



NEWS

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RELEASE: March 3, 2015

Montgomery County featured in the *New York Times*:

Pension Funds Trail Individuals in Embracing Index Funds

By RANDALL SMITH

March 3, 2015

More individuals are pouring money into so-called passive investing or index funds, which aim to match the performance of the main stock and bond markets, but larger institutions like pension funds and endowments have been slower to follow suit, despite the potential for higher returns and lower fees.

These bigger institutions still tend to rely on an army of asset managers and consultants who charge higher fees but promise better returns through so-called alternative investments like [private equity](#) and hedge funds. But many of these investments do no better — or even worse — than index funds, opponents say.

Jeff Hooke, an investment banker at Focus Securities in Washington, who favors the greater use of index funds by public funds to save taxpayer dollars, says he thinks many public fund officials favor active management despite its higher costs because they don't want to "index themselves out of a job." He said some of the officials might have ties to Wall Street or might be swayed by some of the perks of active management, like fancy investment conferences in Florida or Bermuda.

The embrace of index funds can be seen in the [mutual fund](#) market, whose \$14 trillion in assets is held largely by individuals. The percentage invested in passive index-matching strategies has doubled since 2004, to 30 percent from 13.8 percent, according to Morningstar, which tracks [mutual funds](#). One reason is that for the five years that ended in December, only 32 percent of active stock-fund managers beat their target market index, Morningstar says.

But the percentage of institutional investments in index-tracking strategies is a good deal smaller — about 19.2 percent for public pension plans and 11.2 percent for corporate plans, according to Greenwich Associates in Stamford, Conn. While the total for public funds has risen recently, the move has been offset by institutions' hefty commitments to alternatives. These higher-fee alternatives include [private equity](#), hedge funds, real estate and commodities, some of which offer the hope of higher or less volatile returns than those produced by public markets.

One institution that went the index route was the \$509 million Montgomery County Employees Retirement Plan in Pennsylvania. In 2013, it shifted most of its investments to index funds. The move saved the plan an estimated \$1.3 million in annual management fees while potentially improving performance, said Josh Shapiro, chairman of the Montgomery County Board of Commissioners. Mr. Shapiro, a Democrat, was elected in 2011 in a reform tide that swept through the county, an affluent, historically Republican enclave northwest of Philadelphia. He is now pressing two of the state's largest pension funds to follow his lead — a cause taken up on Tuesday by Tom Wolf, the governor of Pennsylvania, a Democrat.

But some of the 15 outside money managers who were dropped by the fund in the shift warned that the move was a mistake, said Uri Monson, the county's chief financial officer. One said the fund would be increasing its risk of losses in a market downturn, Mr. Monson added. "Another one angrily said, 'You'll come crawling back.' "

The money managers terminated included top Wall Street names like [Goldman Sachs](#) and JPMorgan Chase. A team from Brown Advisory visited county officials to argue that funds under their management, nearly 20 percent of the fund's assets, had outperformed their benchmarks.

However, Mr. Shapiro said the fund as a whole underperformed market benchmarks from 2004 through mid-2013, despite fees for active management that amounted to \$1.9 million a year as of early 2013. Over the last 18 months, he said, returns on the county's new stock and bond index funds at the Vanguard Group improved on the fund's earlier performance pattern.

Malcolm Cowen, a consultant to the Montgomery County fund from 2006 to 2013 at Cornerstone Advisors Asset Management in Bethlehem, Pa., said the fund's former managers had been chosen to reflect a conservative, defensive style. The goal was to control volatility and risk because the county wasn't making required contributions. The result: The county outperformed market benchmarks during the severe market downturn of 2008 but lagged during the rebound in 2010 to 2012.

Mr. Shapiro and Mr. Monson said they decided to pursue indexing after research that included meeting in 2012 with Vanguard's founder, John C. Bogle, at the company's headquarters in nearby Valley Forge. Mr. Bogle persuaded the two that "no one is smart enough to beat the market over a sustained period of time," Mr. Shapiro recalled.

To show how pension managers can be seduced into choosing certain expensive managers, Mr. Monson forwarded several invitations from among the dozens he has received to conferences in exotic locales like Dubai, Panama City and São Paulo, Brazil.

Mr. Shapiro has spoken with Governor Wolf about indexing investments at the two largest state funds, the \$53 billion Public School Employees Retirement System and the \$27 billion State Employees Retirement System. Mr. Monson estimates that the funds both slightly trailed a passive portfolio from 2006 to 2013 and could have cut their annual fees by \$476 million and \$140 million respectively through indexing.

In a budget address on Tuesday, Mr. Wolf said, “Our state has been wasting hundreds of millions of taxpayer dollars on Wall Street managers to handle state pension accounts.” Instead, he said, “a safe, conservative account would produce a similar return over the long term while eliminating these excessive management fees.”

This would probably be resisted by the current army of consultants and managers. The school system fund had 57 percent of its assets as of mid-2014 in higher-fee categories than plain stocks and bonds. They included 160 funds in private equity, private debt and venture capital, and 96 real estate partnerships. The school system fund has four consultants. The state system fund has 428 funds in private equity, hedge funds, venture capital and real assets totaling 45 percent of the fund.

For the decade that ended in 2013, the school system fund’s annual return of 6.9 percent, and the state fund’s 7.4 percent return appear to have outpaced the median performance of comparable big public funds tracked by the Wilshire Trust Universe Comparison Service. Over the last five years, both funds have trailed the Wilshire median. Wilshire did not provide data on specific funds.

In separate statements, the funds said that over 15 or 20 years, the fees they spent on active management more than paid for themselves in extra returns. They both said they already index about one-fifth of their assets. What may work for a “smaller” fund like Montgomery County, or even individual investors, “may not be prudent for a large multibillion pension fund like P.S.E.R.S.,” that fund’s chief investment officer, James H. Grossman Jr., said.

In an interview, Mr. Grossman attributed his fund’s recent underperformance to a reduction in risk that cut its allocation of stocks to 40 percent from 70 percent in 2009 — around the market bottom — driven by underfunding and resulting cash deficits.

How Governor Wolf’s call will fare isn’t yet clear. It could become part of the legislative budget process or be considered by the funds’ boards. While the governor appoints a majority of the smaller fund’s board, those seats are now occupied by his predecessors’ choices. And he names only three of the school fund’s 15 board members.

Mr. Bogle said indexing for the big Pennsylvania funds has a good chance of adoption, partly because their performance has been “not that good.” Still, he added, there is “a lot of politics involved, a lot of money changing hands.”

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