Louisiana's Retirement Systems

An Expenditure Analysis

Text

Presented to: B.E.S.E.

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Louisiana’s Chronic Budget Crisis

Historically, a major problem throughout our state government has been the diversion of funding away from essential services towards less critical expenditures*.

*** see “La. in the Economic Vortex” @ lalegisfiscaloffice.com under budget documents.**

In the proposed FY05 Executive Budget, the state, local school boards, and other gov't. entities are faced with large increases in retirement costs - in addition to spiraling health care and risk management costs.

Louisiana cannot afford to squander her precious resources. <u>If responsible alternatives are available, we must pursue them fully.</u>

On December 11, 2003, the L.F.O. issued a report entitled "Louisiana's Retirement Systems, An Expenditure Analysis"

This report detailed some of the most egregious and irresponsible fiscal behavior that the L.F.O. has encountered * - and we have encountered some really dreadful behavior since our inception in 1974.

* surpassed only by the 1990's federally funded, multi-billion dollar "dispro scam".

Today, we will discuss these findings and will present potential remedies...

...that can save us tens of millions initially but hundreds of millions after a only a few years.

Please keep this forefront in your thoughts:

It is our obligation to the needy, the young, the aged, and the less fortunate to ensure that our scarce resources are expended on those in need and not frittered away by greedy, self-serving bureaucrats.

In regards to our retirement systems, the system is broken - <u>but it is in our collective power to fix it.</u>

In the early 1990’s, the legislature relinquished fiscal oversight and control of it’s retirement systems....

and gave these retirement boards unfettered access to the state coffers.

This action resulted in...

Administrative Budget Growth FY96 to FY03b

LASERS (180%, 26%)   Teacher's (124%, 18%)
Combined   147% (21% per year)

State (total) :   42% (6% per year)

K-12:   43% (6.1% per year)

Higher Ed: 61% (8.7% per year)

Legislature: 43% (6.1% per year)

Priorities? What priorities?

Teacher’s & LASERS’ Responses :

The “budgeted” figures are higher than what was actually spent at year’s end (LFO - thus the <u>21</u>% was really <u>“only” 18% per year for seven years</u>).

Both systems have <u>painlessly reduced their budgets by millions since the LFO study began</u> in December, 2002. LASERS plans more reductions in the future. A little oversight can go a long way!

LASERS & Teacher's are receiving the same budget increases from retirement, healthcare, risk management, etc. as we are. They are, despite what they claim, state agencies - except that they don't feel the pain.

All increases are passed on to the other state & local agencies - health care, education, public safety. <u>They can spend as much as they want - everyone else has to pick up their bill!</u>

Who are the losers in this arrangement?

The indigent that need health care.

Our children who must have education.

Our families that need public safety.

The unfortunate that need social services.

Our economy that needs infrastructure and maintenance.

And the list goes on...

We recognize the need for a proper level of retirement administrative expenses* but strongly urge that they be required to follow the normal budget process.

The extraordinary growth in recent years would not have happened if the normal budget process been followed. (the rapid growth started ≈ 1996)

This amounts to tens of millions of dollars that would have been allocated to much higher priorities-

with the lion's share going to education.

We have lost tens of millions over the past seven years as a result of this excessive administrative growth, but this just the tip of the iceberg...

Below the waterline is the expenditure of hundreds of millions of dollars- with nothing gained from this expenditure, as we shall see.

"ACTIVE versus PASSIVE"

<u>Active investment management</u> - High cost, "expert" advisors are hired to beat the market; to bring in returns greater than the market average--firms based in New York, Chicago, etc., but rarely Louisiana. Our retirement systems hire dozens of these firms (LASERS alone hires 24*) and <u>spend over $100,000,000 per year</u> for this "expert advice".

Passive management: low cost, broad based “indexed” investment strategy such as used on deferred compensation and 401K plans.

Could (should) be a mix of in house state jobs and state based private firms.

Texas Teacher’s uses a passive, in house strategy (approx. 65 employees).

The Showdown:

Passive versus Active*

Texas Teachers (passive)

vs.

Louisiana Teacher's (active)

* peer rankings become irrelevant lemmings

Total Amount Invested & Investment Expenses for FY96-02

	Invested	Inv. Cost	Cost/1$Inv.
Tex.-	\$493.5 B.	\$329 M.	.0007¢
La.-	\$72.9 B.	\$332 M.	.0045¢

or: Amount of dollars invested/\$1 inv. cost

Texas= \$1,500 La.= \$220

Over the past 7 years, La. Teacher's spent 666% more on investment costs in order to receive:

“EXPERT ADVICE”

Impact of 666% Higher Costs (FY96-02):

La. Teacher's investment costs:	$332 m.
La. Teacher's costs @ Texas rate:	$51 m.
Difference:	$281 m.

That's a cost of $40 million per year for seven years for "expert advice".

But wait, there's more...

La. Teacher's costs are rising rapidly:

In FY02:	Inv. costs	Investments
La. Teachers	**$77.4** million	**$10.5** billion
Tex. Teachers	**$49.9** million	**$70.7** billion.

Texas' cost per dollar invested remained constant at the long term rate of .0007¢ while La.'s costs shot up from .0045¢ to .0074¢, and increase of 64% over their long term rate (FY04 LASERS in house ≈ .001¢).*

In FY02, La. Teacher's costs/$ invested were almost 10X greater than Texas Teacher's.

At the Texas passive investment rate of .0007, La. Teacher's costs would have been $7.4 million rather than $77.4 million...

...a potential savings of $70 million in only one year from Teacher's alone!

In order to justify the exorbitant cost for “expert advice”, La. Teacher’s “experts” <u>must</u> have greatly outperformed Texas Teacher’s inexpensive indexing.

Right?

The Smoking Gun

A Comparison of Investment Earnings

FY90 - FY02 (13 years*)

Tex. Teacher's cumulative % return-	127.8%
La. Teacher's cumulative % return-	126.9%
Tex. Teacher's average % return-	9.83%
La. Teacher's average % return-	9.76%

As you might have expected, the “expert advice” added nothing to returns. In the long run, passive outperforms active by the difference between passive and active investment costs.

As the sample size increases, the results move towards the market mean - which is exactly what the passive (indexed) strategy is designed to do - quickly, cheaply and safely....

Hit and miss:

the active manager, loaded with "expert information", provides for a greater <u>potential</u> return on any given period than a passive strategy but also for a potential greater loss in any given period.

The passive manager moves towards the market average over time with little cost or risk.

The *active manager* outperforms the market average sometimes, underperforms other times but always *inevitably moves towards the market average over time -* with greater cost and more risk.

The active manager's client can "win" if he leaves the market when (or if) he temporarily gets ahead of the market*.

But retirement systems don't leave. They're in the market for perpetuity.

Thus the potential to temporarily exceed the market has no benefit and an equal potential to underperform is ever present.

The LFO recommends moving from active investment management to an indexed (passive), in house/in state investment process with a single investment agency.*

Savings, once the system is fully (and carefully) implemented, are in the $70 to $100 million range per year plus 40 to 60 high paying jobs in Louisiana.

LASERS’ response - in the past three years they have:

moved to > 40% indexed investments,

moved to > 30% in house investing,

investment costs are now far below

Louisiana Teacher’s

(LASERS in house @ .001)

(LFO has not verified these claims)

La. Teacher’s response:

we cannot hire anyone at the current civil service pay scales for money managers.

How can LASERS and the state treasurer provide successful in house investing but Teacher’s can’t?

Why won’t Teacher’s address the civil service issue (assuming it is partially true)?

"Investors as a group cannot outperform the market, because they are the market.

And from that theory flows the reality: Investors as a group must underperform the market, because the costs of participation--largely operating expenses, advisory fees, and portfolio transaction costs--constitute a direct deduction from the market's return….."

Bogle Financial Markets Research Center

An essential assumption to this position is that the market is efficient--that all of the information is available to everyone.

This is the case in the U.S. markets and other advanced markets. Even the LASERS director agrees that passive outperforms active in such cases.... but then incorrectly argues that active management can add value <u>for Louisiana</u> in inefficient markets such as the Pacific Rim.

Where does he err?

He assumes that the Louisiana board members are more intelligent investors than the <u>average</u> (pacific rim) investor or can <u>consistently</u> choose "winning" active managers in these markets.

He then cites <u>a very short time period</u> to "prove" that they can outperform the market. In the long run, they cannot-- but the high costs will remain.

He then compounded his folly by bragging that in calendar year 2003 LASERS had achieved the highest return in their history (LASERS = 26%, Teachers = 24%) when in fact these figures are very poor results for that year.

(In 2003, the Dow Jones increased by 25% and the Nasdaq by 50%, as the market rebounded.)*

Would you want these boards to invest your hard earned personal money in Pacific Rim ventures for you (or golf courses)?

These are the very individuals that define inefficiency in markets-- via a frightening lack of knowledge about investments-

especially the Pacific Rim economy!

What is the criteria used by these boards in selecting an investment firm amongst the hundreds of finely dressed salesmen/ women, all pitching the same pitch,

“Choose us, we can beat the market...”.

The boards’ staff analyzes their historical earnings- but how would you pick a winner playing roulette (red/black or odd/even)?

Would you choose the gambler that has just hit (red/black) the past three times in a row... the past twelve times... or just once? In any case, you eventually loose because the house “take” is 1/37th-- 18 red, 18 black, and one green for the house.

You can beat the house if you double your bet each time you lose provided you <u>quit when you get ahead.</u> But if you keep playing, the long run odds (1/37th) will be your cost.

Thus, in the long run (and retirement system are in it for the long run), you can’t beat the odds (the market average) so play the game that minimizes your costs (play the best odds).

Indexing will minimize your cost of investing while, as an added benefit, minimize your risk.

So what about those opportunites in the inefficient markets?

If we <u>knew</u> , for certain, that our advisor had more information than the other investors, then we would win. But the problem remains. Every investor is faced with the same dilemma--<u>we don’t know</u> who has the “hot hand” in roulette or the Pacific Rim and we don’t know if our advisor’s advice is the winning advice.

In the final analysis, active management boils down to Dirty Harry's famous line:

"Do you feel lucky, punk?

Well, do ya?"

But there are two (and only two) "sure fire" exceptions:

insider information
and
divine intervention.

The state retirement boards have universally failed to follow the **“PRUDENT MAN RULE”** which is a legal maxim that...

...restricts the discretion in a client's account to investments only in those securities that a prudent person seeking reasonable income and preservation of capital might buy for his or her own investment.

Another important advantage of indexing is the removal of the very real and substantial temptation for corruption. In house, indexed investing in conjunction with state based, private indexing removes these opportunities and provides counter-balancing competition.

The active investor’s speculative purchases, by their very nature, are custom made for an opportunistic swindler to prey on a naive victim who is easily swayed by a free dinner or a trip to New York.

As mentioned above, the LFO estimates that Louisiana can save $70 to $100 million per year by prudently moving to a mix of in house indexing and state based, private firm indexing. At the midrange, this amounts to:

$233,000 per day, seven days a week or...

$1.6 million per week, 52 weeks a year.*

This would also bring home between 40 to 60 jobs paying between $85,000 to $160,000 -

a true rarity in Louisiana’s economy these days.

Since we don’t receive any <u>investment</u> benefits from active management, what do we get for our hundreds of millions in fees for “expert advice”?

Board members and system bureaucrats have received: birthday parties, fancy dinners, and trips to wonderful cities such as New York, Chicago, & San Francisco.

What must be done?

1) achieve economies of scale - form a single investment agency (state treasurer) with oversight from a board composed of qualified members from the portfolio participants - LASERS , Teacher's etc. (Not yet filed)

2) Prudently move to a very high % of indexed investments. Eliminate almost all active investment.

3) **Refinance Unfunded Accrued Liability via pension bonds** to lower debt load (8.25% versus 5.+%). <u>This is a 30 to 40% reduction in interest costs.</u> The U.A.L. payments are not yet covering U.A.L. interest costs. The U.A.L. continues to grow until 2012 where, hopefully. the first dollar of principle will be paid - after 23 years of paying billions in interest.

The window has been open but is closing. (Not yet filed)

4) Reestablish normal budgetary oversight (Not yet filed)

5) Reestablish normal state and/or local policy and procedures for system operations. (SCR12)

6) Savings from all of the above should be utilized as additional UAL payments or experience account payments to offset growing the deficits*. This would provide substantial budget relief.

7) LFO recommends a very in depth financial and compliance audit be conducted by the Legislative Auditor’s Office on all facets of the relationship between investment contractors and the board members. (SCR14)

8) Consideration of a plan for equalizing the retirement systems benefits and other inequities amongst future members. (SCR13)

9) Consideration of implementing a defined contribution plan. (SCR15)

Bills to achieve these goals, which, if successful, will greatly reduce the state and school board U.A.L. obligations by hundreds of millions of dollars very quickly and permanently.

9) Require that a third party (Secretary of State) manage all board elections. (Not yet filed)

SB622
and
SB623

Sources:

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$70 to $100 million per year, year after year.
40 to 60 high paying jobs.

All exported.

For nothing.

A very substantial reduction in interest payments worth, minimally, tens of millions. annually.

But we must act while rates are still low.

Questions?