

June 10<sup>th</sup>, 2015

Memo

From: Andrew Roos, Chief of Staff

To: State Investment Commission, ERSRI Board

RE: Ted Siedle Document

In response to the latest assertions regarding ERSRI's investment performance made by Ted Siedle, I asked our staff to examine the claims in the document he released on June 5, 2015. Our staff found the document to consist of numerous inaccurate and misleading statements.

The effectiveness of various investment strategies for public pension systems like ERSRI is a legitimate topic for public debate, and reasonable people can disagree about what the best strategy may be. However, publishing inaccurate and misleading figures as Mr. Siedle has done, serves only to damage the public discourse. An informed discussion requires accurate information, and therefore it is important that the false statements published by Mr. Siedle be refuted.

**The mistakes in Mr. Siedle's document fall into three major categories:**

- Presents false and misleading information as fact
  - Fabricates inflated numbers about the fees and expenses paid by ERSRI to investment managers
  - Significantly overstates ERSRI's allocation to alternative investments
  - Uses misleading data and inappropriate benchmarks to mischaracterize ERSRI performance
  - Contains numerous factual errors
- Dishonestly accounts for information that Treasury makes available to the public
  - Frequently claims that information is inaccessible when it is clearly available on the Treasury website<sup>1</sup>
  - Presents a false account of Treasury's handling of his public records request

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<sup>1</sup> [www.treasury.ri.gov](http://www.treasury.ri.gov). Included on that site are links to [investments.treasury.ri.gov](http://investments.treasury.ri.gov) and [data.treasury.ri.gov](http://data.treasury.ri.gov), which contain extensive information on ERSRI investments.

- Fails to acknowledge the strong steps RI has taken to improve transparency and accountability
  - As a matter of policy, Rhode Island will only invest with funds who agree to full public disclosure of critical information
  - New data portal provides access to hundreds of documents on state investments
  - Rhode Island is leading calls for stronger national standards for pension transparency

### **False Information Presented as Fact**

- Fabricates fees and expenses paid by ERSRI to investment managers

Beginning in 2013, Treasury began reporting data on the indirect management and performance fees charged to the system by fund managers, going above and beyond the requirements of government accounting standards and the practices of most public funds. In 2015, under Treasurer Magaziner’s “Transparent Treasury” initiative, Treasury went even further, publishing comprehensive totals of fees and expenses paid to fund managers.<sup>2</sup> This full disclosure of fees and expenses has made Rhode Island a national leader in pension transparency. Under this new policy, full fee and expense data is already being published on an asset level, and will be published on a fund-by-fund level in the near future.

Mr. Siedle appears to have ignored these new disclosures, which are easily accessible on the Treasury website, and has instead substituted his own highly inaccurate numbers with no documentation to support his claims.

For example, Mr. Siedle claims that ERSRI paid \$86 million to private equity fund managers in 2014. The actual number, readily viewable on the Treasury website, was \$19.8 million. The justification Mr. Siedle produces to support his inflated number is a 2007 academic paper stating that the “average private equity buyout fund charged more than 7% in fees.” This academic paper does not contain any data or analysis specific to Rhode Island or any of Rhode Island’s fund managers. The paper also assumes fee arrangements that Rhode Island typically does not agree to when engaging fund managers. In short, Mr. Siedle has chosen to ignore actual data on Rhode Island investments, and instead has generated numbers by taking the findings of a single academic study out of context.

Mr. Siedle also claims that ERSRI pays \$30 million to private equity firms for “doing nothing.” He provides no evidence to support this number. Management fees paid by

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<sup>2</sup> ERSRI requires that all fund managers employ reputable third-party auditors to verify performance, fee and expense disclosures.

ERSRI on uncalled private equity commitments were less than \$5 million in fiscal 2014. This could be easily ascertained by publicly available documentation posted on the Treasury website.<sup>3</sup>

Mr. Siedle also misstates the fees charged to ERSRI by real estate managers. His document claims ERSRI paid \$21.6 million to real estate funds in 2014, when the correct number, easily viewable on the ERSRI website, is \$3.2 million. The explanation Mr. Siedle offers for his inflated figure is “his experience”<sup>4</sup> Once again, he ignores hard data, substituting an unsubstantiated number.

While Mr. Siedle has provided no evidence to support his estimates of fees paid out of the system, ERSRI with the launch of its Transparent Treasury initiative has provided great detail regarding all fees and expenses paid by the pension system, and made the numbers easy to follow and readily available online.

- o Significantly overstates ERSRI’s allocation to alternative investments

As disclosed on the Treasury website, ERSRI’s exposure to alternative investments (private equity funds, hedge funds and real estate funds) is 26%. This number is roughly consistent with the national average for public pension funds (estimated by the Pew Charitable Trust to be 23% in 2012).

Despite this \ readily available fact that is confirmed by ERSRI’s custodian in each month’s SIC report, Mr. Siedle’s document asserts that Rhode Island has 40% of its portfolio allocated to alternative investments. He reaches this larger number by misclassifying traditional investments, including inflation-linked bonds and publicly traded infrastructure stocks, as alternatives. ERSRI’s inflation-linked bond allocation is currently 100% invested in bonds issued by the United States Treasury – hardly an “alternative” investment by any definition. Similarly, publicly traded infrastructure stocks are, by definition, publicly traded securities and not alternative investments.

Mr. Siedle also misleadingly counts anticipated future investments by ERSRI into private equity funds toward his 40% claim. He includes future flows into private equity funds while ignoring future distributions out of private equity.

These mistakes result in a misleading picture of ERSRI’s asset mix. Neither ERSRI’s current nor its target allocation to alternatives is 40%. It is disingenuous to suggest otherwise.

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<sup>3</sup> For private equity, both committed capital and unfunded capital (committed but not yet drawn by the manager) are published and posted online monthly in the State Investment Commission reports. As of June 30, 2014, the unfunded amount totaled \$246,830,791.61. ERSRI expense reports on the Treasury website show that ERSRI private equity managers charge management fees of 2% or less, so without any additional information it is clear that total fees paid on uncalled capital are less than \$5 million. Moreover, it is misleading to say that fees on unfunded capital are paid to managers for “doing nothing”, as the research and diligence of potential investments begin before capital is called.

<sup>4</sup> See page 67 of his document.

- Uses misleading data to make the case for “underperformance”

Mr. Siedle’s central argument that ERSRI has underperformed by “billions” of dollars is based entirely on misleading and distorted numbers while ignoring data that contradict his assertions. Though investment performance can always be improved, it is important to use reliable, consistent data and appropriate comparisons when judging investment returns.

The document claims that ERSRI’s real estate and private equity investments have “cost ERSRI millions.” To support this claim, Mr. Siedle presents ERSRI’s real estate returns over a 10-year horizon, and private equity returns over a 5-year horizon. Why not judge the returns over the same time period?

As can be seen in publicly available data on the Treasury website, ERSRI’s after-fee private equity returns over the past 10 years total 9.8%, making private equity the best performing asset class over this time frame and significantly better than ERSRI’s overall 10-year total return of 6.6%. In effect, private equity outperformance has earned ERSRI hundreds of millions over the past ten years – not lost money, as claimed.

Like many others, ERSRI endured challenges during the real estate crash of 2008-2009, and the system’s 10-year real estate returns reflect this difficulty. Since then, ERSRI has significantly altered its strategy in the asset class. Had Mr. Siedle judged ERSRI’s real estate holdings on the same 3-year or 5-year time horizon that he used to judge hedge funds and private equity, he would have seen that ERSRI’s real estate holdings have provided double-digit returns across both time horizons and have been among ERSRI’s most successful investments in those periods.

Mr. Siedle also makes misleading claims about the performance of ERSRI’s equity and absolute return hedge funds. In claiming “underperformance,” he compares ERSRI’s hedge fund performance to the Russell 3000 equity index, implying that hedge funds are meant to serve the same purpose as stock indexes. The purpose of ERSRI’s hedge fund allocation is not to provide equity-like returns, but rather to protect the system against the risk of another market downturn. ERSRI’s hedge fund investments are not expected to produce higher returns than equity indexes, but are expected to provide lower risk as measured by volatility.<sup>5</sup>

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<sup>5</sup> As can be seen in publicly available documents on the Treasury data portal, the total overall 3-year risk of ERSRI investments, as measured by standard deviation, is 5.5. By comparison risks of the fund’s equity and real return hedge funds have been 4.0 and 2.5, respectively. The risks of the system’s equity indexes are 9.6 for domestic stocks and 12.5 for international. ERSRI’s hedge funds have been successfully serving their intended purpose of reducing risk to the system, contrary to the document’s claims.

Finally, Mr. Siedle's assertion of overall ERSRI investment performance is based on inappropriate comparisons. In claiming that ERSRI "underperformed" by \$1.4 billion, Mr. Siedle compares ERSRI's performance under the previous administration to a benchmark composed of 80% of the performance of the S&P 500 stock index and 20% of the Barclays U.S. Aggregate bond index. For a public pension fund like ERSRI, an 80% allocation to stocks would be an incredibly volatile and risky investment strategy and probably a breach of fiduciary duty.

ERSRI is required to pay more than \$800 million in benefits annually, and were the stock market to endure another downturn like that of 2008 or 2000-02, an 80% allocation to stocks would be financially devastating. Making performance comparisons to an 80% stock portfolio is wildly misleading, and such a benchmark would be highly unusual for a public pension fund. A more appropriate and common comparison is a "60/40" benchmark consisting of 60% equity indices and 40% fixed income. As can be seen on the Treasury website, ERSRI has consistently beaten the returns of the 60/40 benchmark over the 1-, 3-, 5- and 10-year time horizons. To have an honest discussion about performance, appropriate, industry-standard benchmarks should be used, rather than inappropriate, non-standard benchmarks that justify misleading contentions.

- Contains numerous factual errors

Examples of the document's inaccuracies include:

- Mr. Siedle claims that ERSRI's allocation to "hedge, venture capital and private equity" was "zero" when Gina Raimondo became Treasurer. In fact, ERSRI had been investing in private equity and venture capital funds for nearly 30 years by that time, with a total allocation of more than \$600 million at the start of then-Treasurer Raimondo's term. This information is easily accessed on the Treasury website.
- The document asserts that fees and expenses paid to real estate managers are not available on the Treasury website. They are. Management and performance fees are available an aggregate level, and will be available on a fund-by-fund basis going forward.
- Mr. Siedle repeatedly states that ERSRI has \$7.5 billion in assets, but total assets have exceeded \$8 billion for more than 18 months.
- The document misstates the fee structure charged by Point Judith Capital, as can be viewed on the Treasury website.
- Mr. Siedle states that "in his opinion" the likelihood of Industry Ventures delivering "competitive net investment performance" to ERSRI is remote.

He omits that public documents provided to him show that this particular investment has thus far earned a 37% annualized return since inception.

- The document claims, with no substantiation, that investment information is withheld from members of the State Investment Commission. In fact, all SIC members are granted access to all investment information maintained by Treasury staff.

### **False Account of What Information Treasury Makes Publicly Available**

- Mr. Siedle's document repeatedly claims that information is "hidden" or "secret" when it is, in fact, available and easily accessible. Total fees and expenses paid to fund managers, broken down by asset class, are readily available and accessible on the Rhode Island Treasury website. These totals include not only management and performance fees, but also all investment-related fund expenses charged by fund managers to ERSRI.
- Mr. Siedle repeatedly states that his request for access to public records from ERSRI was "denied." In fact, none of his requests were denied.

The public records request sent to ERSRI by Mr. Siedle was unusually broad and wide-ranging. Treasury counsel estimated that fulfilling the entire request would require review of approximately 77,613 records. To be as responsive and timely as possible, Treasury staff provided Mr. Siedle with more than 800 pages of documents completely free of charge within 10 days of receiving his request.

Responding to the rest of Mr. Siedle's broad request within the legally mandated 30 days required significant financial resources in the form of staff overtime and possible engagement of external vendors to assist in record retrieval and review. The total cost borne by taxpayers and members of the retirement system to meet this request would easily extend into the tens of thousands of dollars. As such, in accordance with Rhode Island public records law, ERSRI informed Mr. Siedle that complete fulfillment of his request would require him to offset a portion of the projected cost. The figure quoted to Mr. Siedle for his share of the cost was conservative, given the size of his request and the total expense that would have been required to complete it.

Mr. Siedle was informed that if he wished to contest the estimated cost of compliance for his request, he would be free to file an appeal. He never did. He was also informed that he could decrease the cost significantly by providing more clarity as to the type of information he was looking for, to help ERSRI narrow the search. He never responded.

At no time were any of Mr. Siedle's requests "denied." Many documents were provided to him for free, and others could have been provided, had he either agreed to help cover

the significant taxpayer expense required to meet his very broad request or provided greater clarity as to what documents he was seeking to obtain.

A copy of Mr. Siedle's public records request and ERSRI's response is available on the Treasury Data Portal for reference.

### **Failure to Recognize the Strong Steps Treasury Has Taken to Provide Unparalleled Transparency and Accountability**

On May 26, 2015, Treasurer Magaziner announced the "Transparent Treasury Initiative", a wide-ranging series of actions designed to make Treasury information more available and accessible to the public. Many aspects of the Transparent Treasury Initiative are unprecedented, both in Rhode Island and nationally. Mr. Siedle has ignored the major steps Rhode Island has taken to improve transparency in state investments.

Under Treasurer Magaziner's leadership:

- Rhode Island will only invest in funds that agree to full public disclosure of all fees and expenses charged to ERSRI, as well as net-of-fees performance and fund liquidity. Managers will be required to sign a pledge indicating that they understand this requirement before they will be permitted to appear before the State Investment Commission for consideration.
- Existing ERSRI fund managers with contracts that would otherwise prevent such disclosures will be asked to waive their confidentiality rights and comply with the new transparency requirements voluntarily. Negotiations are currently ongoing, and Treasury anticipates that most existing managers will agree to the new standards.
- As of May 26, all fees and expenses paid to fund managers by ERSRI are fully reported on the Treasury website. These fees and expenses are currently reported on the aggregate level, by asset class, and will be reported on a fund-by-fund level going forward (previous bullet notwithstanding).
- A new Treasury Data Portal contains hundreds of documents pertaining to the state's investments, including raw performance data going back more than 30 years. Going forward, all documents distributed in open session of SIC meetings, including fund presentations and consultant due diligence documents, will be posted to the data portal.
- A new Investment Information Center on the Treasury website contains easy-to-access information on the ERSRI's performance, asset allocation, expenses and cash flows, along with descriptions and data for each individual fund manager.

- Treasurer Magaziner has committed to recruiting other state treasurers to jointly petition federal regulators for tougher national standards on pension fund disclosure.
- Treasurer Magaziner has committed to not accepting any political contributions from managers of funds in which Rhode Island invests.

It is important to note that few public pension funds across the country have taken any of these steps on transparency, and none besides Rhode Island have taken all of them. Treasurer Magaziner is committed to continuing to improve the transparency and accountability of the pension system, under the belief that doing so will improve financial performance both for members of the pension system and for all Rhode Islanders.

### **Conclusion: An Informed Discussion on Investments**

Members of the public have every right to question the investment decisions of the Treasury and State Investment Commission. Robust debate on matters of public finance is welcome and serves an important public purpose. Unfortunately, introducing falsehoods and misrepresentations into the public dialogue damages the quality of the debate. This appears to be the case with the document Mr. Siedle released on June 5, 2015; it contains misleading statements and outright falsehoods that undermine the credibility of his opinions and arguments. The Rhode Island Treasury remains committed to an open dialogue with all members of the public, and encourage all participants to remain truthful in their representations.

Treasurer Magaziner and I look forward to working with you as the stewards of Rhode Island's investments. By working together and having reasonable, fact-based discussions about the risks and rewards of different investment choices, we can create a robust portfolio that generates the strong and steady long-term returns that the people of Rhode Island deserve.

Thank you for your service.

Sincerely,

Andrew Roos

Chief of Staff  
General Treasurer Seth Magaziner