Return-Starved Pension CIOs Hammer Managers on Fees

By Tim Sturrock April 12, 2016

Pension CIOs are looking to knock down the fees they pay managers as a way to improve their funds' financial positions as low interest rates continue making steady returns difficult to attain.

The low-interest rate environment has already pushed pensions into riskier assets but new investment options are limited, pension CIOs said, speaking at the annual Pension Bridge conference in San Francisco. And that's leading them to pull other levers to squeeze out every dollar they can for their funds.

"You are going to find more and more demands for better economics… Whether it is management fees or what have you, there's going to be a lot of scrutiny," said Tom Tull, CIO of the $25 million Texas Employees Retirement System.

Active management skill is very rare and should be rewarded "handsomely," but performance fees are a more suitable way to reward asset managers, says Scott Evans, CIO for the $ 162 billion New York City Pension System.

"If structured right, and that's a big 'if,' you have perfect alignment. The managers make a lot of money when the beneficiaries get a lot of value," he said. "If we were aligned like that all across the portfolio, I think we'd be in great shape."

Private equity fees require particular scrutiny since mediocre returns are frequently rewarded with better-than-mediocre fees, he added.

"It's a bad structure and LPs everywhere should not sit still. We need to have a fair gain-sharing in the marketplace today," he says.

Investors need to accept that over the next five years or more returns will fall below return expectations, he said.

CIOs can only do so much, with the investment options they have available to them, explained John Skjervem, CIO of the Oregon State Treasury.

"We're geared as aggressively as we can be. We are as diversified as we can be," says Skjervem who oversees the $90 billion Oregon Investment Council. "We are doing all we can do, so from this point forward I would suggest to you that the lower interest rate environment manifests in ever lower funding ratios because we do not have a higher gear to go to."

Tull sees a need for institutional asset owners to be more tactical in the future.

"There will be an opportunity to be more tactical… The conventions of investing are going to change. They've changed dramatically over the last 20 to 30 years and they will continue as we go forward. It's definitely going to require tactical as an allocation," he said.

He also noted opportunities in emerging markets, but many risks as well.

“Not all emerging markets were created equal,” he says.

While much of the discussion centered on the low-return environment in the future, Tull pointed out that difficult economic conditions are temporary – just as they’ve been over the decades.

“Over time, a lot of the fundamentals will change,” he says.

But, economic realities are not the only challenges facing these CIOs, governance inefficiencies also make for a substantial roadblock.

One of the improvements that Evans suggested for the New York City system is the ability to fire managers with the same ease that he can rebalance the portfolio.

In such a situation, he would still have to explain himself to the system’s five pension boards, which collectively have 58 members, but only after the fact.

The current situation does not allow for quick action when time is a factor, he explained.

“If a manager violates the covenant that we have, does something unethical or completely outside the bounds of their agreement, I need to take it to each board, so it’s a long process,” he said. “I’d like the ability to move decisively to sever the relationship with the manager and hand the assets over to the transition manager the next day.”