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# Concerns Raised Over Consultants to Pension Funds

By MARY WILLIAMS WALSH

**A** small but growing part of the \$2 trillion in state and local pension funds is being steered into high-risk investments by pension consultants and others who often have business dealings with the very money managers they recommend. After making such investments, a few of these pension funds have come up short, forcing the governments to draw on tax dollars.

The Securities and Exchange Commission is so concerned that it has begun an inquiry into the practices of pension consultants, who serve as gatekeepers for thousands of money managers.

The regulators will find not just financial consultants but a web of intermediaries — marketing agents, lobbyists, brokers and world leaders — between pension funds and the investments they choose.

Some play surprising roles. Former President Bill Clinton meets with pension trustees on behalf of the Yucaipa Companies, a private firm that seeks financial returns through social investing. Ehud Barak, the former Israeli prime minister, persuaded the Pennsylvania teachers' pension fund to commit \$125 million to SCP Private Equity Partners, a firm that invests in Israeli military technology. New York's former state comptroller, H. Carl McCall, encouraged the Illinois teachers' pension fund to place \$20 million in Healthpoint, a private firm that invests in orthopedic devices companies.

Some pension consultants play host to gatherings that showcase such famous people to pension officials. Money managers may pay tens of thousands of dollars to participate and often supply the marquee talent. Consultants, meanwhile, are being paid by the pension funds to track and rate the money managers but may take money from the managers for other services.

Under the consultants' watch, more money is flowing into private or alternative investments, which are not publicly traded like stocks and bonds and whose performance cannot be tracked in any agreed-upon way. Private investment pools attracted virtually no state pension money a decade ago, but the typical state pension fund now has nearly 5 percent of its assets in them, and some states have far more.

Though such unregulated investments offer the potential for high returns, they carry more risk than

conventional stocks and bonds. A few governments have lost money. Richard Holbein, a pension consultant in Dallas, put the Arkansas teachers' pension fund in touch with Andrew S. Fastow, then chief financial officer of [Enron](#), who was pitching investments in one of Enron's off-balance-sheet entities. Arkansas committed \$30 million and may have lost it all.

Another of Mr. Holbein's clients, the Louisiana teachers' pension fund, committed an unusually large part of its portfolio to private equities and other alternative investments at his recommendation. Because of recent losses, Louisiana and its taxpayers must contribute \$589 million to the pension fund — \$147 million more than last year.

Louisiana fund officials and Mr. Holbein say that private equity tends to be a volatile investment with unexpected swings from year to year, but the overall approach remains sound and does not present a long-term problem for the fund.

In other cases, pension money is landing in investments that deduct big fees. Some of the costs may not be clearly disclosed, and some may be wholly unnecessary.

The Chicago teachers' pension fund was about to commit \$35 million to a Boston real estate partnership last December when one official noticed that nearly 2 percent of the money would go to the consulting firm of Edward M. Kennedy Jr., the senator's son, which the real estate developer had retained to market the investments. Normally, pension funds are not billed for marketing fees. The teachers' fund refused to pay and was permitted to invest anyway.

Specialists say the structure of public pension funds leaves them particularly vulnerable. Fund boards are responsible for investing hundreds of millions of dollars, but only the biggest ones can afford professional investment staffs. Public trustees are often drawn from the ranks of firefighters, teachers and other public employees whose retirements they are protecting. They often have little financial training and are expected to serve as volunteers. Most public funds therefore rely heavily on consultants, even though the consultants may have business ties with the very money managers they are supposed to help select.

"In my opinion, there is a mismatch," said Brian N. Minturn, who was fired last year by the Louisiana teachers' pension fund. He said he was dismissed after he raised concerns that the prominent Dallas investment firm of Hicks, Muse Tate & Furst was plying the trustees and their consultants with food and drink, and taking them on golf excursions, hunting trips and other outings that he thought distracted them from their fiduciary duty to vet investments prudently. An ethics panel ultimately found that some pension officials, Mr. Holbein and Hicks, Muse had violated state ethics laws.

"On the side of the pension fund, you may have food-service workers on \$35,000 a year, and they never get to do any of this kind of stuff," he said. "And on the side of the alternative investments, there is very high-powered talent, and very strong motivations, to go out and get whatever you can."

What the investment community wants, of course, is big blocks of money.

"If you look at where the money is, it's kind of what Willie Sutton said about why he robbed banks," said Mr. Minturn, who once worked for Fidelity Investments and the Invesco funds. "Pension funds are just these huge piles of money."

Consultants and many pension fund officials say that they are not being swayed by business relationships, and that private equities are an important tool in their portfolios, when used in moderation.

"Our board does believe in diversifying our portfolio into some active investments that are riskier," said Brad Pacheco, a spokesman for the California state employees' pension fund, known as Calpers. "They do it to add value to the fund." In some cases, pension officials say they also choose alternative investments to achieve other goals, like local development.

Mr. Minturn and some other concerned pension specialists said they had no objection to private investment partnerships per se, but questioned the appropriateness of investing public pension money in them. Because the assets are not publicly traded, they cannot be sold quickly to raise cash; they have no listed price, and their performance cannot be tracked or evaluated in conventional ways. They also involve fees much larger than those for publicly traded stocks or simpler investments. They sometimes generate large profits, but not always, and the partnerships are usually structured so that the outside investors — like pension funds — bear most of the risk.

A few states and municipalities bar pension funds from investing in private equities. Most states limit these investments to a small share of their portfolios. Data compiled by Wilshire Associates, the investment advisory company, suggests that the average state pension fund had 4.7 percent of its assets in private equities last year.

By Wilshire's count, the Louisiana teachers' pension fund had 18 percent of its portfolio in such investments last year. But when its total commitment over time to various private partnerships is calculated — and the state cannot really back out of these pledges — Louisiana had at one point committed 42 percent of its assets to what it calls "alternative investments," according to state pension plan documents.

Mr. Holbein said that Louisiana's investment problems were unforeseeable. Though some individual private equity funds may falter, he said he believed that they could produce higher returns than publicly traded stocks on the whole. He advocated a high level of alternative investments for Louisiana, he said, because a state law requires the teachers' pension fund to accumulate money quickly to reach full funding. More conservative investments will not provide adequate gains, he said.

In December, the S.E.C. sent 12-page letters to about two dozen pension consultants, requesting extensive information about what they do for pension funds, how they are paid and how their pension work may conflict with their other business operations. The agency appears to be trying to learn how

often pension consultants work for both sides of the table, receiving compensation from their pension clients and money managers. Lori A. Richards, director of the commission's inspections unit, said the study was still in progress and the commission had not drawn any conclusions.

Pension consultants sort money managers into asset classes and build databases using their own criteria to help trustees compare and select managers. Some consultants also sell their databases and tracking software to money managers and even sell advice on how to achieve higher rankings.

A 2002 audit of Hawaii's pension fund found that its consultant, Callan Associates, had recommended 16 money managers over time — and 14 of them were paying Callan for marketing advice and other services. "The consultant's objectivity could be suspect," said the state auditor, Marion M. Higa, calling for further scrutiny. She noted that the Hawaii fund's overall five-year investment performance "ranks in the bottom 5 to 15 percent nationwide."

A Callan spokeswoman said that Hawaii's trustees stood by Callan after the audit, issuing a statement calling it "a highly regarded investment advisory firm with an unblemished reputation for integrity." In a statement, Callan said that it kept its various business lines separate and that it told all money managers that they would not win preferential treatment from Callan's pension consultants by buying other Callan services.

Early this year, Wilshire Associates took steps to make its pension consulting work more independent of its other lines of business, and the leader of its consulting and asset-management units left the firm. "Wilshire has never participated in 'pay to play,'" a spokeswoman said.

Many consultants hold educational conferences for pension trustees. The trustees pay a modest admission fee or none at all; the costs are borne by money managers, who pay tens of thousands of dollars for the chance to attend and meet the trustees. The more they pay, the more influence they tend to have over content and the more access to trustees, from leading workshops to closer seating assignments.

CRA RogersCasey, a consulting firm, charges money managers \$35,000 to \$40,000 to send two representatives to its gatherings, which take place at resorts and in the past have featured speakers like retired Gen. H. Norman Schwarzkopf; Colin L. Powell, now the secretary of state; and Mary Matalin, the Republican political strategist.

Mercer Investment Consulting, a large firm that is a unit of the [Marsh & McLennan Companies](#), charges money managers \$35,000 to \$58,000 a year to attend its conferences. This month, Mercer sent a letter to its clients, telling them it had complied fully with the S.E.C.'s request for information and outlining its other business activities, like software sales and investment conferences.

"Making these products and services available to the broader investment community does not in any way impact our objectivity," the letter said.

Bill Clinton addressed at least two public trustees' conferences last year and was well received, said Jack Silver, a former trustee of the Chicago teachers' pension fund who attended both. Mr. Silver has been an outspoken critic of the undisclosed business relationships of pension intermediaries, but he said Mr. Clinton made useful remarks about the economy — not a sales pitch — and that the trustees benefited from his appearance. So, he added, did Mr. Clinton's sponsor, Yucaipa. "It's marketing," Mr. Silver said. "When you have somebody like him, people remember."

Yucaipa's managing partner, Ronald W. Burkle, is a billionaire and has been a substantial donor to many politicians, including Mr. Clinton and several past and present trustees of Calpers. In 2001, Calpers voted to commit \$450 million to three Yucaipa private investment funds, which are designed to generate returns and societal benefits, by financing neglected businesses in poor neighborhoods and companies that treat workers conscientiously. Calpers' most recent annual report showed that these funds have drawn about \$51 million in total investments and related fees, and have so far not produced returns.

A Calpers spokesman said that private investment funds routinely draw on the partners' capital in the first few years, and pay returns only later. He also said the commitment to Yucaipa's funds is only a small part of Calpers's \$164 billion portfolio. Yucaipa said its fledgling investments were poised to bear fruit, but it could not provide additional information last week.

Some pension officials say they find the out-of-office politicians useful liaisons. Jon Bauman, the executive director of the Illinois teachers' pension fund, said his board had been considering an investment in Healthpoint when Mr. McCall became vice chairman. His arrival "added to a favorable opinion," Mr. Bauman said.

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# In Louisiana, a Pension Official Blows the Whistle on Adviser Conflicts

By MARY WILLIAMS WALSH

Louisiana officials are trying to determine what, if anything, has gone awry with their teachers' pension plan.

They recently learned that they must unexpectedly come up with an extra \$147 million for the fund.

Now, legislators are considering whether to relax their funding rules. The trustees say the rules require the pension fund to grow very quickly, forcing them to invest in higher-risk assets in search of higher returns. These assets can swing sharply in value, throwing the fund off its targets in some years and forcing the state to raise extra money.

But some critics say that the investment strategy is flawed, noting that the teachers' fund wound up with one of the highest levels of risk of any state fund tracked by Wilshire Associates, the investment advisory firm.

Brian N. Minturn was surprised when he went to work at the Louisiana teachers' fund in 2002 and discovered the extent of its investments in private equities. He spent about 17 months observing the ways of the industry. Private equity firms welcomed pension trustees to annual meetings at golf resorts where the atmosphere discouraged tough questions, he said. They sponsored "educational" jaunts in Alaska where it was hard to concentrate on investment risk. They invited pension officials to sit on their "advisory boards," which meant dining with former White House aides and secretaries of defense.

"You think, 'Wait a minute. They don't know about pension funds,' " Mr. Minturn said. "It's just a schmooze deal."

Louisiana teachers' largest private-equity commitment was with Hicks, Muse, Tate & Furst of Dallas. Mr. Minturn said he reviewed the paperwork and disagreed with how the fund's consultant, Richard Holbein, was tracking its performance. He also thought the fees were not being disclosed in enough detail.

He went to his first advisory board meeting planning to ask Hicks, Muse about it. The meeting turned into a dinner in a suite at a Dallas Stars hockey game, where the firm's founding partner, Thomas O. Hicks, is a majority team owner. Also in attendance was his fund's consultant, Mr. Holbein, who, it turned out, sat on the advisory boards of Hicks, Muse and three other investment firms.

In an interview, Mr. Holbein said that he served on the boards to monitor investments on behalf of his clients. He said he was not compensated by Hicks, Muse or the other firms for his services. An official of Hicks, Muse also said that the firm had not compensated Mr. Holbein.

Mr. Minturn asked the state ethics board to study the propriety of state employees receiving meals, trips and other gratuities from a firm soliciting state business.

Not long afterward, the pension fund's trustees gave him an unfavorable performance review and fired him. Bonita B. Brown, the director who succeeded Mr. Minturn, confirmed that he had received a negative review.

The ethics board issued its findings in January. It said that some pension-fund officials, Mr. Holbein and Hicks, Muse had all violated state ethics laws. It imposed civil penalties ranging from \$1,500 to \$5,000 and asked those who had received gratuities from Hicks, Muse to reimburse the firm. Hicks, Muse said in a statement that it had offered the gratuities "as token and customary good-will gestures," and that it had no idea its practices were violating the law in Louisiana or anywhere else.

"It is simply not reasonable to suppose that the items in question influenced, could have influenced, or were intended to influence investment decisions," the firm said.

The pension fund trustees kept Mr. Holbein as their consultant but added two more. Someone other than Mr. Holbein now handles private equities, but the overall investment strategy is unchanged.

Louisiana law requires the teachers' pension fund to be fully funded by 2029. The state's actuaries have said that it can reach that goal with planned contributions if it achieves average yearly investment returns of 8.25 percent. That is one of the highest targets of any of the state pension plans tracked by Wilshire.

"We have unique needs," Ms. Brown said. "If we didn't have those unique needs, believe me, we would not be in alternative investments."