# APPENDIX

# New Jersey Senate Legislative Oversight Committee

New Jersey Division of Investment

June 4, 2015

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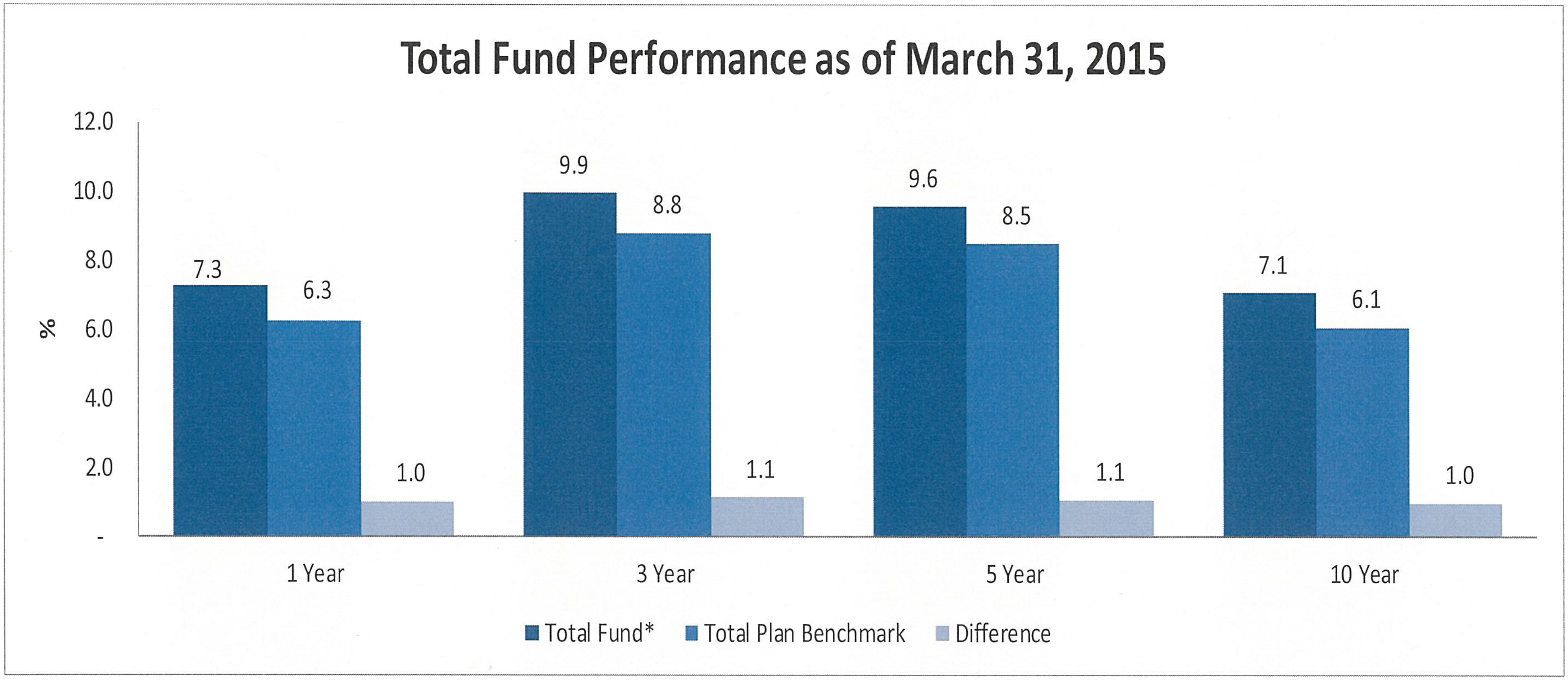
# Total Plan Performance Has Been Strong

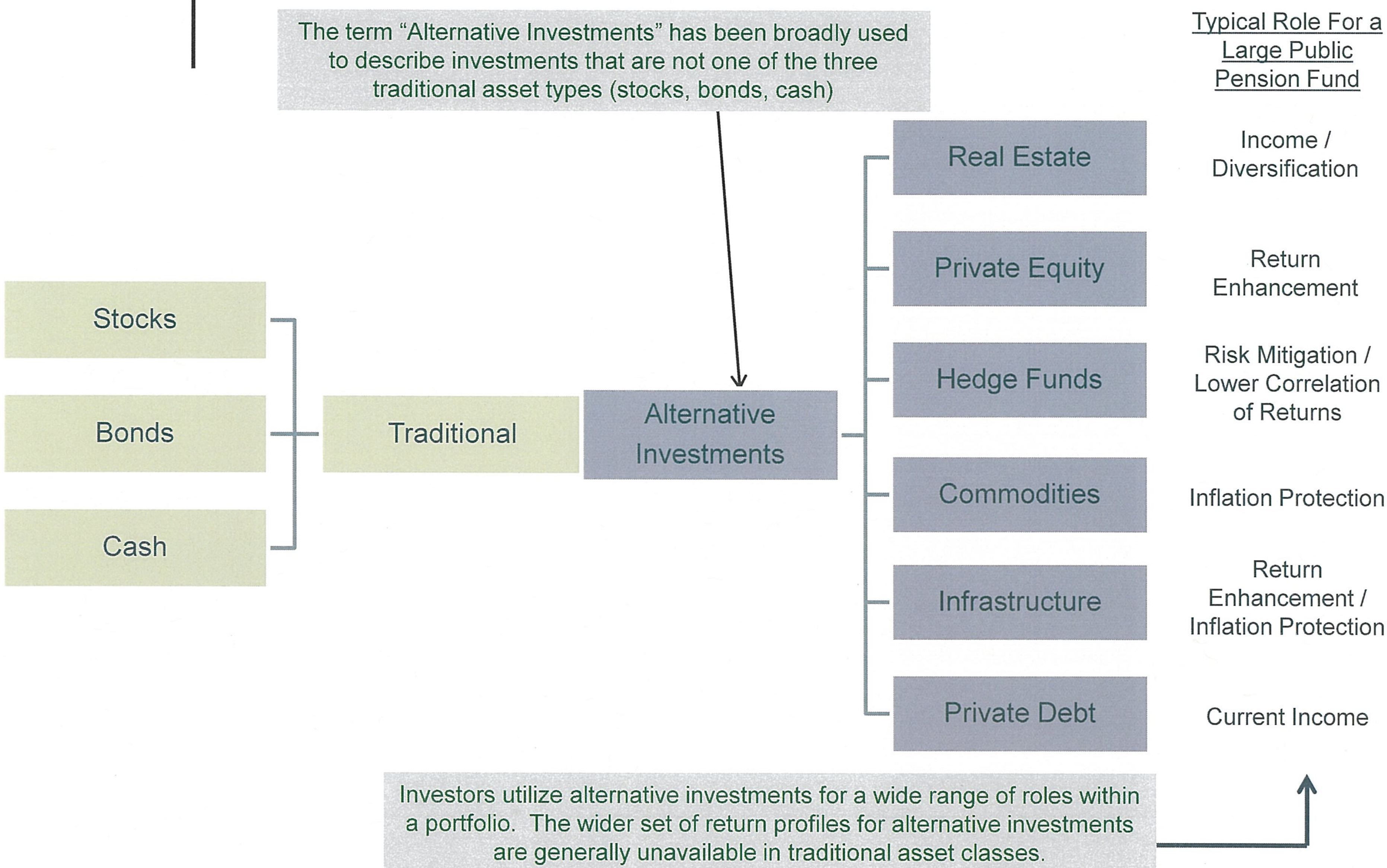



The performance for the Fund has been strong on an absolute basis. Outperformance of the benchmark has generated over $7 billion of additional value for the Pension Fund over the last 10 years.

* Annualized, net of fees; Excludes Police and Fire Mortgage Program

2x

# A Comparison of Traditional and Alternative Investments

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# History of New Jersey's Alternative Investment Program

Genesis of the New Jersey Alternative Investments Program

**2001**

- Fund loses $10 billion in equity portfolio (13% of Total Plan assets)

**2002**

- Fund loses $7 billion in equity portfolio (12% of Total Plan assets)
- Independent consultant issues report that noted excessive reliance on public securities
- Independent consultant recommends investments in additional strategies (including private equity, hedge funds, and real estate) in order to improve diversification and achieve a better risk/return profile for the funds.

**2003**

**2004**

- General consultant is retained and concurs with 2002 recommendation

**2005**

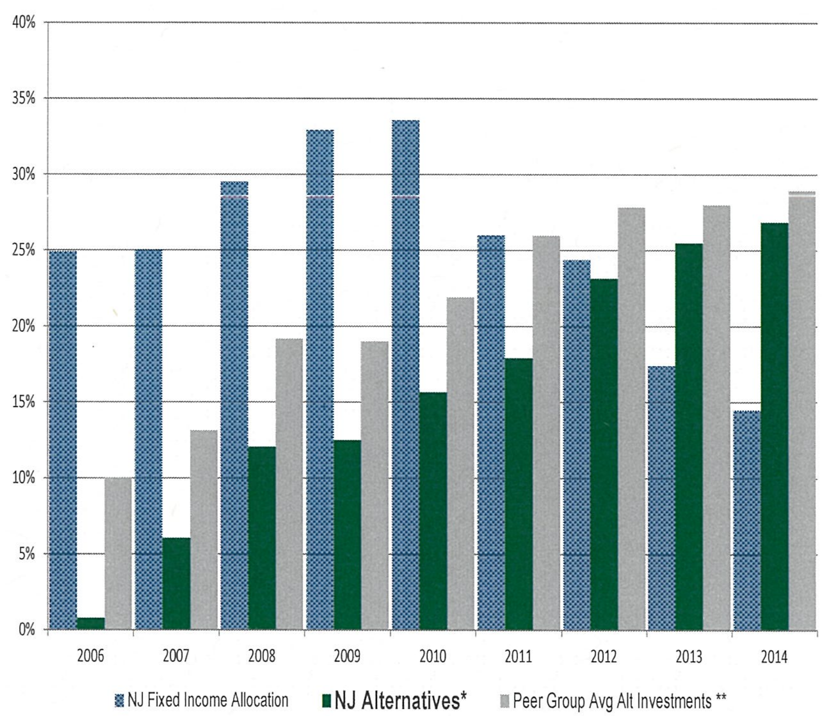
- Division of Investment commences Alternative Investments Program

The NJ Alternative Investment Program was started in response to large losses realized in the public equity markets.

4x

# Alternative Investments Are No Longer an "Alternative"

% of Total Assets




Alternative Investments Are A Mainstream Asset Class For Large Public Pension Funds

- a review of the asset allocation of 95 US State Pension Systems found that only 5 had no allocation to alternative investments
- New Jersey's allocation to alternatives is less than the typical large public pension fund
- Since 2010, New Jersey has funded its commitment to alternatives via a reduction in its allocation to fixed income

**While NJ has increased its commitment to Alternative Investments, the Fund remains underweight its allocation relative to its peers.**

* Per SIC Regulation Definitions
** Universe of 11 Large US Public Pension Funds

5x

# Alternative Investments Are Expected to Realize Higher Returns

Most **public market asset classes** are expected to realize returns that are below the Pension Fund's actuarial rate of return, while most **private market alternative securities** are expected to realize returns that exceed the Pension Fund's actuarial rate of return [1]

| Asset Class | Expected Return |
|---|---|
| Investment Grade Corporate Bonds | 3.01% |
| High Yield Bonds | 4.36% |
| US Equities | 6.76% |
| Non-US Developed Market Equities | 7.00% |
| NJ Pension Fund Actuarial Rate of Return | 7.90% |
| Equity-Oriented Hedge Funds | 8.04% |
| Credit-Oriented Hedge Funds | 8.38% |
| Emerging Market Equities | 8.40% |
| Equity-Related Real Estate | 8.60% |
| Private Real Assets | 8.74% |
| Debt-Related Private Equity | 9.09% |
| Buyouts/Venture Capital | 10.12% |

Most public pension funds will not be expected to meet their actuarial assumptions without investing in alternative investments

(1) The Division of Investment's capital market assumptions are incorporated into the annual asset allocation process; the Division works closely with independent consultants and other third party investment firms in the development of its capital market assumptions

lex

# New Jersey Fully Discloses All Management Fees Paid to and Carried Interest Retained by Alternative Investment Funds

| Public Pension Fund | Total Assets ($mil)* | Disclose Carried Interest Retained* |
|---|---|---|
| #1 | $260,162 | Some |
| #2 | $165,820 | No |
| #3 | $160,660 | Some |
| #4 | $132,383 | No |
| #5 | $117,050 | Yes |
| #6 | $93,296 | No |
| *New Jersey* | *$81,220* | *Yes* |
| #7 | $80,295 | No |
| #8 | $79,994 | Yes |
| #9 | $74,599 | No |
| #11 | $69,884 | No |
| #12 | $67,902 | No |
| #13 | $62,129 | No |
| #14 | $58,300 | Some |
| #15 | $56,278 | No |
| #16 | $53,152 | No |
| #17 | $49,296 | Some |

Most Large Public Pension Funds Do Not Fully Disclose Fees and Carried Interest

- there is no standard requirement for fee disclosure and, unlike New Jersey, most large public plans do not fully disclose fees

- of 17 of the largest U.S. Public Pension Funds, only 2 other plans fully disclose carried interest retained by investment managers, as New Jersey has elected to do

- the differences in reporting methodologies may result in a misinterpretation of the level of fees across funds with those which are more transparent appearing to pay higher fees

- additionally, as New Jersey has chosen to disclose a greater level of carried interest detail beginning in fiscal year 2014 vs. years past, year by year comparisons of fees and carried interest related to New Jersey's alternative investments are not meaningful

New Jersey has elected to disclose all fees paid and carried interest retained in its Alternative Investments Program. In FY14, the Program generated $3.1 billion in net profits and realized a net return of 15.2%

* Based on FY13 and 14 CAFR/Annual Reports

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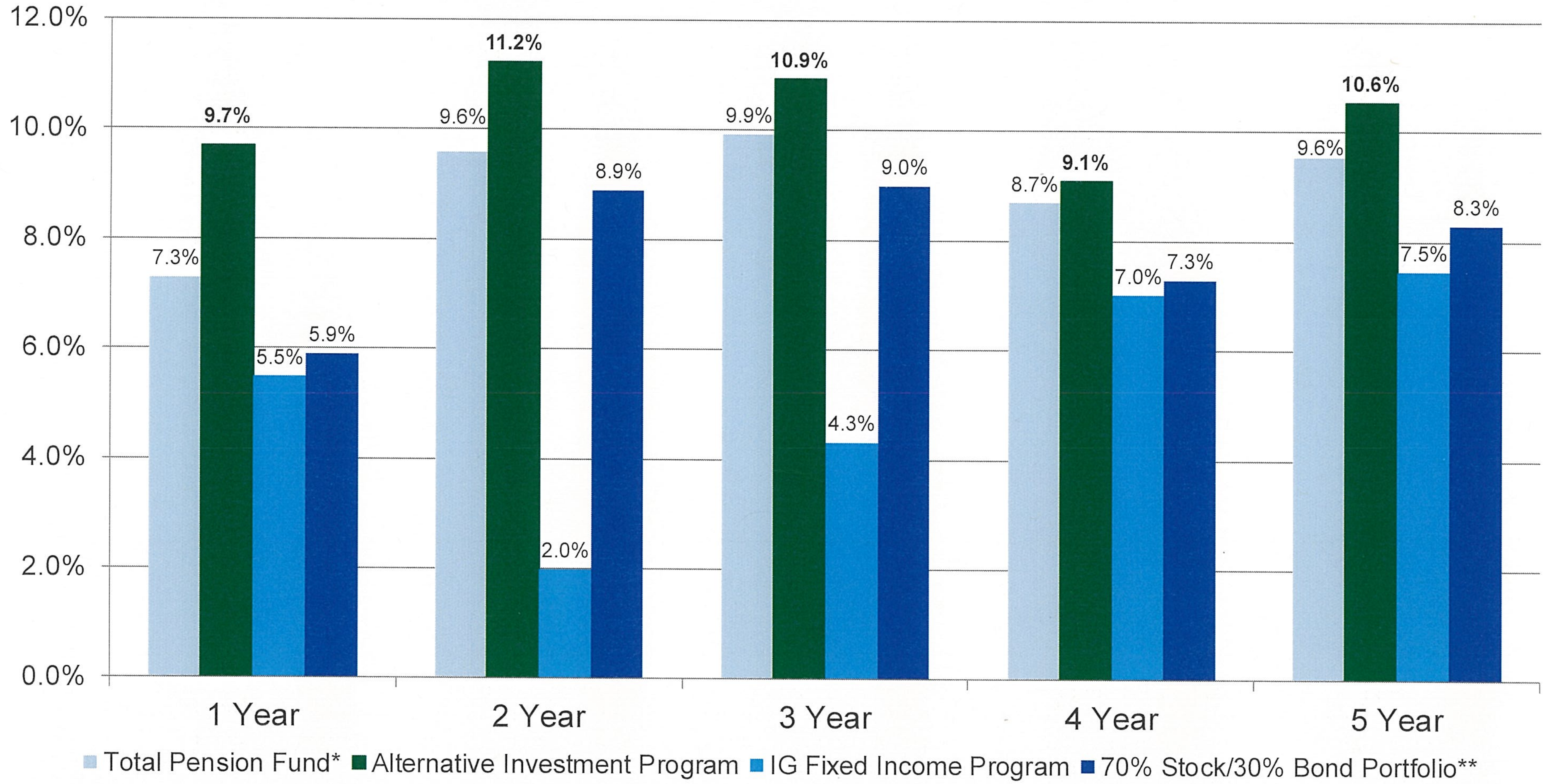
# The NJ Alternative Investments Program Has Realized Returns Above the Public Marketplace

Annualized Returns as of March 31, 2015 (Net of All Fees)




The NJ Alternative Investments Program has added value and outperformed the Total Pension Fund, net of all fees. The allocation shift from fixed income to the Program has benefited the Fund.

*Excluding Police & Fire Mortgage Program
** 70% MSCI All Country World Index/30% Barclays Aggregate

8x

# NEW JERSEY SENATE

## LEGISLATIVE OVERSIGHT COMMITTEE

SENATOR ROBERT GORDON, CHAIRMAN

June 4, 2015

10:30 a.m.

INVITED COMMENTS:

Tom Bruno, Chair

NJ Public Employees' Retirement System

Board of Trustees

Good Morning Chairman Gordon, Vice Chair Weinberg and members of this Committee.

First, allow me to thank you for the invitation to speak before you on the issue of NJ's Public Pension and in particular, the concerns stated by the PERS Board of Trustees relative to the condition of the Fund, the need for a forensic audit of the management fees, the need for an actuarial study of the Pension Task Force's recommendation to freeze the current level of the Pensions and create a new pension, the conspicuous absence of any of the elected Trustees on the Task Force, and the attempts by the Administration to obstruct our efforts to carry out our fiduciary responsibilities in collecting the money due the Fund and in securing an independent forensic analyst and special actuary for the aforementioned audits.

The condition of the Fund has been adversely impacted by a confluence of events over the past two decades. The improper borrowing from the Fund by Governor Florio nearly cost us our tax exempt status, but the failure to make the normal payments into the Fund beginning with Governor Whitman in the mid 1990's, along with her change to the actuarial smoothing method of valuation instead of the market valuation method (as is now required by the GASB 67) and her use of the profits of the Fund rather than leaving the profits there to cover those economic downturns and market corrections such as those experienced in 2001 and 2008-2009 were the ingredients needed to brew the calamity before us now. Add a dash of 2001's Chapter 133 which changed the pension formula from a denominator of 60 to 55 resulting in a 12% increase to all active employees forward and all retirees as far back as 1955 and you have the perfect storm.

Still, in 2001, lawmakers knew that their actions would upset the delicate balance of assumptions and solvency, so they created the Benefit Enhancement Fund to offset the added benefit. Unfortunately, when Governor McGreevey took office, he was faced with a $9 Billion deficit and utilized the Benefit Enhancement Fund to make his payments.

So that is a quick synopsis of what led us to the dire circumstances we find ourselves today. In 2010 and 2011, so-called Pension Reforms were passed in an effort to stabilize the Fund. Employees were asked to decrease their benefits by more than 34% including a loss of COLA's for retirees and asked to pay an additional 40% in contributions. This followed repeated increases from 3% up to the 5.5% at the time the Reforms were passed. In exchange for that, the Governor and the Legislature agreed to pay BOTH the normal costs AND the Unfunded Accrued Liability payments. After making two payments, the Governor decided the law he virtually authored and literally signed into law was unconstitutional and refused to make the FULL payment. He then took the extra employee contributions and used the employees' own contribution to cover the State's obligation. Given that the Courts have held that public pensions are deferred compensation of wages already earned, it is repugnant at its core to have the employees essentially pay themselves their wages in this manner.

In an effort to carry out our fiduciary responsibilities, the Board of Trustees voted to enforce the unambiguous language found in the statutes of P.L. 2011 Chapter 78 and litigate the Governor for the money due the Fund. For nearly 1 full year, the Administration refused to pay the independent attorney that THEY required we retain since the Attorney General's office claimed a conflict. Even after the judge's order to do so, they claimed the order did not apply to Amicus. But this is just ONE area where the Board of Trustees have a RESPONSIBILITY to carry out, but lack the AUTHORITY to do so.

For example, at our April Board meeting, the Board voted to commission a forensic audit of the management fees being charged to our Fund and to commission an actuarial audit study of the Task Force recommendations found in the "Roadmap to Resolution." Our reasons are apolitical.

In the first instance, the State Investment Council's Annual Report was replete with new terminology for what appears to be fees. When compared to the last three years, we found some terms no longer used, some appear to have been combined in the past but are listed separately and on different pages of the report now, while still others seem to be all new terms that industry leaders have said to me that they have no idea what the terms mean since they are not industry standard. Efforts to get information from the SIC has been met with cooperation sometimes while other times we are informed that you can't compare apples to apples where fees are concerned... a fact that was particularly disconcerting to the elected Trustees. An additional concern for the elected Trustees was the disproportionate costs to manage our Fund. Of the $82 Billion in the Fund, roughly 26% is alternative investments managed by private firms at a cost of over $600 Million as best as we can tell from the convoluted way the fees are presented; however, the remaining 74% of that $82 Billion is managed in-house by state workers at a cost of $10 million! That includes their salaries and benefits and all overhead.

In the second instance, the Task Force, which did not have a single stakeholder from the beneficiaries' side on the panel, came out with a recommendation to freeze the pension at its current level and start a new one managed by unions. The way the pension system works is best described as a bucket with a hole in the bottom and a spigot flowing on the top. The hole on the bottom allows a certain amount out (to pay for beneficiaries benefits) and the spigot flows at a rate that is designed to slightly exceed the rate of loss from those payments. If the spigot is "frozen," logic would dictate that the bucket will run out much faster. Creating ANY pension means startup costs. These recommendations don't pass the smell test and the Trustees voted to have an independent actuarial study focus on those aspects of the recommendations as we believe implementation would place the Fund in peril.

The Trustees specifically asked the Deputy Director of Finance of the Division of Pension and Benefits, John Megariotis for his advice and assistance in securing an independent forensic analyst and an independent actuary for the audit study at our Actuarial Valuation Report public meeting and we were told that we must ask the State Investment Council (SIC) to do it. Frankly, the SIC and DOI are potentially compromised. It is their Annual Report which is the source of the Board of Trustees' questions regarding fees. The Council is comprised predominantly of Administration officials with a minority of non-Administration stakeholder positions and would have NO interest in hiring someone to find what may have been hidden in their own report. Despite that assumption, the fact remains that the Council has not been formally asked to pursue the Trustees' directive. Again, we have the responsibility but no authority to act. Meanwhile, public employees, who have NEVER missed a payment into the system, are having their money pay exorbitant management fees for what appear to be less than average returns, but the management firms are reportedly contributors to Republican National Committee which give the beneficiaries the idea that their contributions to their future are being siphoned off to fund political campaigns.

Two months after the Board voted to have a forensic audit of the management fees done, we are no closer to securing that than before we met.

The elected Trustees are consistently frustrated with being legally responsible as fiduciaries of the Fund but without the authority to meet that fiduciary responsibility. Whether it is to verify that our Fund is not being used politically in unethical pay-to-play scenarios, or to simply ensure that the fees we are paying are legitimate, properly reported in their entirety and providing the enhanced rate of return that has been reported to us… we must have the ability to not simply demand things are done right, but to enforce those demands.

We should, at the very least, be asked for input as stakeholders in any regulatory and legislative changes to the Pension system, but most importantly, the elected Trustees need to have the legal authority to complete their fiduciary responsibilities.

Thank you.

Tom Bruno

[redacted]

# Review of New Jersey State Pension Fund <ins>Investment Results and Fees</ins> Presentation to Legislature

Jeff Hooke

June 4, 2015

14x

# General

- NJ State Pension Funds (the "Fund") has $81 billion in investment assets, covering seven public pension systems.
- These include stocks, bonds, hedge funds, private equity funds, commodities and real estate
- A properly designed Fund ensures that "money is there" when retirees anticipate checks
- Fund paid out $16 B in benefits for fiscal year ending June 30, 2015. It was replenished by $22 B, including $7.3 B employer / $2.5 B employee contributions and $12 B investment income.

15x

# General

- Important for pension funds to be adequately funded in the present.
- Risk: Future politicians or future taxpayers have an obligation to authorize extra revenues from General Treasury if the pension fund has a shortfall. However, it is possible they may try and avoid this obligation in the future.
- Comfort: If the state has severe debt repayment problems in the future, the Fund is “bankruptcy remote.” This means the state’s creditors cannot attach the Fund’s investment assets designated for retirees.

# Fund Investment Allocation

- The Fund's asset allocations at June 30, 2014 were roughly similar to many state pension funds, with a somewhat heavier alternative asset commitment.

| | |
|---|---|
| Publicly-traded stocks | 45% |
| Publicly-traded bonds and cash | 24 |
| Alternative assets & other | 31 |
| | 100% |

- Most of the publicly-traded securities are managed "in-house," which is unusual for a state pension fund. Most funds "farm-out" investment selections to third-party managers.

16x

# Fund Investment Allocation

- Alternative assets include hedge funds, private equity (e.g., leveraged buyout funds), real estate funds and commodity funds.
- Alternative managers charge higher fees than traditional stock and bond managers. They assert higher returns, lower risk, greater diversification, or all three attributes, relative to publicly-traded stocks or bonds. There is little or no historical proof of the managers' assertions.
- Most state pension funds, including New Jersey, have increased exposure to alternatives, spending billions on fees in an attempt to beat publicly-traded security benchmarks, like the S&P 500.



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# The Fund's Commitment to Alternatives Hasn't Worked Out Well

- The Fund's increased commitment to alternatives hasn't increased its investment returns, versus a traditional public security portfolio. The Fund would have made more money - $600 million the last five fiscal years – if it had stuck with its traditional public stock and bond mix.
- The Fund's hedge fund and private equity returns have been below relevant traditional investment benchmarks. If the Fund had stayed with the S&P 500 (instead of private equity) and 60-40 mix instead of hedge funds, the Fund would have made an extra $2.4 billion.
- $1.5 billion in fees, over the 2010-2014 fiscal year, were a poor use of taxpayer funds as a result.
- Fund can reduce hedge fund exposure quickly, but cutting its private equity allocation will take years since the latter have 10 year 'no-cut' contracts.

# Investment Returns vs Peer Group

- Fund investment returns are below average vs. its peer group last five years – when major commitment to alternatives started. 0.54% shortfall over five years approximates $1.8 billion. TUCS benchmark used by NJ and many others.

19*

Annualized Returns, Net of Fees
New Jersey vs. Wilshire TUCS Public Fund Median ($5B)
Years Ending June 30, 2014

| | 1 | 3 | 5 | 10 |
|---|---|---|---|---|
| New Jersey | 16.87% | 10.23% | 12.37% | 7.51% |
| Wilshire TUCS | 17.28 | 10.24 | 12.91 | 7.37 |
| Difference | (0.41)% | (0.01)% | (0.54)% | 0.14% |

# Investment Returns- Peer Group/NJ vs. Index

- The Fund and its peer group median both underperformed a passive, replicating index designed two years ago

Passive Replicating Index Fund vs. New Jersey and Peer Group
Annualized Investment Returns, Net of Fees
Years Ending June 30, 2014

| | 1 | 3 | 5 | 10 |
|---|---|---|---|---|
| New Jersey | 16.87% | 10.23% | 12.37% | 7.51% |
| Replicating Index | 18.29 | 10.94 | 14.48 | N.A. |
| | (1.42)% | (0.71)% | (2.11)% | |
| Wilshire TUCS | 17.28% | 10.24% | 12.91% | 7.37% |
| Replicating Index | 18.29 | 10.94 | 14.48 | N.A. |
| | (1.01)% | (0.70)% | (1.57)% | |

- 2.11% in higher returns over 5 years = $7 billion extra income for New Jersey
- Indexes are designated collections of stocks (e.g., S&P 500) and/or bonds. "Passive" money managers simply duplicate an index, and change reduced fees.



20x

21x

# Fees

- N.J. had higher fees – as a percent of assets – than nearby states with June 30 year-end. Fixed fees, performance fees and carried interest . California included as a leader.

Third Party Fees Versus Selected States
Year Ending June 30, 2014
Fees as a Percent of Year End Assets

| | |
|---|---|
| New Jersey | 0.74% |
| | |
| California | 0.38% |
| Delaware | 0.26 |
| Maryland | 0.73 |
| Massachusetts | 0.55 |
| Virginia | 0.51 |
| Five State Median(1) | 0.51% |

(1) The fees in the table exclude commissions, technology and investment consulting fees, although some would say these are relevant.

- N.J. underperformed the above five-state median in investment returns.

# Fees

- Fund fees tripled the last five years, as alternatives rose from 17% to 31% of assets

New Jersey State Pension Fund
Third Party Manager Fees by Year
Year Ending June 30

| | Amount (millions) | Index |
|---|---|---|
| 2014 | $ 600.2 | 428 |
| 2013 | 398.7 | 248 |
| 2012 | 209.2 | 149 |
| 2011 | 191.4 | 136 |
| 2010 | 140.5 | 100 |

- Total fees = $1.5 B over five years



22x

23x

# Alternative Asset Returns

- Like many states, NJ's private equity managers didn't beat relevant benchmarks

Annualized Returns – Two Alternative Categories – Net of Fees
Year Ending June 30, 2014

| | 1 | 3 | 5 |
|---|---|---|---|
| N. J. Private Equity | 24.14% | 14.35% | 16.30% |
| S&P 500 plus 3% | 27.61 | 19.58 | 21.83 |
| Difference | (3.47)% | (5.23)% | (5.53)% |
| | | | |
| N. J. Hedge Funds | 10.53% | 7.08% | 8.34% |
| Vanguard Balanced U.S. Fund (60% Bonds/40% Stocks) | 16.36 | 11.44 | 13.65 |
| Difference | (5.83)% | (4.36)% | (5.31)% |

- NJ in-house managers of publicly-traded stocks beat private equity and hedge funds last five fiscal years. Underlying investments are somewhat different.

# Interim Results- March 30, 2015

- The Wilshire TUCS median return for pension plans above $5 billion was 3.1% for the interim nine months ended March 30,2015.
- The NJ Fund's return was 2.3%, or somewhat lower.

24x

# Critique of Department of Investment Testimony, April 15, 2015

- Cherry Picking: The PowerPoint uses four different reference dates to justify its conclusions: March 31, 2015, December 31, 2014, June 30, 2014, and June 30, 2013. It uses four different sample sizes of peer groups: 10, 11, 13, and 17. It uses 7 years in two places when the industry emphasizes 1, 3, 5 and 10 years. The lack of consistency suggests that the PowerPoint "cherry picked" data to make the Fund look good.
- To make alternatives look better, the Fund compares their returns to investment grade bonds (page 6), as did the Treasurer on May 7th. Alternatives have a high equity component, so this comparison is illogical, but it makes the Fund's shift to alternatives look good because the stock market was rising.
- Page 7. Alternatives provided big profits in fiscal 2014. However, relevant index funds would have provided more profit. Neither the Treasurer nor PowerPoint mentioned this fact.



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# Critique of Treasurer Budget Testimony of May 7th Relating to Pension Fund Investments

- "Fixed money management fees, performance fees and carried interest payments" are all fees, according to accounting rules. NJ is more open than the average states about reporting such fees, but a researcher can usually determine most fees from carefully reading state pension fund CAFRs and related footnotes. Calls to state pension funds also provide information.
- He is correct in saying most states have expanded alternative allocation in recent years. NJ's allocation is slightly above average, based on my review. NJ's fees to assets under management is also higher than average, which he seems to dispute.
- The legislature should note that the majority of private equity investments have yet to be sold, so the rate-of-return calculations for private equity are the third-party managers' "best guess."



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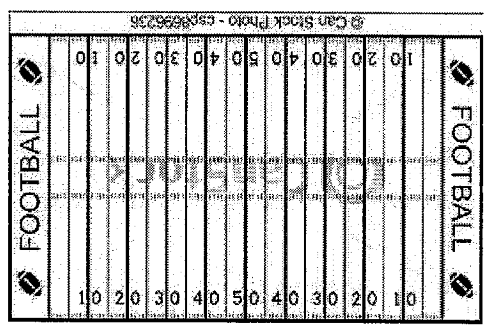
# Alternative Returns Beat (i) Fixed Income; and (ii) 70/30 Equity/Bond Blend

- The Department of Investment indicates the above, over the five years ended March 31, 2015. The Treasurer seems to agree.
- The problem with the (i) comparison is "apples to oranges." Alternatives have a much higher equity component than fixed income. In a rising stock market, alternatives will obviously win.
- Regarding (ii) The D of I's 70 /30 equity/bond blend uses an international stock index (All-country MSCI, including US) but a domestic bond index (Barclays Aggregate).
- Because of the heavy domestic orientation of alternatives, using a domestic equity index is more appropriate, or more "apples to apples." This change provides the opposite conclusion.

# Investor's Point of View –Basic Problem

- "Cloning" a hedge/pe fund with public index funds is possible.
- 10-year holding of a hedge/pe fund costs 15% in fees, so only 85% of the investor's money is put to work, vs. 99% with index fund.
- Hedge/pe fund starts on the 20 yard line, while public index starts at 35. Who is going to score a TD more often?

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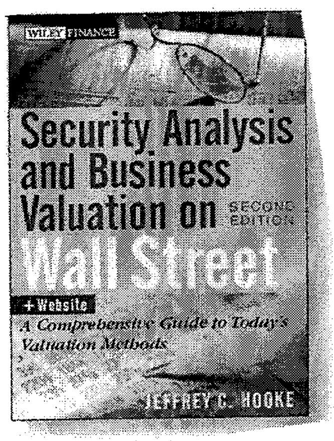
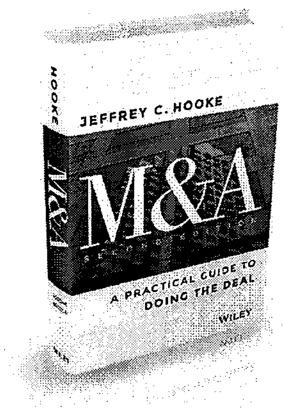
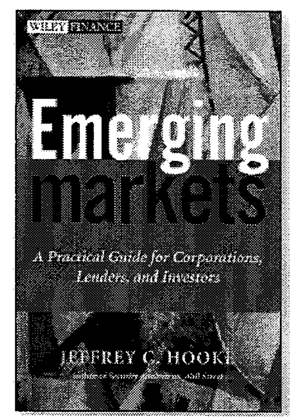
# Jeff Hooke Background

- Investment banker, private equity executive, institutional lender, finance book author, public policy researcher, Wharton MBA, Penn B.S. Mr. Hooke does not engage in money management. Retained by New Jersey AFL – CIO to review the Fund.



# Analysis of

# New Jersey State Pension Funds:

# Investment Returns and

# Investment Fees

**June 4, 2015**

*Jeffrey Hooke*
*Chevy Chase, MD 20815*

# Table of Contents

# I. EXECUTIVE SUMMARY

- **General:** The New Jersey aggregates seven public pension systems (the "Fund") for reporting purposes. The Division of Investment under the direction of the State Investment Council (collectively the "Fund staff") manages most of its publicly-traded stock and bond portfolios "in-house". The in-house U.S. stock portfolio returns closely tracked the S&P 500 index during the five fiscal years ending June 30, 2014.

- **Higher Exposure to Alternative Assets:** Like many state pension funds, the Fund has increased its exposure to alternative asset managers like hedge funds and private equity over the last five fiscal years. The Fund's exposure is likely above-average in comparison to the average state fund.

- **Fund Investment Returns Underperform Peers**: The Fund's investment returns have underperformed its peer group median the last 1, 3 and 5 fiscal years. Over the last five fiscal years, the shortfall cost the fund close to $2 billion in income.

- **Money Management Fees Higher, But Returns Below Average:** The Fund's third party management fees (as a percent of assets) have grown over 300% in the last five years. Most of these fees are attributable to hedge funds and private equity funds. Fees for fiscal 2014 and the five years ending June 30, 2014 were $600 million and $1.5 billion, respectively. As noted, the Fund's performance fell below its peers' median.

- **Alternatives Didn't Beat Benchmarks**: Despite the high fees, the hedge funds and private equity fund returns beat neither (i) the in-house equity managers nor (ii) the associated benchmarks, so the shift to alternatives was not productive. The in-house managers (i.e., publicly-traded stocks) invest in slightly different underlying corporate assets.

- **Indexing Would Have Made $2.4 Billion More**: The Fund could earn more money by replacing alternatives with passive benchmarks, based on the historical record. For example, substituting (i) the S&P 500 for private equity funds; and (i) 60%/40% U.S. stock and bond portfolio for hedge funds would have produced $2.4 billion more income the last five fiscal years.

- **Using Traditional Investments Would Have Seen $600 Million More Income**: Simply putting the private equity/hedge fund money into New Jersey's traditional stocks and bonds would have produced $600 million more over the last five fiscal years.

- **Reducing Alternatives is Possible**: Liquidating hedge fund exposure (and dedicating the proceeds to in-house managers or to an index fund) is a relatively painless process. Selling interests in private equity funds is more complicated since the fund managers are given 10 year "no cut" contracts.

## II. INVESTMENT ALLOCATION, DESCRIPTION AND STYLES

As of June 30, 2014, the Fund held $81 billion in investment assets, according to the State Investment Council 2014 Annual Report. The Fund staff segments the investment portfolio as follows.

Table 1
New Jersey State Pension Fund
Investment Asset Allocation
At June 30, 2014

| | Amount | % | Managed By |
|---|---|---|---|
| U.S. Publicly-traded Stocks | $21.6 | 26.6% | Staff |
| International Publicly-traded Stocks | 15.2 | 18.7 | Mostly Staff |
| Publicly-traded Bonds (Invest. Grade) | 11.8 | 14.5 | Staff |
| Cash and Short-Term Equivalents | 5.4 | 6.7 | Staff |
| Publicly-traded Bonds (Junk Grade) | 1.7 | 2.1 | Mostly Staff |
| **Subtotal- Traditional** | $55.7 | 68.6% | |
| Global Credit Hedge Funds | $2.3 | 2.8 | Third Party |
| Hedge Funds | 8.9 | 11.0 | Third Party |
| Private Equity | 7.3 | 9.0 | Third Party |
| Real Estate | 4.1 | 5.0 | Third Party |
| Commodities | 2.0 | 2.5 | Third Party |
| Police/Fire Mortgages | 0.9 | 1.1 | N.A. |
| **Subtotal- Alternative** | $25.5 | 31.4% | |
| Total | $81.2 | 100% | |

The Fund allocation to alternatives is likely higher than the average state pension fund.

The Fund staff manages most of the Fund's assets "in-house," with direct responsibility for the majority of traditional publicly-traded stocks and bonds.

The Fund outsources alternatives management.

*Definition of Investment Categories*

The categories can be divided into (i) traditional investments; and (ii) alternative investments.

**Traditional:**

U.S. Publicly-traded Stocks: Common stocks of companies based in the U.S. and listed on a U.S. stock exchange, like IBM and McDonald's.

International Publicly-traded Stocks: Firms based in foreign countries, such as Germany, France and China. (e.g., Nestle and Alibaba).

Publicly-traded Bonds (Investment Grade): Publicly-traded bonds of companies (or governments) with high credit ratings (BBB or better).

Publicly-traded Bonds (Junk Grade): Publicly-traded bonds rated BB or lower.

**Alternatives:**

Hedge Funds: Investment pools that generally invest in publicly-traded stocks and bonds, or derivatives thereof. Some funds also invest in currencies and commodities. Hedge funds also have the authorization from their investors to "short" securities, i.e., to bet that the value of a security will decline. "Shorting" is considered more risky than buying "long." Hedge funds purport to make profits in both "good" and "bad" stock markets, although historic evidence is lacking to support this premise.

Private Equity: This category is principally represented by leveraged buyout funds ("LBO funds"). LBO funds acquire U.S. companies, for the most part, using large amounts of borrowed money. By "buying right", improving the acquisitions, and selling the investments after a 5-10 year holding period, the LBO fund hopes to provide its investors with a return substantially higher than the S&P 500 index over the matching time period. The past evidence to support this assertion through 2015 has yet to be documented, and at this writing, roughly 60% of LBO investments have yet to be sold, according to Prequin, the private equity database firm. Private equity returns (including those of the Fund) are thus "guesstimates."

Real Estate: Commercial office buildings, industrial parks, apartment buildings and similar assets.

Commodities and Real Assets: Copper, silver, oil, timber and similar assets.

Diversification Myth: In written testimony before the Assembly Budget Committee (May 6, 2015), the State Treasurer mentioned the "diversification" benefits of alternative assets being included with traditional publicly-traded stock and bond portfolios. This statement shows a lack of understanding about alternatives.

Hedge funds, as noted, principally invest in publicly-traded securities. For example, Pershing Square hedge fund, run by Bill Ackman, has sizeable positions in Valeant (long), Air Products (long) and Canadian Pacific Railway (long), and Herbalife (short).

Private equity funds, in contrast, acquire mainly securities in privately-owned corporations. However, the underlying issuers of such private securities have economic attributes that are similar in many ways to their publicly-traded counterparts. That's hardly "diversification."

*Third Party Management*

A third party "investment manager" hired by the Fund is allocated a certain amount of the Fund's monies, and the Fund allows the manager to buy and sell investments with these monies on the Fund's behalf. The principal objective of this arrangement, which is prevalent in the institutional money management industry, is for the third party manager to use its acumen to exceed certain "benchmark returns" established by the industry for the asset category that the manager has been assigned. For example, a manager buying and selling international stocks may be measured against the MSCI Index (ex U.S.).

For these investment selection services, the Fund compensates the managers, much like the retail holders of a Fidelity mutual fund pay Fidelity a fee to select investments for the holders within preset criteria.

The third party managers hired by the Fund are called "active managers." Depending on their category, they research investment opportunities, negotiate investment prices, structure transactions, monitor investments, and then make the eventual sell decision.

In the area of publicly-traded stocks and bonds, there is also an investment style called "passive management." Here, the manager does little or no analytical work regarding the assets. Instead, the manager simply maintains a portfolio that replicates a benchmark measurement index, like the S&P 500 U.S. index. In this way, the passive portfolio is guaranteed to match the returns of the index. Countless academic studies have illustrated that "active managers" are unable to beat consistently their benchmark index. Morningstar, the mutual fund research firm, produces an annual study that typically shows 80% of mutual funds (trading public securities) failing to beat their respective indexes. This pattern has furthered the growth of index funds, which copy benchmark indexes on their investors' behalf, and charge lower fees than active managers.

The Fund, like most state pension funds, relies heavily on the active management style, and it pays a significant amount of third party investment manager fees as a result.

## III. INVESTMENT RETURNS

Peer Group: The institutional investment industry generally looks at 1, 3, 5 and 10 year return periods for comparison purposes. For the 1, 3 and 5 year periods, the Fund's investment returns were lower than its peer group median ($5 billion plus), as measured by Wilshire TUCS, the blue chip consulting firm (the State Investment Council also uses TUCS in some of its reports). The Fund's 10-year return was slightly higher. See Table 2.

Table 2
Annualized Returns, Net of Fees
New Jersey vs. Wilshire TUCS Median
Years Ending June 30, 2014

| | 1 | 3 | 5 | 10 |
|---|---|---|---|---|
| New Jersey | 16.87% | 10.23% | 12.37% | 7.51% |
| Wilshire TUCS | 17.28 | 10.24 | 12.91 | 7.37 |
| Difference | (0.41)% | (0.01)% | (0.54)% | 0.14% |

Table 2 suggests that the management fees paid by New Jersey aren't producing the desired result. Note the shortfalls over 1, 3 and 5 years. The 10 year return reflects beginning assets before alternatives increased. Assuming a $70 billion portfolio average size over five years, the 0.54% shortfall amounts to $1.9 billion in foregone income.

The pension funds in the Wilshire TUCS index use active management for the bulk of their assets (Nevada is the only state that has committed to 100% indexing, to my knowledge). Their asset allocations, for the most part, are roughly similar to New Jersey. New Jersey may be slightly above average in the percent of monies dedicated to alternative assets.

Replicating Index: In a pro bono study for the Maryland Public Policy Institute (published in 2013) and featured in the *Wall Street Journal*, among other publications, I worked with an institutional money manager to design a multi-index, passive portfolio (of publicly-traded stocks and bonds) that replicated the asset allocations of the typical state pension fund. The replicating portfolio returns beat the average state pension fund using active managers.

For this study, the passive portfolio returns were updated for June 30, 2014, the end of the latest fiscal year. See Table 3.

Table 3
Passive Replicating Index
vs. New Jersey and Peer Group
Annualized Investment Returns, Net of Fees
Years Ending June 30, 2014

| | 1 | 3 | 5 | 10 |
|---|---|---|---|---|
| New Jersey | 16.87% | 10.23% | 12.37% | 7.51% |
| Replicating Index | 18.29 | 10.94 | 14.48 | N.A.[1] |
| | (1.42)% | (0.71)% | (2.11)% | |
| Wilshire TUCS | 17.28% | 10.24% | 12.91% | 7.37% |
| Replicating Index | 18.29 | 10.94 | 14.48 | N.A.[1] |
| | (1.01)% | (0.70)% | (1.57)% | |

[1] One of the replicating portfolio components does not go back 10 years.

Table 3 suggests that New Jersey (and other state funds) should consider reducing active management and converting their funds to the passive style. This conversion would produce higher returns, partly in the form of lower fees.

Two percent (i.e., 2.11%) in higher returns over five fiscal years for New Jersey would have meant $7 billion in additional income for the Fund.

Nearby States: As one illustration, Table 4 compares New Jersey returns to those of nearby states (with a June 30 year-end) as well as to CALPERS, the larger California pension fund often considered a leader. Judging by 5 and 10 year returns, New Jersey is in the "middle of the pack." I selected nearby states, so as to avoid a "cherry-picking" accusation, as the small project budget precluded a 50-state review. New York, Pennsylvania and Connecticut do not have June 30 year ends.

Table 4
New Jersey Investment Returns
vs. Selected States, Net of Fees
Annualized, Year Ending June 30, 2014

| | 1 | 3 | 5 | 10 |
|---|---|---|---|---|
| New Jersey | 16.87% | 10.23% | 12.37% | 7.51% |
| California | 18.40 | 10.40 | 12.50 | 7.20 |
| Delaware | 17.50 | 10.00 | 13.60 | 8.50 |
| Maryland | 14.37 | 8.30 | 11.70 | 6.50 |
| Massachusetts | 17.53 | 9.79 | 12.80 | 7.92 |
| Virginia | 15.70 | 9.50 | 12.30 | N.A. |
| Four State Median | 17.50% | 9.79% | 12.50% | 7.56% |
| Difference | (0.53)% | 0.44% | (0.13)% | (0.05) % |

Source: Comprehensive Annual Finance Reports (CAFRs) of the following state funds: New Jersey (combined), California (CALPERS), Delaware (DPERS), Maryland (SRPS), Massachusetts (PRIM) and Virginia (VRS)

## IV. FEES

New Jersey paid $600.2 million in third-party management fees for fiscal 2014. Over 90% of these fees were paid to alternative investment managers.

Alternative fee managers are paid a fixed fee each year. This fixed fee is based on either (i) a percentage of the assets under management; or (ii) a percent of the Fund's dollar commitment to a fund (usually private equity) even if the commitment has not been spent. The Fund's fixed fees in this regard are 1.5% per year on its alternatives portfolio, according to the Division of Investment's April 15 presentation.

In addition, alternative asset managers are paid a performance fee (sometimes called a "carried interest") that is typically 20% of profits over a preset return, such as 8% annually. The problem with this "performance" arrangement is that (i) the manager often doesn't share in the losses, if any; and (ii) if the market goes up through no fault of the manager, the manager stands to benefit handsomely. The Fund takes most of the risk.

As a percent of year-end funds under management, the Fund's fees were 0.74% in fiscal 2014, as indicated in the next table. Fixed fees, performance fees and carried interest are included per audited CAFRs.

Table 5
New Jersey State Pension Fund
Third Party Fees Versus Selected States
Year Ending June 30, 2014
Fees as a Percent of Year End Assets

| | |
|---|---|
| New Jersey | 0.74% |
| | |
| California | 0.38% |
| Delaware | 0.26 |
| Maryland | 0.73 |
| Massachusetts | 0.55 |
| Virginia | 0.51 |
| Five State Median[(1)] | 0.51% |

[(1)] Delaware and Massachusetts do not report performance fees or carried interest separately, but include them in total. Massachusetts is average assets. The fees in the table exclude commissions, technology and investment consulting fees, although some would say these are relevant.

As reflected in Table 5, and Tables 2 and 3, the Fund's fees are relatively high, but, ironically, its 1, 3 and 5 year performance is below the Wilshire TUCS median and replicating indices.

The Fund's fees have increased over 300% in the last five years. See the next table. The five year total is $1.5 billion.

Table 6
New Jersey State Pension Fund
Third Party Manager Fees by Year
Year Ending June 30

| | Amount (millions) | Index |
|---|---|---|
| 2014 | $ 600.2 | 428 |
| 2013 | 398.7 | 248 |
| 2012 | 209.2 | 149 |
| 2011 | 191.4 | 136 |
| 2010 | 140.5 | 100 |

As noted, over 90% of these fees went to alternative investment managers, principally to hedge funds and LBO funds.

The Fund's allocation to alternatives rose from 17% of assets in 2010 to approximately 31% in 2014.



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## V. ALTERNATIVES ASSET RETURNS

Neither the hedge fund nor private fund categories exceeded relevant benchmarks, so one might conclude that the alternative approach failed. See the next table.

Table 7
New Jersey State Pension Fund
Annualized Returns – Two Alternatives – Net of Fees
Year Ending June 30, 2014

| | 1 | 3 | 5 |
|---|---|---|---|
| N. J. Private Equity | 24.14% | 14.35% | 16.30% |
| S&P 500 plus 3% | 27.61 | 19.58 | 21.83 |
| Difference | (3.47)% | (5.23)% | (5.53)% |
| N. J. Hedge Funds | 10.53% | 7.08% | 8.34% |
| Vanguard Balanced U.S. Fund (60% Bonds/40% Stocks) | 16.36 | 11.44 | 13.65 |
| Difference | (5.83)% | (4.36)% | (5.31)% |

Because of the equity orientation, high leverage and limited liquidity of leveraged buyout funds, many institutional investors believe the S&P 500 index plus 3% is an appropriate benchmark. Others use the Russell 2000 plus 3%, or something similar. The New Jersey private equity portfolio has not met the benchmark, despite the high fees.

The appropriate benchmark for hedge funds is less clear because of the varying styles of New Jersey hedge funds, which, as noted, buy and sell many different investment vehicles. Because hedge funds are not 100% equity, this report uses a 60/40 U.S. mutual fund's returns as a comparator.

Interestingly, the U.S. public stock portfolio (with cash and hedges) managed by the in-house Fund staff has outperformed the third party, private equity managers (i.e., mostly LBO's) over the last five years. During this time, the private equity managers were paid over $300 million in fees. See the next table.

Table 8

New Jersey State Pension Fund

Private Equity Versus In-House U.S. Public Equity

Annualized Returns

Years Ending June 30, 2014

| | 1 | 3 | 5 |
|---|---|---|---|
| N. J. Private Equity Managers | 24.14% | 14.35% | 16.30% |
| In-House - U.S. Public Equity | 25.45 | 16.46 | 19.36 |
| Difference | (1.31)% | (2.11)% | (3.06)% |

The comparison in Table 8 has an "apples to oranges" quality because the companies in private equity (LBO) portfolios are somewhat different than the broad, publicly-traded stock market. The LBO portfolios are dominated by mid-sized, low tech, consistent earnings businesses (before applying the added LBO debt). Such firms represent perhaps 30% of the broad public market. A pension fund can increase its exposure to LBO-type businesses, on a low fee basis, by selecting them in the public markets.

The New Jersey private equity managers compared favorably with the four of the five states that (i) provided private equity returns; and (ii) were part of our small sample. See the next table.

Table 9

New Jersey Private Equity – Annualized Returns

Versus Selected States' Private Equity

Years Ending June 30, 2014

| | 1 | 3 | 5 |
|---|---|---|---|
| New Jersey | 24.14% | 14.35% | 16.30% |
| California | 20.00 | 12.80 | 18.70 |
| Maryland | 19.56 | 12.81 | 15.32 |
| Massachusetts | 26.75 | 17.23 | 18.86 |
| Virginia | 23.20 | 15.10 | 16.00 |
| Median | 21.60% | 13.96% | 17.35% |
| Difference | 2.54% | 0.39% | 1.05% |

Again, these returns, for the part, are unrealized (the underlying investments are unsold and unlisted), so the percentage returns are reasonable "guesses" by the private equity firms.

Hypothetical Replacement of Alternatives With Traditional Assets Last Five Years Provides Extra Income

Assume the average private equity fund and hedge fund balance over the last five fiscal years was $5 billion and $6 billion, respectively. The five year returns for the S&P 500 and Vanguard 60-40 were 18.83% and 13.65%, respectively (vs. 16.30% and 8.34% for New Jersey private equity and hedge funds).

If the Fund had invested in (i) an S&P 500 index fund instead of private equity funds; and (ii) a 60-40 US equity-bond fund instead of hedge funds, the Fund would have had (iii) $760 million and (iv) $1.6 billion more income, or $2.4 billion combined.

Or, if the Fund had zero private equity and hedge funds, and put the money into its traditional investments (managed in-house), the Fund would have earned an extra $600 million over the five fiscal years ended June 30, 2014.

## VI. U.S. PUBLIC STOCKS – IN-HOUSE

As noted, the in-house New Jersey managers of U.S. public stocks achieved better returns than the private equity funds and hedge funds employed by the Fund. The comparisons are tainted somewhat by the different attributes of the three investment styles.

The in-house U.S. public stock portfolio closely tracks the S&P 500 index, and many of the Fund's public stocks are the same as those in the S&P 500.

## VII. REDUCING ALTERNATIVES

The Fund should be able to decrease its exposure to the global credit, hedge fund and commodity asset classes within 6-12 months. The Fund should have contracts with the managers allowing for the short-term redemption of the Fund's assets. The underlying portfolios are highly saleable assets.

Private equity funds, on the other hand, involve the Fund signing long-term, non-cancellable contracts for 10-12 years with the managers. A small secondary market exists for private equity fund interests; and, thus, selling the Fund's investments in this sector will require substantial time and uncertainty.

## VIII. INTERIM RESULTS

For the nine months ended March 30, 2015, the Wilshire TUCS median return for pension funds above $5 billion was 3.1%.

The Fund's return was 2.3%.

Slightly lower returns in the short term will not overshadow larger five year trends.

## IX. RECENT TESTIMONY BY DIVISION OF INVESTMENT

I was asked to review the PowerPoint testimony by the Division on April 15, 2015.

A few comments:

- Cherry Picking: The PowerPoint uses four different reference dates to justify its conclusions: March 31, 2015, December 31, 2014, June 30, 2014, and June 30, 2013. It uses four different sample sizes of peer groups: 10, 11, 13, and 17. It uses 7 years in two places when the industry emphasizes 1, 3, 5 and 10 years. The lack of consistency suggests that the PowerPoint "cherry picked" data to make the Fund look good.
- To make alternatives look better, the Fund compares their returns to investment grade bonds (page 6). Since the alternatives have a high equity component, this comparison is illogical, and it is designed to make the Fund's shift to alternatives look good because the stock market was rising.
- Page 7. Alternatives did provide profits in fiscal 2014. However, relevant index funds would have provided more profit. The PowerPoint failed to mention this fact.
- Page 8. I think a study of all fifty state funds would show New Jersey's alternative commitments are slightly higher than average. The chart shows a small $8 billion state pension fund among others.
- Page 9. The PowerPoint indicates that the Fund's investment returns are "near the top of its class." TUCS data indicates that the Fund underperformed its peer group in the 1, 3 5 year fiscal periods and over performed for 10 years.
- The PowerPoint suggests (page 13) that many state funds (and their independent auditors) engage in accounting deception by not including performance fees or carried interests in their accounting statements. My experience is that most account for fees properly, but a number of states try to hide performance or carried interest fees in accounting footnotes or obscure language. Supervisory authorities, like the SEC, should, nonetheless, examine this matter more closely.
- The "carried interest" discussion avoids review of what happens when hedge/private equity funds (i) lose money; or (ii) fail to beat a preferred return. In these cases, they still get paid their 1.5% fixed fee. Often the carried interest is not cumulative, so losses in early years are not counted against future profits, if any. The manager shares in the "good," but not in the "bad." Pension funds need to revise such arrangements.
- In its May 28th report, the Division indicated that alternatives provided much more income over the five years ended March 30, 2015 than either a (i) fixed income or (ii) 70/30 equity/ bond portfolio. The problem with the comparison is the "apples to oranges" quality. Alternatives have a high equity component, so they will beat fixed income in a rising stock market. The Division's hypothetical 70/30 equity split was 70% international equity/30% domestic bonds. Most alternatives are domestic in nature. Had the Division used domestic equities – more 'apples to apples" -- the opposite conclusion would have been reached.

## X. BACKGROUND OF JEFF HOOKE

He is a broad-based finance and investment executive with global experience throughout the U.S., Europe and the emerging markets of Latin America and Asia. He has negotiated numerous transactions, including mergers and acquisitions, public offerings, mezzanine financings, private equity investments, international bank syndications, corporate valuations and fairness opinions.

He is a Managing Director of Focus Securities, a mid-market investment bank in the United States. Assignments included M&A advisory, corporate finance and valuation work.

Earlier, Hooke focused on emerging market investment and private equity. At the Emerging Markets Partnership (1998-1999) a $5 billion private equity group, he was a Director of the $1.8 billion AIG Asia II fund. Earlier (1991-1997), he was a Principal Investment Officer of the International Finance Corporation, the $20 billion private sector division of the World Bank.

His New York investment banking career (1981-1990) covered two major firms: Lehman Brothers (1987-1990) and Schroder Wertheim (1981-1987). At Lehman he was a Vice President providing M&A, finance and restructuring services to retailing companies. At Schroder Wertheim, Mr. Hooke was a generalist banker working with a wide variety of companies and industries. He began his career as an investment officer in the private placement department of Metropolitan Life Insurance (1977-1981).

Mr. Hooke has an MBA from The Wharton School and a BS degree (cum laude) from the University of Pennsylvania.

He is the author of three authoritative books on security analysis, M&A and emerging markets investing, respectively: The Emerging Markets, Security Analysis on Wall Street and M&A, A Practical Guide to Doing the Deal. A portion of the security analysis book is required reading for the CFA exam, and the second edition was released in May, 2010. The second edition of M&A, A Practical Guide to Doing the Deal was released in December 2015. Three of Mr. Hooke's books have been used as textbooks at the graduate level.

Mr. Hooke has taught finance, mergers and acquisitions, and business valuation at several universities. He lectures on these topics at industry forums around the world. He has authored numerous public policy studies. He is a visiting fellow at the Maryland Public Policy Institute, and served in 2013 as a research vice president at Committee on Economic Development, a Washington, DC based think tank.



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June 4, 2015

**To:** **Members of Senate Legislative Oversight Committee**

**From:** **Adam Liebtag**
**NJ AFL-CIO Representative to the State Investment Council**
**and CWA Local 1036 President**

**RE:** **Testimony on Pension Investment Fees**

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Thank you for holding what hopefully will be the first of several hearings concerning the investment of public pension funds and the fees paid by taxpayers and members of the system to outside hedge fund and alternative investment managers. At the end of the day, all parties – the State administration, the staff who manage investments, the active members of the systems, and the beneficiaries – all want the fund to invest wisely and safely with maximum returns and minimum risk.

At this time, based on the increasing ratio of alternatives and hedge funds in the overall portfolio and on the large costs paid in fees and bonuses to outside managers, we are raising questions about both the expenses and the performance of these alternative investments in hedge funds, private equity and the like.

I have the honor and privilege of serving as the NJ AFL-CIO representative to the NJ State Investment Council (SIC). I was appointed in 2011 as a designee of the NJ AFL-CIO, representing all public sector union members within the various pension systems. In March, I was elected Vice Chair of the SIC after Tom Byrne was elected as Chair. There has been a history, although not always consistent, of a labor representative serving in the Vice Chair role. Aside from my role on the SIC, my full-time efforts are devoted to serving as President of Communications Workers of America Local 1036, which represents 7,300 mostly public sector workers in state executive branch, judiciary, county, and municipal government units. Almost every member in our Local is in the Public Employees Retirement System (PERS).

From a broader perspective, according to the audited financial statements for the Division of Pension and Benefits as of June 30, 2014, there were:

- 428,000 members in Public Employees Retirement System (PERS)
- 82,000 members in Police and Fire Retirement System (PFRS)
- 248,000 members in Teacher's Pension and Annuity Fund (TPAF)
- 5,900 members in State Police Retirement System (SPRS)
- 1,200 members in other systems



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*(6/30/14 Audited Financial Statement, pg20)*

So, there well over 700,000 working families that have paid into their pension over a career, and whose retirement security depends on the pension system's survival. The majority of these hundreds of thousands of members are represented by NJ AFL-CIO affiliates and CWA alone represents at least 80,000. Therefore, we are deeply concerned about beneficiaries' access to transparent and accurate information about pension investments, as well as periodic and fact-driven review of investment performance and costs.

Labor representatives to the Council are not picking individual stocks or lobbying to take over investment responsibility. However, as beneficiaries, members are deeply concerned about the sharply rising targeted and actual allocation of hedge funds and alternatives in our overall investment portfolio and the related hundreds of millions of dollars in fees paid to outside alternative fund managers.

At every union meeting in the State, active members and retirees are asking about the $600+ million in fees paid to fund managers in fiscal year 2014, whether this trend will continue, and whether this model has really yielded better returns after expenses. Given the rapid increase in hedge fund commitments and hedge fund fees, we are right to scrutinize these investments. If we compare the fees paid with state pension funds to outside managers and the returns those fees paid for, to the performance of the Division of Investment in a more traditional portfolio, we aren't convinced hedge funds and alternatives are worth the risk or worth the cost.

**Based on the Treasurer's own data, the non-alternative portfolio outperformed the alternative portfolio in FY2014. Costs for the Division of Investment to manage their portfolio in-house were very low, returns exceeded benchmarks, and it outperformed the alternative portfolio.**

**Trend of Alternative Investments Since 2010**

| FYE | Alt. Invest $$ | Alt Invst Fees | Total Pension Funds | % of Total Fund Managed In House | In House Cost | Note |
|---|---|---|---|---|---|---|
| 6/30/10 | $10.5 billion | $127 million | $66.8 billion | 80% | $10 million | |
| 6/30/11 | $13.2 billion | $174 million | $85.2 billion | 81% | $9.9 million | |
| 6/30/12 | $17.3 billion | $192 million | $78.7 billion | 74% | $10.5 million | |
| 6/30/13 | $20.3 billion | $399 million | $83.5 billion | 71% | $10.7 million | |
| 6/30/14 | $23.4 billion | $600 million | $89 billion | 74% | $10.6 million | 29.5% target allocation |
| | Total | $1.497 billion | | Total | $51.7 million | |

*Sources: Annual Reports of State Investment Council FY2010 - FY2014*

It is important to note that in FY 2007, the alternative section of the portfolio was targeted at 10.3%. By FY 2014, the target allocation had more than doubled to 29.5%. Within the last five fiscal years, the State has paid outside alternative investment managers almost $1.5 billion dollars, with a steady increase of around $3 billion more each year.

At this point FY15, with a target of about 30% of the portfolio invested in alternatives, this means our entire pension investment performance is heavily reliant on these outside managers' performance.

It has been argued that since a large portion of the fees paid to alternative investment managers is performance-based, i.e. there is a bonus paid to the manager if performance exceeds a certain hurdle or benchmark, it is a "good thing" for the fund to pay these higher fees. In other words, if the alternative investment is performing well then the overall pension fund and its beneficiaries are well-served, and the large performance bonuses paid are indicators of that.

However, this argument doesn't also recognize that strong market performance drives all fund performance. In many ways, hedge funds and alternatives are a "hedge" against the market, so the portfolio managed in house by the Division of Investment also has strong performance during peak market periods. And this portion of the portfolio does not pay the large fees and performance bonuses attached to the alternative investments.

The role of the State Investment Council is not to pick stocks or make day to day investment decisions. Those are the duties of the Division of Investment staff. DOI is underfunded, understaffed, undercompensated relative to their peers in the investment industry. By way of comparison to hedge funds, the Division of Investment charges only $10-14 million in administrative expenses to manage over 70% of the pension fund while hedge fund managers received $600 million the same year.

As beneficiaries of the system, and as members who are contributing every single paycheck (we've never missed a pension payment, unlike the State), I believe our faith is stronger in the Division of Investment in-house management than in paying 60 times the cost to an outside hedge fund manager.

Below is a chart submitted by the State Treasurer in response to OLS questions on the FY16 budget. It is available on the Legislature's website:

| Alternative Investment Program (AIP) Performance and Fee Payments to Investment Firms | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| Asset Class | Allocation as of June 30, 2014 | FY 2014 Management Fees | FY 2014 Performance Fees | FY 2014 Total Fees | FY 2014 Fees per $1 Invested | FY 2014 Rate of Return | 3-Year Annualized Rate of Return | 5-Year Annualized Rate of Return |
| AIP: | | | | | | | | |
| Hedge Funds | $8,656,630,000 | $93,100,000 | $143,900,000 | $237,000,000 | $0.027 | 10.53% | 7.08% | 8.34% |
| Private Equity Funds | $7,358,950,000 | $79,600,000 | $91,300,000 | $170,900,000 | $0.023 | 24.14% | 14.35% | 16.39% |
| Real Estate Funds | $3,712,320,000 | $37,200,000 | $49,100,000 | $86,300,000 | $0.023 | 14.21% | 11.86% | 9.23% |
| Real Assets | $2,085,020,000 | $14,600,000 | $8,900,000 | $23,500,000 | $0.011 | 9.74% | -0.54% | 4.36% |
| TOTAL AIP | $21,812,920,000 | $224,500,000 | $293,200,000 | $517,700,000 | $0.024 | NA | NA | NA |
| Division of Investment: | | | | | | | | |
| Domestic Equity | $21,450,300,000 | NA | NA | NA | NA | 25.45% | 16.46% | 19.36% |
| International Equity | $15,212,930,000 | NA | NA | NA | NA | 19.38% | 3.70% | 8.36% |
| Fixed Income | $15,755,470,000 | NA | NA | NA | NA | 7.66% | 8.27% | 9.45% |
| Cash | $6,998,340,000 | NA | NA | NA | NA | NA | NA | NA |
| Police & Fire Mortgages | $890,000,000 | NA | NA | NA | NA | NA | NA | NA |
| Total Pension Fund | $81,219,960,000 | NA | NA | NA | NA | 16.87% | 10.23% | 12.37% |
| Comparative Indices: | | | | | | | | |
| Dow Jones | NA | NA | NA | NA | NA | 12.86% | 10.67% | 14.78% |
| S&P 500 | NA | NA | NA | NA | NA | 22.04% | 14.07% | 16.40% |

The performance of the in house investments compare favorably to the alternative investment returns from FY14 and historically. In State Investment Council meetings, the Treasurer's testimony to the Legislature, and in other public forums, the State compares hedge fund and alternative performance to market indices or to hypothetical stock-bond blended portfolios. In these comparisons, it argues that the NJ alternative investments outperform these benchmarks and have added value to the pension fund. I don't argue that math, but I do argue whether these selected benchmarks are the right comparisons. In fact, just comparing alternatives to the more traditional portions of the NJ portfolio show that in house performance has fared just as well or better, and at much less cost. Perhaps we should benchmark and analyze performance of NJ's alternative investment program against its own non-alternative performance. Then, net of fees and expenses, we would see the real value of allocating funds to the alternatives.

Given the increasing amount of public funds flowing into the hands of select hedge fund managers, currently valued at $600 million and growing, there is a growing outcry from beneficiaries to reduce or limit using hedge funds and outside managers to this degree, and at this huge expense. The State is limited to no more than 38% of the pension fund being invested in alternatives, and it currently stands at a 30.05% target for FY16.

*It is a legitimate public policy question: should NJ State public pension funds be a revenue stream for Wall Street managers with monies paid for largely with public employee and employer contributions?*

To put $600 million in context:

- The State's pension obligation under chapter 78 in FY14 was $1.3 billion and the Governor only paid $700 million. That's $600 million short in the same fiscal year that NJ paid alternative investment managers $600 million in fees.

- The entire Department of Agriculture's budget is $542 million, which includes all support for Jersey Fresh marketing and aid to farmers, the child nutrition program, and all other Agriculture staff, operations, and programs.

- The much-reported proposed settlement with Exxon for environmental damages is about $225 million, less than half of the fees paid to alternative investment managers. The performance of these managers and their fees deserves as much consideration as an expenditure of public dollars.