	<b>13.1%</b>	<b>10.0%</b>	<b>17.4%</b>	<b>\$149.1</b>
Teacher Retirement System of Texas	7.7%	11.9%	11.1%	16.9%	\$132.2
New York State Teachers' Retirement System	7.7%	13.8%	11.4%	18.2%	\$108.2
North Carolina Teacher and State Employee Retirement System	6.9%	11.5%	9.1%	15.9%	\$90.1
State Teachers Retirement System of Ohio	8.0%	13.6%	10.7%	16.8%	\$75.4

<sup>1</sup> Period-to-period performance results are very sensitive and dependent upon the beginning and endpoints of measurement. Reporting dates for these plans ranged from March 31, 2014, to August 31, 2014. Annualized returns are net of fees.

<sup>2</sup> FRS performance is as of June 30, 2014.

Source: State Board of Administration and OPPAGA review of comprehensive annual financial reports from the Florida Retirement System Pension Plan and other pension plans.

### ***What steps has the SBA taken to implement the legislatively authorized increase in alternative investments?***

Alternative investments represent a relatively small proportion of SBA assets and generally have not met benchmark returns. The FRS Pension Plan is the only SBA major mandate fund that includes alternative investments.<sup>6</sup> The SBA divides these investments into two asset classes: private equity and strategic investments. The investments are generally conducted outside the public securities markets. SBA officials reported that the goals for alternative investments include achieving potentially better risk diversification and investment returns than those found in traditional markets, thereby improving the plan's ability to pay benefit obligations, and providing a hedge against inflation.

For the period ending June 30, 2014, the board's alternative investments had a market value of \$16.2 billion, which is 10.9% of the \$149.1 billion Pension Plan assets. Compared to the FRS Pension Plan's holdings in global equities (\$89.8 billion, or 60.2%) and fixed income investments (\$30.1 billion, or 20.2%), these investments constituted a relatively small proportion of overall plan assets.

The SBA's Board of Trustees sets a unique industry-accepted benchmark for each alternative investment. Like other pension plan asset classes, these are market-based benchmarks; the board adjusts and monitors these benchmarks on a monthly basis.<sup>7</sup> The SBA's summaries of alternative investment performance suggest that, net of fees, these assets are generally not achieving benchmark targets. (See Exhibit 5.)

### **Exhibit 5 Alternative Investments Generally Did Not Meet the SBA's Earnings Benchmarks as of June 30, 2014<sup>1</sup>**

Period	Net Return <sup>2</sup>	Benchmark	
		Return	Value-Added
1-Year	16.78%	19.27%	-2.49%
3-Year	11.78%	13.72%	-1.95%
5-Year	16.53%	16.63%	-0.10%
10-Year	9.03%	10.31%	-1.28%
15-Year	7.61%	7.79%	-0.17%
20-Year	9.21%	8.54%	0.67%
Since Inception (January 1989)	9.61%	10.46%	-0.85%

<sup>1</sup> Data represents net returns as of June 30, 2014, and excludes public market investments. Some of these returns relative to private equity are interim returns, and as such may not be meaningful or indicative of ultimate performance during the early stages of the investment cycle.

<sup>2</sup> SBA reconciles fund manager reports of returns for all alternative investments.

Source: State Board of Administration.

SBA reports that in the early stages of an alternative investment, performance is usually low or negative because fees are paid up front to a general partner, valuations are low, and investment gains have not yet been recognized. Consequently, adding new investments, as SBA has done over the past few years, will often initially depress an alternative investment portfolio's overall return.

SBA plans to increase the proportion of the FRS Pension Plan funds invested in alternative investments. The 2012 Legislature authorized the SBA to increase its allocation to alternative investments from 10% to 20%.<sup>8</sup> As of March 1, 2014, the target allocation for alternative investments was 18%. The target allocation is 6% for private equity and 12% for strategic investment.<sup>9</sup> In the near term, the SBA plans to focus on private equity opportunities in U.S. small and middle-market buyout funds, as well as strategic investment commitments in opportunistic debt and real assets. According to SBA officials, they will determine actual patterns of new

<sup>6</sup> Section 215.4401(3)(a), *F.S.*, defines an alternative investment as an investment by the SBA in a private equity fund, venture fund, hedge fund, or distress fund, or a direct investment in a portfolio company through an investment manager.

<sup>7</sup> For example, the earnings target for the private equity asset class in Fiscal Year 2013-14 was the returns for the Russell 3000 Index plus 300 basis points.

<sup>8</sup> Chapter 2012-112, *Laws of Florida*.

<sup>9</sup> The actual allocation of strategic investments was valued at 5.4% as of June 30, 2014, despite a target allocation of 12%. It is a relatively new (2007) investment vehicle for the SBA, and its low current actual allocation allows the SBA flexibility to invest within the statutory cap.

investment by the opportunities available in the market.

Total alternative investment fees have increased significantly, but the SBA reported that its fees are lower than industry averages. The SBA incurs higher external management fees for alternative investments than it does for all other asset classes. For example, during Fiscal Year 2013-14, SBA's external manager fees for private equity and strategic investment asset classes were 1.79% and 1.59%, respectively, compared to 0.27% and 0.67% for its global equity and real estate investments.

Total alternative investment external manager fees increased in Fiscal Years 2012-13 and 2013-14, and these fees continue to generate a disproportionate share of the external manager fees associated with FRS Pension Plan investments. During Fiscal Year 2013-14, the SBA's total external manager fees were \$463.6 million, with 52%, or \$240.2 million, devoted to managing alternative investments. This is a 55% increase from Fiscal Year 2011-12, when alternative investment management fees totaled \$154.5 million.

The SBA reported that the fee increase likely occurred because during Fiscal Years 2012-13 and 2013-14, the board opened 50 additional alternative investment accounts, some of which required upfront manager fee payments based on total commitment as opposed to funds actually invested at opening.<sup>10</sup> Because the fees for alternative investments increase with the dollar amount invested, as the SBA shifts an increasing amount of traditional assets toward alternative investments, increases in investment fees will continue.

The SBA reported that it has been able to negotiate lower alternative investment management fees when dealing with smaller investment funds and those parts of the market in which the board has more market power, including specific hedge funds. Board officials reported that its alternative investment fee terms are generally lower than industry averages (1.5% to 2.0%).<sup>11</sup>

<sup>10</sup> During the same two-year period, the total amount invested in alternative investments increased 37%.

<sup>11</sup> The findings of an SBA consultant report support this assertion. In 2014, CEM Benchmarking compared the board's operational costs to public peers of similar size. Across all asset classes, including alternatives such as hedge funds, the consultant reported that the SBA's fee costs were lower than its peers on average. The consultant attributed the overall lower fees

The SBA continues to increase oversight for alternative investments. SBA reported that it provides greater oversight for alternative investments. In 2013, OPPAGA noted that the board had implemented oversight procedures, certifications, and scorecards for fund managers. The SBA reported that it has continued to implement a range of oversight activities and processes on its alternative investments.

In particular, SBA documentation on investment manager and fund selection processes highlight a range of checks and balances, including executive reviews, research by SBA consultants, fund manager presentations to staff, detailed fund manager reference checks with partners, consultants, and other industry contacts, as well as "prudent man opinions" from third party consultants.

In addition to conducting due diligence on individual funds, the SBA reported that it will continue addressing the overall risk of alternative investments. These strategies include

- monthly reports on risk exposure;
- developing annual risk rankings of investment funds and testing investment manager fund restrictions based on these rankings;
- reviewing compliance with investment portfolio guidelines for separately managed accounts; and
- continuing to implement a contractor's internal software system, which will allow SBA to develop an independent, internal assessment of risk.

## Agency Response ---

In accordance with the provisions of s. 11.51(2), *Florida Statutes*, a draft of our report was submitted to the Executive Director of the State Board of Administration for review and response. The Executive Director's written response has been reproduced in Appendix A.

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to the SBA paying less than its peers do for similar services. However, for some private equity investments, the SBA's costs were higher than other large public funds.

## Appendix A

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**STATE BOARD OF ADMINISTRATION  
OF FLORIDA**

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March 18, 2015

Mr. R. Philip Twogood  
Coordinator  
Office of Program Policy Analysis & Government Accountability (OPPAGA)  
Claude Pepper Building, Room 312  
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Tallahassee, Florida 32399-1475

Dear Mr. Twogood:

We reviewed the preliminary and tentative OPPAGA's report titled: *FRS Pension Plan Investment Returns Are Similar to Other Public Pensions Funds; SBA Continues to Increase Alternative Investments*. We have no objection or questions in regard to the information presented in the report.

We welcome OPPAGA's efforts and, as always, we appreciate your diligence and professionalism.

Sincerely,

A handwritten signature in blue ink that reads "Ashbel C. Williams".

Ashbel C. Williams  
Executive Director & CIO

# *The Florida Legislature*

## *Office of Program Policy Analysis and Government Accountability*



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