

# During Fiscal Years 2018 Through 2020, 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 2018 through 2020, Major SBA Fund Returns Exceeded Market-Based Investment Benchmarks over the Long Term

## EXECUTIVE SUMMARY

Almost all State Board of Administration (SBA) investment returns for all five major mandate funds met or exceeded market-based investment benchmarks over the last 10 years.

Investment returns of the Florida Retirement System Pension Plan fund exceeded the SBA's overall investment objectives for six of eight periods during a 30-year span. In addition, the fund's multi-year performances were similar to returns for other states with large pension funds. For example, as of June 30, 2019, Florida's pension plan fund had a 10-year return of 9.8%, while 11 comparable state pension funds had 10-year returns ranging from 8.4% to 10.4%. The pension plan also had returns that equaled or exceeded returns of other large defined benefit pension plans as measured by two private financial companies.

The SBA continues to take steps to reduce investment costs, including managing more of its assets using lower cost internal resources instead of generally more costly external firms. During Fiscal Years 2018-19 and 2019-20, the SBA had increased the total amount of the pension fund that it managed internally by 2.2%.

### 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 2018-19 and Fiscal Year 2019-20 performances for its major mandate funds.

# INTRODUCTION

The State Board of Administration (SBA) is a constitutional entity and the state of Florida's principal independent investment management organization. It invests funds contributed by state agencies, state universities and colleges, and local governments.<sup>1</sup> The SBA is governed by a three-member Board of Trustees composed of the Governor as Chair, the chief financial officer, and the attorney general. These trustees delegate authority to the SBA's executive director and chief investment officer, who oversees the day-to-day financial investments and operations of the organization.

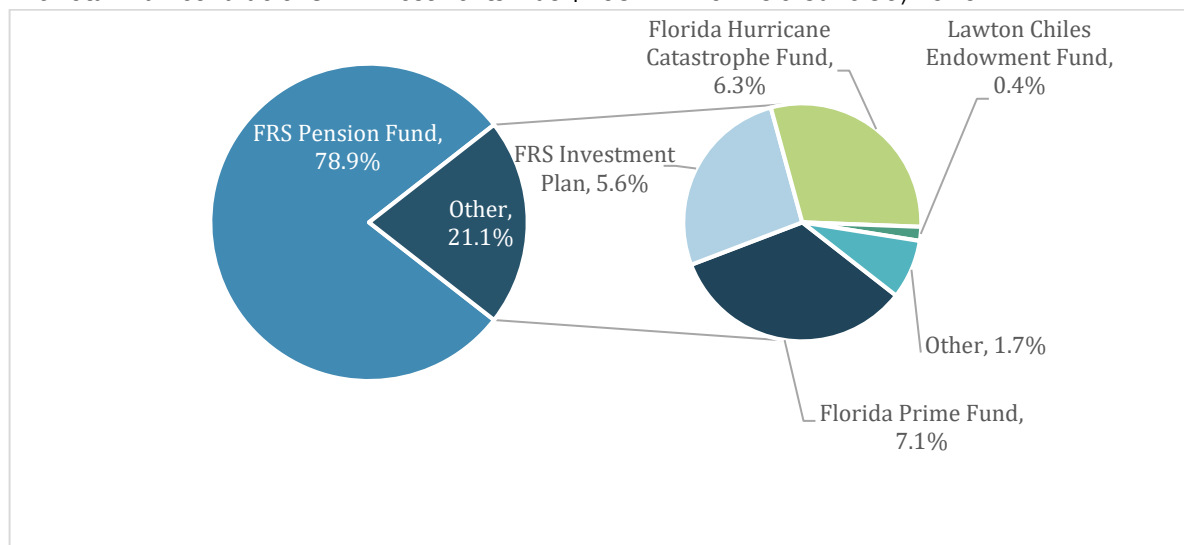
As of June 30, 2020, the SBA managed 30 funds with a total market value of \$203.7 billion. The board has five major mandate funds

- 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 \$160.7 billion and comprised 78.9% of the total assets managed by the board in Fiscal Year 2019-20. (See Exhibit 1.)

## Exhibit 1

### The Total Market Value of SBA Investments Was \$203.7 Billion As of June 30, 2020



Source: State Board of Administration data as of June 30, 2020.

Unlike most state agencies, the SBA 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 2020-21, the SBA has an approved operating budget of \$54.6 million with 207.75 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 SBA operating budget does not include the FRS Investment Plan, Florida Hurricane Catastrophe Fund, Division of Bond Finance, and Florida Prepaid College Board which have their own budgets and underlying funding sources.

# FINDINGS

OPPAGA evaluates fund performance in three ways: by 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

- most major mandate fund investment returns were above market-based benchmarks for periods up to 10 years;
- the FRS Pension Plan fund generally exceeded its overall investment objective over a 30-year period;
- FRS Pension Plan one-year investment returns were lower than those of most other large state pension funds but had similar multi-year returns, while FRS investment returns are similar to those of some large public plans when using consistent reporting periods; and
- the SBA continues to take steps to reduce investment costs.

## Most major mandate funds either met or exceeded market-based investment benchmarks over a 10-year period

OPPAGA's review focuses on the SBA's investment returns, as these revenues help fund state and local government programs. For example, Florida Retirement System investment gains obtained by the SBA pay approximately 60%+ of retiree benefits.<sup>4</sup> In addition, the enhanced funding of various state programs, such as children's health and welfare programs, is possible through the SBA investing a portion of the Lawton Chiles Endowment Fund.

To measure investment performance, the board establishes benchmarks for each of the five major mandate funds based on market indices.<sup>5</sup> The SBA sets up benchmarks that are appropriate to the goals of funds it manages. For example, the Florida Hurricane Catastrophe Fund (FHCF) provides reimbursements to insurers for a portion of their catastrophic hurricane losses. To meet the purpose of the FHCF, the SBA invests in short-term, high-quality, highly liquid securities; these investments generally yield lower returns and have lower associated benchmarks. In contrast, the SBA's goal for the FRS Investment Plan is to offer investment options that avoid excessive risk, have a prudent degree of diversification relative to broad market indices, and prove to have long-term rates of returns that exceed the returns on comparable market benchmark indices. The SBA allows plan participants to choose investment options such as retirement date funds, U.S. stocks funds, and money market funds.

Almost all of the SBA's investment returns for the five major mandate funds either matched or exceeded their benchmarks over a 10-year period.<sup>6</sup> As of June 30, 2020, most major mandate funds had returns above their 1-year, 3-year, 5-year, and 10-year benchmarks. (See Exhibit 2.) For instance,

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<sup>4</sup> Employer and plan participants pay the remainder of benefits.

<sup>5</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 Florida PRIME is measured against the Standard & Poor's U.S. AAA & AA Rated GIP All 30 Day Net Yield Index.

<sup>6</sup> Fund benchmarks are set using versions of common market indices. For example, the benchmark for the Private Equity asset class is 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, plus a fixed premium return of 300 basis points per annum. The SBA's Board of Trustees approves benchmarks for the FRS Pension Plan, the FRS Investment Plan, the Lawton Chiles Endowment Fund, and Florida PRIME Fund. 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.

FRS Pension Plan investments exceeded overall 1-year, 3-year, 5-year, and 10-year benchmarks by a range of 0.1% to 0.7%. The only major mandate fund that did not meet or exceed all of its benchmarks was the Lawton Chiles Endowment Fund, which fell short of its 1-year benchmark by 0.4%.

## Exhibit 2

### As of June 30, 2020, Most SBA Major Mandate Funds Met or Exceeded Market-Based Investment Benchmarks for Periods up to 10 Years

Major Mandate	Trailing Returns <sup>1</sup>			
	1-Year	3-Year	5-Year	10-Year
<b>Lawton Chiles Endowment Fund</b>	3.3%	6.0%	6.2%	8.6%
Performance Benchmark	3.7%	5.9%	5.8%	7.9%
<b>FRS Investment Plan</b>	2.6%	5.8%	5.9%	7.5%
Performance Benchmark	2.0%	5.3%	5.6%	7.2%
<b>FRS Pension Plan</b>	3.1%	6.1%	6.4%	8.7%
Performance Benchmark	3.0%	5.6%	5.8%	8.0%
<b>Florida PRIME Fund 30 Day Average Yield</b>	1.7%	2.0%	1.5%	0.8%
Performance Benchmark	1.5%	1.7%	1.2%	0.6%
<b>Hurricane Catastrophe Fund</b>				
CAT Operating Funds Composite	1.9%	1.9%	1.4%	0.9%
Performance Benchmark	1.9%	1.8%	1.3%	0.7%
CAT 2016A Fund	3.0%	2.5%	N/A	N/A
Performance Benchmark	3.0%	2.4%	N/A	N/A
CAT 2013A Fund	1.9%	2.0%	1.5%	N/A
Performance Benchmark	1.9%	2.0%	1.4%	N/A

<sup>1</sup> A trailing return shows how a fund has performed over the period shown. For example, a one-year trailing return as of June 30, 2020, would show a fund's performance from July 1, 2019, through June 30, 2020. A 10-year trailing return as of June 30, 2020, would show a fund's performance from July 1, 2009, to June 30, 2020. 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 objectives over a 30-year period

In addition to using market-based investment benchmarks, the SBA also measures the investment performance of the pension plan by comparing the fund's performance to an overall long-term investment objective. The overall long-term investment objective is set by the SBA Board of Trustees and is a compound return plus the rate of inflation per annum over the long run.<sup>7,8</sup> Thus, this objective fluctuates yearly as inflation changes and 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's overall pension plan long-term objective was reduced from 4.5% plus inflation to 4.0% plus inflation.<sup>9</sup>

The SBA reports the majority of the plan's performance (90% or greater) is the result of asset allocation. Approximately 80% of the plan's assets are allocated to return seeking assets like equities, private equities, real estate, and alternative investments. The largest share of the plan's Fiscal Year 2019-20 assets are invested in global equities (53.9%). To the extent that equity markets perform well, the total return of the pension plan is higher and vice versa.

The SBA exceeded or matched its overall FRS Pension Plan nominal investment objective in six of the eight periods OPPAGA examined. (See Exhibit 3.) For example, the fund did not meet the one-year

<sup>7</sup> The SBA Board of Trustees also sets the level of investment risk.

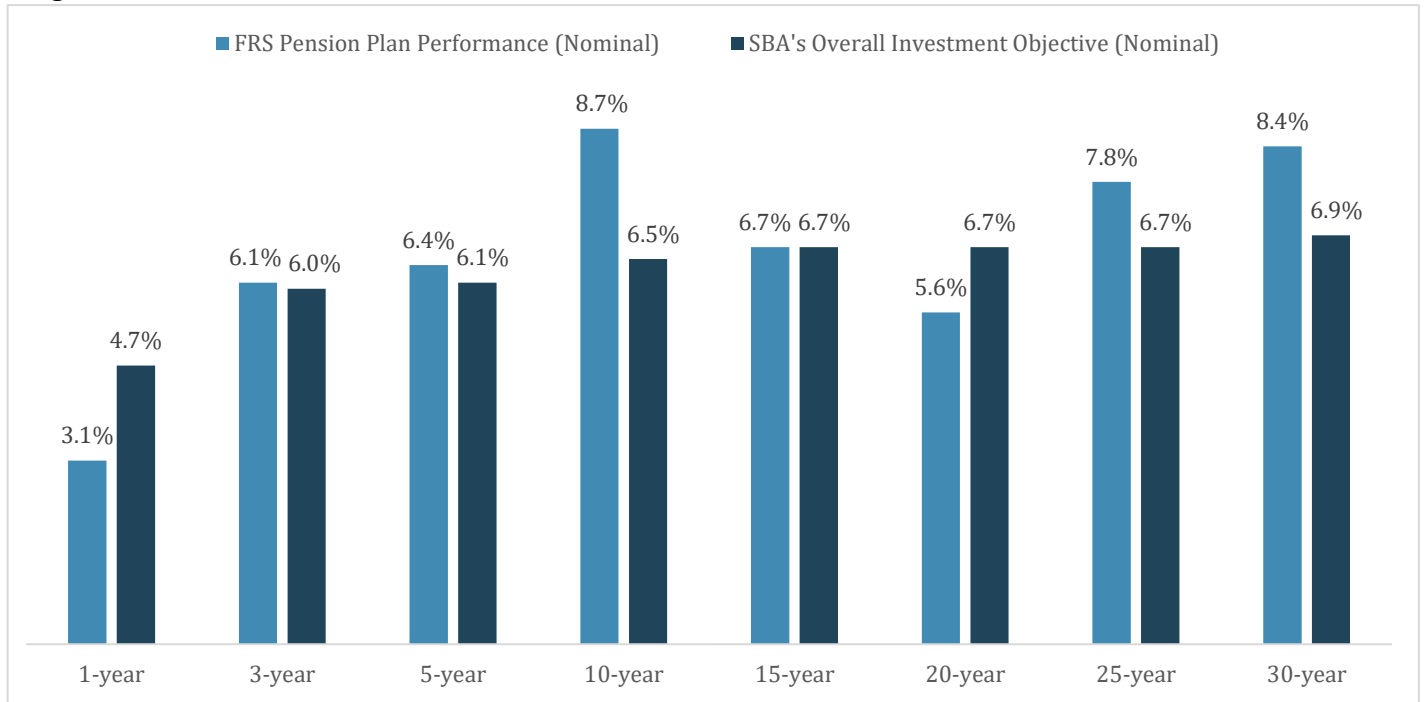
<sup>8</sup> The SBA uses the compounded U.S. Department of Labor Consumer Price Index (all Urban Consumers) to represent the inflation rate.

<sup>9</sup> The SBA states that the decision to lower the overall FRS Pension Plan investment objective was based on market conditions. Capital market investment returns were expected to remain lower than in previous years.

investment objective, which the SBA attributed to significant COVID-19 pandemic-related social isolation, business closures, and energy price collapse in March 2020. However, through asset diversification and investment in opportunities that supported returns (e.g., those with longer-term growth patterns and minimal exposure to the retail economy), the plan’s assets declined less than the equity market overall. In addition, certain plan assets were able to be exchanged very quickly, allowing the plan to meet its cash needs during a challenging time for the fixed income market. The SBA reported that the array of strategies they employed resulted in increased returns for global equity and fixed income liquid asset classes. For the period of March 31, 2020, to June 30, 2020, those returns were 20.1% and 3.1%, respectively. During this same period, pension plan assets increased from \$148.1 billion to \$160.7 billion (a 9.7% increase).

**Exhibit 3**

**As of June 30, 2020, Pension Plan Investment Returns 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, 2020.

**FRS Pension Plan one-year investment returns were lower than those of most other large state retirement plans but generally comparable to those of other large public funds**

**Variations in other state fiscal years may explain SBA’s one-year returns being lower than those for most large state pension funds.** In Fiscal Year 2018-19, the SBA’s one-year investment performance for FRS Pension Plan funds was 6.3%. This one-year return was lower than 10 of the 11 other large pension plans OPPAGA examined and higher than the one-year returns of one other pension plan. However, these period-to-period performance results are dependent on the beginning and endpoints of measurements. For example, the New York State and Local Retirement System ends their fiscal year on March 31, while the Ohio Public Employees Retirement System has a fiscal year that

ends on December 31. Consequently, certain market volatility events will be included in some state fiscal years and not in others.

In contrast, the FRS Pension Plan’s performance over multi-year periods was more comparable to these 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, 2019, was 9.8%, and the 11 comparison funds had 10-year returns that ranged from 8.4% to 10.4%. (See Exhibit 4.)

#### Exhibit 4

#### Although One-Year Performance Was Lower Than Returns for Other Large State Retirement Plans in Fiscal Year 2018-19, 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	
California Public Employees’ Retirement System	6.7%	8.8%	5.8%	9.1%	\$376.3
California State Teachers’ Retirement System	6.8%	9.7%	7.0%	10.1%	\$236.9
New York State and Local Retirement System	5.2%	9.3%	7.0%	10.3%	\$210.5
FRS Pension Plan <sup>3</sup>	6.3%	9.6%	6.6%	9.8%	\$163.1
Teacher Retirement System of Texas	6.4%	9.5%	6.7%	9.9%	\$158.9
New York State Teachers’ Retirement System	7.1%	9.5%	7.2%	10.4%	\$120.5
Washington State Department of Retirement Systems	8.4%	10.7%	7.9%	10.3%	\$110.0
Ohio Public Employees Retirement System <sup>2</sup>	17.6%	9.8%	7.5%	8.6%	\$106.2
North Carolina Retirement System	6.6%	8.2%	5.5%	8.4%	\$102.0
Virginia Retirement System	6.7%	8.8%	6.5%	9.4%	\$84.4
State Teachers Retirement System of Ohio	7.1%	10.3%	7.4%	10.4%	\$80.9
Teachers Retirement System of Georgia	6.8%	9.4%	6.6%	9.7%	\$76.1

<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, 2019, to December 31, 2019.

<sup>2</sup> Includes defined benefit, health care, and defined contribution portfolio investments.

<sup>3</sup> FRS Pension performance is as of June 30, 2019.

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

**When examining consistent reporting periods, FRS Pension Plan returns are similar to those of some large public plans.** Using Florida’s fiscal year (July 1-June 30) as the comparison time frame, FRS Pension Plan investment returns compete favorably with returns from other large plans over a 10-year period. Two sources of performance data compare funds across that 10-year period. The first source is the Wilshire Trust Universe Comparison Service top ten universe, which represents the top 10 corporate and public defined benefit plans in assets under management.<sup>10</sup> The second source of performance data is Bank of New York (BNY) Mellon public plan peer universe, which represents public pension plans with assets greater than \$1 billion under management.<sup>11</sup> When comparing FRS Pension Plan annual investment returns to Wilshire Trust data, its performance equaled or exceeded median returns of the top 10 defined benefit plans during the 10-year period ending June 30, 2019.

<sup>10</sup> The assets of the defined benefit plans comprising the Wilshire Trust Universe Comparison Services top ten universe totaled \$1,606.2 billion as of June 30, 2019.

<sup>11</sup> This plan is the public plans subset of the BNY Mellon U.S. Master Trust Universe Median Plan. During the period ending June 30, 2019, 87 public plans participated in the BNY Mellon Public Plan Universe.

Further, during the same period, BNY Mellon data shows that FRS Pension Plan annual investment returns are in the top quartile of all public plans with assets greater than \$1 billion.<sup>12</sup>

## The SBA continues to take steps to reduce investment costs

During the current review, the SBA increased the percentage of funds managed internally and took steps to reduce the costs of externally managed funds. The SBA reports that it tracks and reports on internal and external expenses to monitor investment costs. SBA data shows that it costs less to manage assets internally than externally. As of June 30, 2020, the total direct and allocated cost of internally managing global equity and fixed income assets was 4.09 basis points and 4.42 basis points, respectively.<sup>13</sup> Conversely, the average cost of externally managing global equity and fixed income assets was 30.25 basis points and 8.03 basis points, respectively. The SBA increased the percentage of pension fund assets managed using lower cost internal management from 44.2% as of June 30, 2018, to 46.4% as of June 30, 2020.

During the review period, the SBA also took steps to reduce the investment costs of externally managed investments. Notably, the board took advantage of fee discounts for investing early in the fundraising process and negotiated fee concessions.<sup>14</sup> For example, in one investment, the SBA negotiated a 28% reduction in fees from the published standard rate, resulting in an estimated annual savings of \$1.4 million based on the size of the initial investment. In another investment, the SBA negotiated a 46% reduction in fees from the published standard rate, implying an annual savings of \$3.5 million. Additionally, the SBA's private equity asset class increased its allocations to private market co-investments, which were obtained without management fees or having a percentage of the investment profits generated by the fund going to an external partner.

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<sup>12</sup> The SBA states it is better to compare the FRS Pension Plan's performance to other "public" pension plans as corporate pension plans have higher allocations to fixed income as opposed to public plans, which tend to allocate more to equities. Additionally, the BNY Mellon public plan peer universe compares the FRS Pension fund investment returns to many more pension plans (a total of 87 plans in the comparison group) than the Wilshire Trust Universe Comparison (10 plans in the comparison group). Plans presented in Exhibit 4 may be included in these data sources.

<sup>13</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>14</sup> Sometimes managers offer fee breaks (discounts) to those investors that are willing to commit capital early in the fundraising process.



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# OPPAGA

Office of Program Policy Analysis and Government Accountability

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Project supervised by Emily Leventhal (850/717-0525)  
Project conducted by Rich Woerner (850/717-0562)  
R. Philip Twogood, Coordinator