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WHY PUBLIC PENSIONS SHOULD CONDUCT PERIODIC INTERNAL CHECK-UPS

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Public pensions face greater public scrutiny and difficult financial markets which provide compelling reasons for pension boards to review and assess investment compliance issues, long-term pension sustainability, and the performance, practices, and costs associated with the pension's outside managers and consultants.

One of the consequences of the financial crisis and downturn that began in 2008 is that many public pension systems have taken affirmative steps to review the costs of their investments and question whether investments with hedge funds and private equity funds are appropriate in light of the relevant costs, risks and upside potential. For example, in September 2014, the California Public Employeesô Retirement System (ñCalPERSò), the nationôs largest public pension, ended its investments in hedge funds due to the cost, complexity, and risk associated with hedge fund investments.[1]

Many pensions have followed CalPERSô lead.[2] According to a study by the Pew Charitable Trusts, as of 2012, public pensions had approximately $3 trillion in assets available to pay more than $4 trillion in expected benefit payouts ï leaving an underfunded gap of more than $1 trillion.[3] In an effort to boost returns, pensions have shifted away from fixed-income returns such as government and high-quality corporate bonds, and significantly increased their reliance on stocks and alternative investments such as private equity, hedge funds, real estate and commodities.

During the past decade, this significant change in investment strategy and allocation has affected the costs, fees, complexity, and costs associated with pension investments. In addition, pension boards and pension beneficiaries have struggled to understand the structure and economic returns of alternative investments which are more complex and less transparent than stocks and bonds.

During this same time period the scope and detail of financial disclosures required by the Government Accounting Standards Board, and other regulatory agencies, related to pension investments and their ñfair valueò has increased significantly.[4]

CalPERS has taken a leading role in identifying and publicizing ñbest practicesò for pensions with respect to investment compliance issues, long-term sustainability, and relationships with outside managers and consultants.[5] Pension fiduciaries need to understand the benefits and risks of alternative investments, and should assess the efficacy and true cost of outside managers and advisors. Moreover, pension boards need to monitor the pensionǿs overall investment strategy, and be responsive to beneficiaries who are increasingly questioning the costs associated with pension investments.

Pensions that do not voluntarily perform internal reviews can be subject to outside investigations by governmental authorities, or private investigations, sometimes funded through ñcrowd fundingò.[6] New York Cityǿs public pension recently conducted an extensive internal review.[7]

Public pensions can shield themselves from disruptive outside investigations by proactively retaining their own forensic and legal professionals to investigate and review investments, investment advisor performance and costs, governance issues, and investment policy scope and implementation. These periodic check-ups demonstrate to pension constituents and regulators that pension management is attentive and vigilant in protecting pension assets and monitoring long-term pension sustainability.

Below is a checklist of some of the critical issues that should be addressed in an internal check-up.

- Review of relationships with investment advisors and fiduciaries, with a focus on their independence, and their performance.
- Compliance with overall investment guidelines.
- Review of investments in all categories to consider compliance with pension investment guidelines. For example, what is the appropriate percentage of real estate investments?
- Review the pensionǿs strategic asset allocation and long-term sustainability.
- Engage an independent auditor to ensure that the pension is using appropriate values for plan assets and liabilities.
- Engage independent professionals to analyze fee arrangement and incentive compensation agreements with outside managers, advisors, and consultants.
- Analyze the true costs of alternative investments (hedge funds, private equity funds, and real estate investments), and seek to better understand and disclose outside management fees, including incentive compensation.
- Review management and placement agent fees, and incentive compensation arrangements with respect to alternative investments. For example, placement agent fees often are paid by the partnerships which own the private equity or real estate investment entity. The pension is often a limited partner in the partnerships, but should not be paying a portion of the placement fee.
- Review governance practices and conflicts of interest policies.
- Gifts to board or staff members from outside managers and consultants should be carefully scrutinized and limited. Expenses for lavish diners and entertainment associated with annual, advisory board, and other meetings should be reconsidered. The pension should strive for transparency and accountability with respect to these issues.
- Rules should be established regarding post-board employment for board members and staff by outside advisors and managers.[8]
- Increase sensitivity to diversity issues and environmental issues in connection with choosing investments, and advisors.[9]

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Diamond McCarthy LLP is a national litigation boutique law firm with vast experience in forensic investigations, including public pension investigations.

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[1] http://www.bloomberg.com/news/articles/2014-09-15/calpers-to-exit-hedge-funds-citing-expenses-complexity.

[2] For example, public pensions in Los Angeles, New Mexico, and Louisiana have eliminated or reduced their hedge fund investments. http://www.pionline.com/article/20140818/PRINT/308189978/hedge-fund-investing-strong-in-2014.

[3] National Bureau of Economic Research http://www.nber.org/digest/nov08/w14343.html.

[4] Since 2012, the Government Accounting Standards Board has issued three new standards directly affecting the financial reporting obligations of public pensions in this area, including GASB Statement Nos. 67, 68, and 72.

[5] For example, CalPERS has published its core beliefs at https://www.calpers.ca.gov/docs/forms-publications/calpers-beliefs.pdf.

[6] For example, Rhode Islandôs pension was the subject of a ñcrowd-fundedò investigation. https://www.kickstarter.com/projects/1525282896/rhode-island-state-pension-forensic-investigation.

[7] http://www.nytimes.com/2016/01/27/nyregion/new-york-citys-pension-system-in-danger-of-operational-failure-report-says.html?smprod=nytcore-iphone&smid=nytcore-iphone-share.

[8] For example, see: https://www.calpers.ca.gov/docs/ethics-fact-sheet.pdf.

[9] CalPERS Investment Belief No. 4 addresses fair labor practices, health and safety, and diversity issues. https://www.calpers.ca.gov/docs/forms-publications/calpers-beliefs.pdf.