

# During Fiscal Years 2016 Through 2018, Major SBA Fund Returns Exceeded Market-Based Investment Benchmarks Over the Long Term

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# OPPAGA

Office of Program Policy Analysis and Government Accountability

## During Fiscal Years 2016 Through 2018, Major SBA Fund Returns Exceeded Market-Based Investment Benchmarks Over the Long Term

### EXECUTIVE SUMMARY

Over the past 10 years, State Board of Administration (SBA) investment returns for all five major mandate funds exceeded market-based investment benchmarks.

Florida Retirement System Pension Plan fund investment returns exceeded the board's overall investment objective for all but one period during a 30-year span. In addition, the fund's multi-year performances were similar to returns for some other states with large pension funds. As of June 30, 2017, Florida's pension plan fund had a 10-year return of 5.5%, while nine comparable state pension funds had 10-year returns ranging from 4.4% to 5.8%.

According to a consultant, the SBA generally has lower total investment costs than its peers. The SBA has taken steps which could reduce costs, including increasing the proportion of funds managed internally. During Fiscal Years 2016-17 and 2017-18, the SBA increased the total amount of the pension fund that it managed internally by 1.6% (\$10.6 billion).

#### REPORT SCOPE

Section 215.44(6), *Florida Statutes*, directs OPPAGA to examine the State Board of Administration's management of investments every two years. This review examines the board's Fiscal Year 2016-17 and Fiscal Year 2017-18 performances to examine how well major mandate funds are performing.

# INTRODUCTION

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

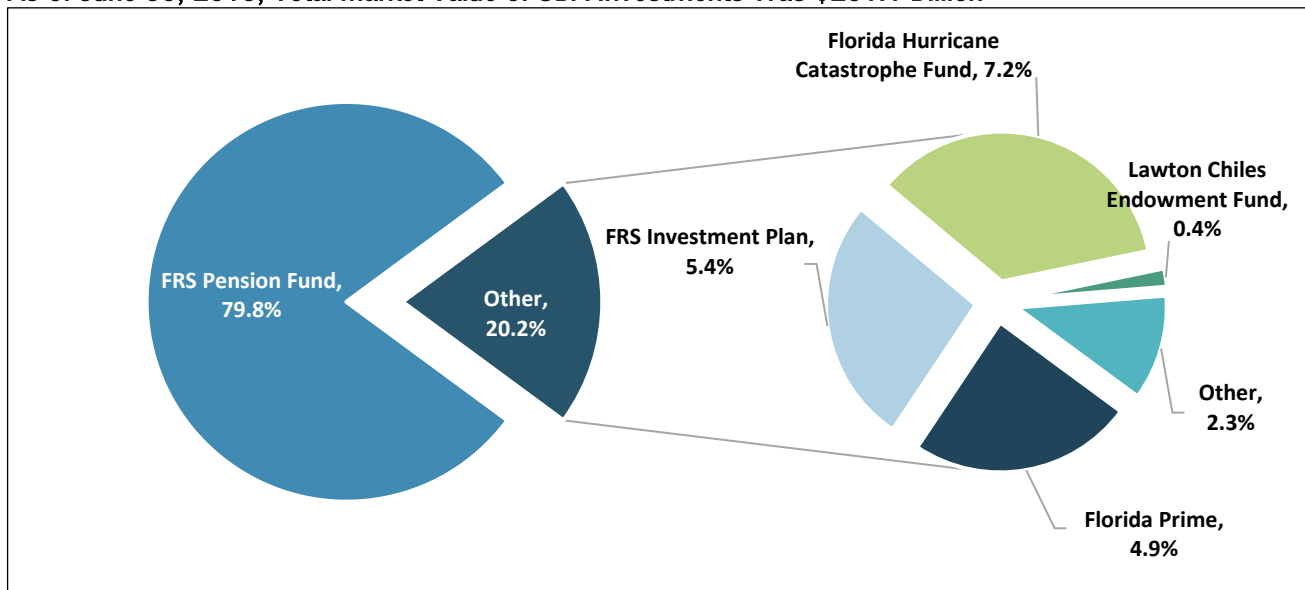
As of June 30, 2018, the SBA managed 35 funds with a total market value of \$201.1 billion. The board has five major mandate funds.

- Florida Retirement System (FRS) Pension Plan
- Florida Hurricane Catastrophe Fund
- FRS Investment Plan
- Florida PRIME Fund
- Lawton Chiles Endowment Fund<sup>2</sup>

The largest fund is the FRS Pension Plan, which had net assets of \$160.4 billion and comprised 79.8% of the total assets managed by the board in Fiscal Year 2017-18. (See Exhibit 1.)

## Exhibit 1

As of June 30, 2018, Total Market Value of SBA Investments Was \$201.1 Billion



Source: State Board of Administration data as of June 30, 2018.

Unlike most state agencies, the SBA is a constitutional entity, and does not receive a legislative appropriation to fund its activities. Rather, the board funds its operational and administrative expenses through fees on the funds for which the board provides investment management services. To manage these investment activities in Fiscal Year 2017-18, the SBA had an operating budget of \$46.7 million with 201.75 full time equivalent authorized positions.<sup>3</sup>

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

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

<sup>3</sup> The board also manages the FRS Investment Plan/Office of Defined Contribution Programs and the Florida Hurricane Catastrophe Fund with a total approved budget in Fiscal Year 2017-18 of \$33,327,390 and 20 full-time equivalent positions. While the SBA administratively houses the

# FINDINGS

The State Board of Administration uses several methods to evaluate fund performance. These methods include comparing investment returns to (1) market-based benchmarks, (2) returns of other large fund managers, and (3) the SBA's overall objective for each fund.

OPPAGA's review of the SBA's performance in investing fund assets found that

- all major mandate fund investment returns were above market-based benchmarks for all periods up to 10 years;
- FRS Pension Plan investment returns have generally exceeded the SBA's overall investment objective for most of a 30-year period;
- FRS Pension Plan 1-year investment returns were higher than those of most other comparably sized state pension funds but had similar multi-year returns; and
- the SBA's consultant reports that the board has relatively low operational costs and recent fund management changes may further reduce these costs.

## Over a 10-year period, major mandate funds exceeded market-based investment benchmarks

The SBA's investment returns help fund state and local government programs, including the state's Hurricane Catastrophe Fund and pension benefits. To measure investment performance, the board establishes benchmarks for each of the five major mandate funds based on market indices.<sup>4</sup>

The SBA's fund benchmarks vary depending on the state's goals for the individual funds. For example, various units of local government, such as school districts, state colleges, municipalities, and public corporations, are eligible to invest their surplus funds with Florida PRIME. This fund invests these surplus funds with the goals of preservation of capital, liquidity, and competitive yield; these investments generally yield lower returns and have lower associated benchmarks. In contrast, the SBA's goal for investing FRS Pension Plan assets is to provide returns sufficient for the plan to ensure timely payment of promised benefits to current and future plan participants as well as to keep costs at a reasonable level. To obtain sufficient returns, the SBA invests FRS Pension Plan assets primarily in investment vehicles, such as stocks, that can yield higher long-term returns than bonds and cash; these investments generally have higher benchmarks.

The SBA's investment returns for the five major mandate funds consistently exceeded their benchmarks over a 10-year period.<sup>5</sup> As of June 30, 2018, every major mandate fund had returns above

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Division of Bond Finance and the Florida Prepaid College Board's Prepaid College and College Savings programs, their budget processes are separate from that of the SBA.

<sup>4</sup> A market index tracks and measures changes in the performance of a group of stocks, bonds, or other investments from a specific starting date. For example, the performance of self-directed brokerage accounts within the FRS Investment Plan for which investments are based on stock market indices 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.

<sup>5</sup> Fund benchmarks are set using versions of common market indices. For example, the benchmark for the Global Equity class of asset is a customized version of the MSCI All County World Investable Market Index, in dollar terms, net of withholding taxes on non-resident institutional investors, adjusted to reflect the provisions of the Protecting Florida's Investments Act. The SBA's Board of Trustees approves benchmarks for the FRS Pension Plan, the FRS Investment Plan, the Lawton Chiles Endowment, and Florida PRIME. The Chief Operating Officer of the Hurricane Catastrophe Fund and the Executive Director and Chief Investment Officer of the SBA approve the Hurricane Catastrophe Fund benchmarks.

their 1-year, 3-year, 5-year, and 10-year benchmarks. (See Exhibit 2.) For instance, the FRS Pension Plan exceeded each of its 1-year, 5-year, and 10-year benchmarks by 0.8%, while exceeding its 3-year benchmark by 0.7%.

## Exhibit 2

### As of June 30, 2018, All SBA Major Mandate Fund Returns Exceeded Market-Based Investment Benchmarks for Periods up to 10 Years

Major Mandate	Trailing Return			
	1-Year Trailing Return <sup>1</sup>	3-Year Trailing Return	5-Year Trailing Return	10-Year Trailing Return
<b>Lawton Chiles Endowment</b>	9.9%	7.7%	8.7%	6.5%
Performance Benchmark	8.4%	6.5%	7.6%	5.6%
<b>FRS Investment Plan</b>	9.6%	7.2%	7.8%	6.1%
Performance Benchmark	8.8%	6.9%	7.5%	5.7%
<b>FRS Pension Plan</b>	9.0%	7.6%	8.7%	6.9%
Performance Benchmark	8.2%	6.9%	7.9%	6.1%
<b>Florida PRIME Fund 30 Day Avg. Yield</b>	1.6%	1.0%	0.7%	0.6%
Performance Benchmark	1.3%	0.7%	0.4%	0.4%
<b>Hurricane Catastrophe Fund</b>				
<i>CAT Fund Operating Liquidity</i>	1.3%	0.9%	0.6%	0.6%
Performance Benchmark	1.2%	0.7%	0.5%	0.5%
<i>CAT2016A Fund</i>	1.3%	N/A	N/A	N/A
Performance Benchmark	1.1%	N/A	N/A	N/A
<i>CAT 2013A Fund</i>	1.2%	0.8%	0.6%	N/A
Performance Benchmark	1.1%	0.7%	0.5%	N/A

<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, 2018 would show a fund's performance from July 1, 2017 through June 30, 2018. A 10-year trailing return as of June 30, 2018 would show a fund's performance from July 1, 2007 to June 30, 2018. Cells above containing N/A indicate the fund has not operated long enough to achieve those longer-term returns.

Source: State Board of Administration.

## The FRS Pension Plan fund generally exceeded its overall investment objective over time

The SBA also measures the investment performance of the pension plan by comparing the fund's performance to an overall investment objective. This objective is composed of a set level of compound investment earnings plus the annual inflation rate.<sup>6</sup> Thus, this objective fluctuates yearly as inflation changes. This objective is used to evaluate the performance of the fund over multiple market cycles (e.g., over a 30-year period). As of July 1, 2018, the SBA reduced the FRS Pension Plan's long-term return objective from 4.5% plus inflation to 4.0% plus inflation.<sup>7</sup>

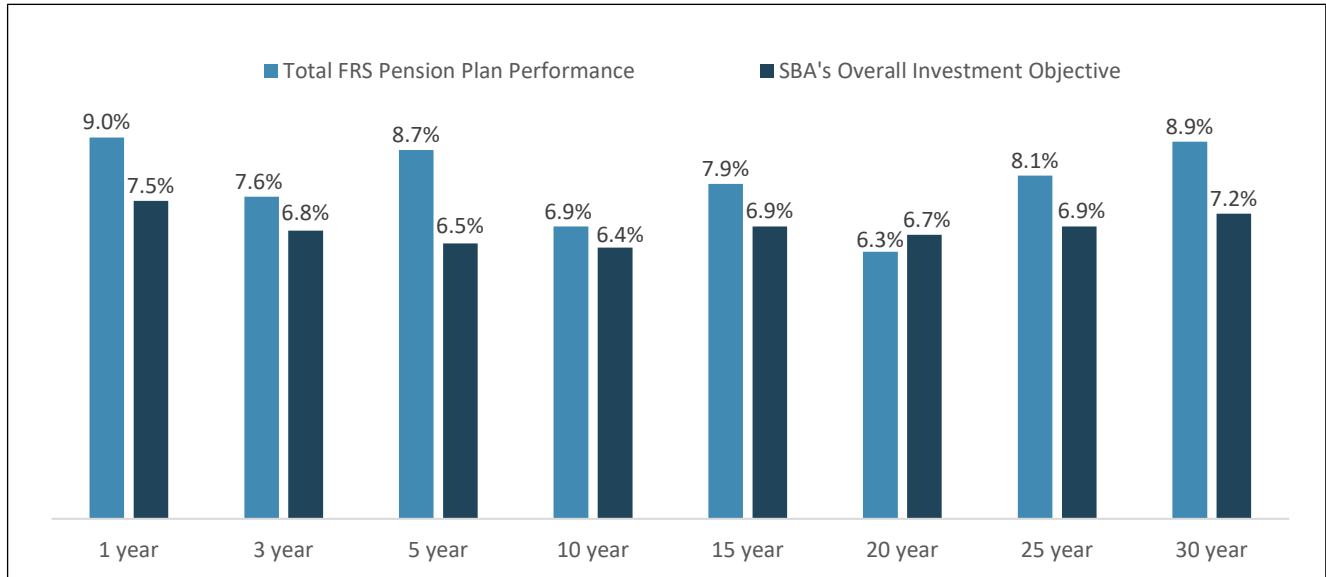
<sup>6</sup> The SBA Board of Trustees sets the overall investment objective and the level of investment risk. The SBA reported that this objective closely tracks the investment return assumed by the FRS actuary. The objective is based on an analysis of expected benefit growth, contribution levels, market performance, and risk tolerance for the fund. The SBA uses the compounded U.S. Department of Labor Consumer Price Index (all Urban Consumers) to represent the inflation rate.

<sup>7</sup> Prior to April 2000, the overall investment objective was the assumed rate of return used by the Department of Management Services consulting actuary in valuing the pension system's liabilities (8%). In April 2000, the SBA changed this objective to an absolute real target rate of return of 4.3% plus the rate of inflation. In August 2003, the SBA reduced its target to 4% over the rate of inflation. The investment objective of a real return rate (the return received after the rate of inflation is taken into account) of 5% took effect in Fiscal Year 2006-07. As of July 1, 2017, the SBA reduced the FRS Pension Plan's long-term return objective from 5% plus inflation to 4.5% plus inflation.

The SBA exceeded its overall FRS Pension Plan investment objective in seven of the eight periods OPPAGA examined. (See Exhibit 3.) The SBA attributes the pension plan's performance to the significant investment in Global Equity (the plan has an investment policy target of 53% for the plan's assets invested in Global Equities). To the extent that equity markets perform well, the total return of the pension plan is higher and vice versa.<sup>8</sup>

**Exhibit 3**

**As of June 30, 2018, Pension Plan Investment Returns Generally Exceeded the SBA's Overall Investment Objective in the Long Term<sup>1</sup>**



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

Source: State Board of Administration data as of June 30, 2018.

**FRS Pension Plan one-year performance was higher than most large state pension funds but similar across multi-year intervals**

In Fiscal Year 2016-17, the SBA's one-year investment performance for FRS Pension Plan funds was 13.8%. This one-year return was higher than seven of the nine other large pension plans OPPAGA examined and lower than the one-year returns for two other pension plans.

The FRS Pension Plan's performance over multi-year periods was comparable to other large public pension funds. For example, the SBA's 10-year return on the FRS Pension Plan fund for the period ending June 30, 2017, was 5.5%, and the nine comparison funds had 10-year returns that ranged from 4.4% to 5.8%. (See Exhibit 4.)

<sup>8</sup> In Fiscal Years 2017-18 and 2018-19, both the SBA's general consultant (AonHewitt) and the FRS Pension Plan's actuary (Milliman) projected lower investment returns on FRS Pension Plan assets. In 2017 and 2018, Milliman estimated long-term real returns of 4.2% and 4.0%, respectively. AonHewitt estimated long-term real returns of 4.5% in 2017 with an updated forecast of 4.0% in 2018.

## Exhibit 4

Although 1-Year Performance Was Higher Than Returns for Other Large State Retirement Plans in Fiscal Year 2016-17, FRS Pension Plan Investment Returns Were Comparable to These Plans Over 10 Years<sup>1</sup>

Fund	Overall Rate of Return				Net Market Value of Pension Assets (in Billions)
	1-Year	3-Year	5-Year	10-Year	
Ohio Public Employees Retirement System <sup>3</sup>	16.6%	8.1%	9.0%	5.8%	\$101.0
State Teachers Retirement System of Ohio	14.3%	6.7%	10.1%	5.5%	\$77.7
<b>FRS Pension Plan<sup>2</sup></b>	<b>13.8%</b>	<b>5.9%</b>	<b>9.5%</b>	<b>5.5%</b>	<b>\$153.6</b>
North Carolina Teacher and State Employee Retirement	13.5%	6.6%	7.6%	5.4%	\$98.3
California State Teachers' Retirement System	13.4%	6.3%	10.1%	5.0%	\$208.7
Washington State Department of Retirement Systems	13.4%	6.9%	10.0%	5.5%	\$93.3
Teacher Retirement System of Texas	12.9%	6.0%	8.8%	5.4%	\$145.9
New York State Teachers' Retirement System	12.5%	6.6%	10.2%	5.6%	\$113.3
New York State and Local Retirement System	11.5%	6.2%	8.4%	5.6%	\$192.4
California Public Employees' Retirement System	11.2%	4.6%	8.8%	4.4%	\$326.4

<sup>1</sup> Period-to-period performance results are very sensitive and dependent on the beginning and endpoints of measurement. Reporting dates for these plans ranged from March 31, 2017 to December 31, 2017. Annualized returns are net of fees.

<sup>2</sup> FRS Pension performance is as of June 30, 2017.

<sup>3</sup> Includes Defined Benefit, Health Care, and Defined Contribution portfolio investments.

Source: Comprehensive annual financial reports and other financial reports from the Florida Retirement System Pension Plan and other pension plans.

## According to a consultant, the SBA's total investment costs were slightly below those of peers; recent steps may further reduce costs

Historically, the proportion of pension plan funds managed internally has lowered the SBA's overall costs relative to peer funds. As noted above, the SBA's major mandate funds, including the FRS Pension Plan fund, are exceeding internal benchmarks for net returns. A key component of the funds' performance is the SBA's operating costs. According to a 2017 consultant report, the board's total investment costs are slightly below the median total investment costs of peer funds.<sup>9</sup>

The consultant presented several factors that contribute to the differences in the SBA's total investment costs compared to peers. First, the consultant noted that larger funds could reduce costs through economies of scale. One way the SBA reports it has reduced operating costs is by negotiating management fees 25% to 65% below customary levels for externally managed public market assets, using the size of the pension fund as an incentive. Next, the consultant noted that the SBA's asset mix may result in lower overall investment costs. Specifically, the consultant reported that peer retirement funds hold a larger proportion of high cost asset classes (e.g., infrastructure, hedge funds, and private equity) than the FRS Pension Plan fund. In Florida, the proportions of such investments are limited by board policy; 22% of the pension plan assets were held in higher cost assets at the end of 2017, compared to a peer average of 26%.

In addition, the consultant attributed the pension plan fund's relatively lower cost status to differences in implementation styles. The use of external active management tends to be more expensive than

<sup>9</sup> "Investment Cost Effectiveness Analysis (for the 5-year period ending December 31, 2017)," CEM Benchmarking, December 10, 2018.

internal or passive management, and within external active investments, the use of a fund of funds strategy is more expensive than direct fund investment.<sup>10</sup> The consultant suggested that in some holdings, the SBA uses the fund of funds strategy more often than peer funds. Specifically, 9% of its holdings in hedge funds, real estate, and private equity were fund of funds, while on average, peer funds invest only 5% of these holdings via a fund of funds instrument. However, the SBA offset these costs by using less external active management than peers, using this strategy with 53% of holdings compared to an average of 55% for peers.

Further, the consultant provided data that showed that the SBA's internal management costs were lower than external asset management costs and suggested that managing some funds internally could achieve efficiencies. For example, during the five-year period ending December 31, 2017, the SBA's cost to actively manage fixed income assets using board staff was 3.0 basis points (0.03%), while actively managing the same assets using external management had costs of 8.4 basis points (0.084%). In addition, the SBA's cost for actively managing global stock using internal resources was 3.4 basis points (0.034%), compared to a cost of 50.9 basis points (0.509%) for actively managing such assets using external resources.<sup>11</sup>

**During the current review, the SBA took steps to reduce its operating costs.** Additionally, the SBA recently increased the proportion of funds managed internally, which could further reduce operational costs. During Fiscal Years 2016-17 and 2017-18, the SBA increased the total amount managed internally by 1.6%, from \$60.2 billion (42.5% of total assets) to \$70.8 billion (44.1% of total assets). Most of these internally managed funds are primarily in public liquid markets, global equities, fixed income (e.g., bonds), and real estate.<sup>12</sup> The board has not yet evaluated the cost savings associated with this change, but some efficiencies may emerge from internally managing investments. For example, increasing internal management avoids overhead costs, such as information technology infrastructure and profit margin embedded in the fees of external managers. Further, the SBA reports it can obtain better net returns because even with recent staff salary increases, compensation for SBA internal fund managers is lower than that of external fund managers.

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<sup>10</sup> A "fund of funds" is a fund investing in funds (e.g., mutual funds or hedge funds) containing different underlying assets instead of investing directly in stocks, bonds, and other securities. These funds can diversify holdings but can also result in investors paying an additional layer of fees for the underlying funds.

<sup>11</sup> One basis point is equal to one one-hundredth of one percentage point (0.01%). Therefore, 100 basis points would be equivalent to 1%.

<sup>12</sup> In general, the SBA will consider managing a fund internally when it determines that the anticipated internal net return will exceed the costs and returns of using external managers. The SBA also considers other factors, including the number of skilled staff available to effectively manage the fund, and board policy, which details the risk plan and ranges of funds that will be actively or passively managed.



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# AGENCY RESPONSE



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March 12, 2019

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

Dear Mr. Twogood:

We reviewed the preliminary and tentative OPPAGA's report titled: *During Fiscal Years 2016 Through 2018, Major SBA Fund Returns Exceeded Market-Based Investment Benchmarks Over the Long Term*. 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, appearing to read "Ashbel C. Williams".

Ashbel C. Williams  
Executive Director & CIO



# OPPAGA

Office of Program Policy Analysis and Government Accountability

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