The Situation: The Pennsylvania Legislature passed Act 5 in 2017, which, among other things, created the Pennsylvania Public Pension Management and Asset Investment Review Commission ("Commission"). The Commission was instructed to examine expenses and recommend steps to achieve $3 billion in savings over 30 years for the Commonwealth’s two largest public pension plans, SERS and PSERS.

The Result: The Commission’s final report ("Report") recommends steps to enhance transparency, suspension of private equity investment, expanded reliance on indexing strategies, and a restructuring of the investment staff serving the plans. An "Independent Review" of the Commission’s Report (supplied as an appendix) concludes that many of the recommendations may harm the Plans and/or reflect an uninformed view.

Looking Ahead: The extent to which the Plans will implement the Report’s recommendations remains to be seen, as does the mechanism for accomplishing those implementation measures.

The Report includes a variety of critiques of the past performance and decisions of SERS and PSERS (the "Plans"). The Commission’s recommendations do not come as a surprise, and mirror the public criticism of the Plans by certain Commission members and other Pennsylvania political figures.

Below, we provide an overview of four recommendations in the Report: (i) fully index public market investments and eliminate active management; (ii) suspend private equity investments; (iii) "negotiate harder;" and (iv) transparency.

Abandon Active Management for Public Market Equities
The Report recommends abandoning active management entirely in favor of investing in index funds for public market equities, citing unspecified "compelling and substantial evidence ... that active management underperforms in the long run." This recommendation mirrors extensive public criticism of active management and the fees associated with such arrangements from Pennsylvania political figures, including Treasurer Joe Torsella, Auditor General Eugene Pasquale, and others. The Report does not directly address reasonable arguments in defense of active management, including the contention from the Independent Review (included as Appendix III) that, from 2000-2017, the Plans made $6.2 billion more than if they had gone all-in on indexed funds as the Report now recommends.

Suspend Private Equity Investment
The Report opines that the Plans’ staff and boards lack the expertise and infrastructure to effectively evaluate, monitor and execute private equity investments and thus that such investments should be suspended. Per the Report, "the heart of the issue is the fact that the respective boards ... are constituted primarily of member and political representation, which ... is not appropriate for the governance of investment organizations." The Report states that a "governance overhaul ... [is] outside the scope of this project," but notwithstanding recommends a new Central Pension Investment Office ("CPIO") "composed of high-caliber investment professionals recruited and retained by [an] oversight committee." As conceived, the CPIO would be the sole contracting authority for each of its client Plans and would manage...
The Report is critical of the past performance of PSERS and SERS, and recommends a substantial shift in the overall approach to managing pension assets that is substantially consistent with public criticism and commentary from Pennsylvania political figures.

It is worth noting that PSERS’ private equity portfolio has had a 10.1% annualized return since its inception in 1992 and SERS’ private equity portfolio has had a 10.9% annualized return since its inception in 1986. The Report offers no assessment of whether and to what extent this performance is deficient.

It remains to be seen which of the Report’s recommendations, which are ostensibly directed to the Governor, the Legislature, and the Plans themselves, will be effectuated, and it is likewise unclear whether implementation will arrive via legislation, executive action, or simply by virtue of internal Plan decision-making.

Negotiate Harder
The Report postulates that the Plans could save $27.66 million on private equity investments by negotiating harder with help from a third party. The Report suggests potential topics, but does not identify the particular terms that should be sought to accomplish the projected savings or the level of consistency such terms would have with market conditions.

Transparency
The Report recommends that the Plans require external managers to use the ILPA template—a practice the Plans have implemented in part. The Report goes on to suggest the elimination of exemptions under Pennsylvania’s Right-to-Know Law, publication of all investment agreements and side letters with investment managers retained by the Plans, and public disclosure of rejected proposals. The Report argues such additional transparency will facilitate trust and better decision-making.

The Commission relegated the only contrarian viewpoint—authored by a respected 40-year veteran advisor to scores of public pensions—to a separately-printed appendix (available here). That independent review, in most cases, concludes that the Commission’s recommendations need further qualification or are potentially injurious. For example, on transparency, the independent review argues that the recommended transparency measures also carry risks, including undermining the desirability of the Plans as participants in top-performing funds.

What Can We Expect From Here?
It remains to be seen which of the Report’s recommendations, which are ostensibly directed to the Governor, the Legislature, and the Plans themselves, will be effectuated, and it is likewise unclear whether implementation will arrive via legislation, executive action, or simply by virtue of internal Plan decision-making.
4. It remains unclear which, if any, of the Report's recommendations will be implemented in whole or part, and how that implementation will occur.