

December 12, 2004

How Consultants Can Retire on Your Pension

By GRETCHEN MORGENSON and MARY WILLIAMS WALSH

NINE years ago, William Keith Phillips, a top stockbroker at Paine Webber, met with the trustees of the Chattanooga Pension Fund in Tennessee to pitch his services as a consultant. He gave them an intriguing, if unusual, choice. They could pay for his investment advice directly, as pension funds often do, or they could save money by agreeing to allocate a portion of its trading commissions to cover his fees. Under a commission arrangement, Mr. Phillips told the trustees, the fund would be less likely to incur out-of-pocket expenses, leaving more money to invest for its 1,600 beneficiaries.

Seven and a half years later, Chattanooga's pension trustees discovered just how expensive that money-saving plan had been. According to an arbitration proceeding they filed against Mr. Phillips, the agreement cost the fund \$20 million in losses, undisclosed commissions and fees. And since 2001, Chattanooga has had to raise nearly \$3.7 million from taxpayers to keep the \$180 million fund fiscally sound.

The Chattanooga trustees fired Mr. Phillips in 2003 and, last October, filed arbitration proceedings against him, UBS Wealth Management USA, formerly the Paine Webber Group, and his new firm, [Morgan Stanley](#). The case, which is pending, accuses the consultant of, among other things, fraud and breach of fiduciary duty. The commission arrangement was central to the problem because it put Mr. Phillips's interests ahead of his client's, the fund said in its complaint.

"The very important and in many ways unique relationship that a pension fund board has with its consultant is based on trust," said David R. Eichenthal, finance officer and chairman of the general pension plan for the city of Chattanooga. "To the extent that Phillips breached that trust, we thought it was important for the pension fund to do everything possible to hold him accountable for the results."

Pension experts say the Chattanooga case is hardly rare among retirement funds. The Securities and Exchange Commission is concerned enough about conflicts of interest among consultants who advise pension funds on asset allocation, selection of money managers and other investment matters that it is conducting an industrywide inquiry. The results of the S.E.C.'s investigation are expected soon, and enforcement actions may follow.

Aubrey Harwell, a lawyer for Mr. Phillips, declined to make him available for this article. Mr. Harwell said: "No. 1, these are allegations and not proven facts. And No. 2, the performance during the days that Keith Phillips was consulting were well beyond the benchmarks." Details of the commission arrangement, he added, were fully disclosed to the pension fund. But this is not the first time a pension client has sued Mr. Phillips. In 2000, the Metro Nashville Pension Plan filed an arbitration based on similar accusations. That arbitration was settled two years later, with UBS paying \$10.3 million to the pension fund.

As financial services conglomerates have added a wide array of operations in recent years, the possibility of conflicts of interest has also grown. And nowhere are the conflicts more potentially lucrative - and more obscure - than in the management of pension assets.

"Recommendations to pension funds regarding asset allocation, money manager selection and securities brokerage policies are frequently driven by undisclosed financial arrangements," said Edward A. H. Siedle, president of Benchmark Financial Services Inc., in Ocean Ridge, Fla., and a former lawyer for the S.E.C. "Pensions often accept that poor investment performance is attributable to unfortunate investment assumptions when, in fact, more sinister forces were at work. Investment performance often is compromised as the result of conflicts of interest, undisclosed financial arrangements, excessive fees and fraud."

An estimated \$5 trillion sits in thousands of pension funds across the nation, run for the benefit of private company, state or municipal workers who rely on the funds for retirement income. Some funds are huge, with billions of dollars under management, and are overseen by a board of finance professionals. Many, however, are tiny, with just a few million dollars invested. These funds are often run by volunteers less versed in the ways of Wall Street.

Pension fund boards typically hire a consultant to advise them on investment strategies and the hiring of money managers. Problems can crop up when these pension consulting firms, which have a fiduciary duty to the fund, put their own interests first.

JUST as pension funds come in many sizes, so, too, do the consulting firms that serve them. Some are one-person operations while others work within a large financial-services firm. Among the biggest companies in pension consulting are Mercer Inc., a unit of [Marsh & McLennan](#), and Callan Associates, a privately held company based in San Francisco.

In recent years, however, Wall Street firms have played an increasingly large role in the world of pension consulting. [Merrill Lynch](#), Smith Barney and Morgan Stanley are all big in this field.

The potential for conflicts is greatest at firms with brokerage or trading operations, pension authorities say, and it almost always involves how the consultants are compensated.

The trouble is, much of a consultant's pay can be hidden from view. The Chattanooga complaint said Mr.

Phillips and his colleagues controlled and manipulated the information given to the pension board, keeping it in the dark about excessive fees and conflicts inherent in the recommendations they made to the fund. Mr. Phillips's reports on the pension fund's performance were misleading, the complaint said, because they did not take into consideration all of the fees and commissions it paid.

Only when the Chattanooga board began considering rival consultants to advise it in 2002 did Mr. Phillips acknowledge the conflicts of interest in his previous arrangement with the pension fund, the complaint said. Arguing that the Chattanooga board should keep him on, Mr. Phillips said that under a new agreement conflicts would be removed, according to the complaint, and that there would be "full and fair disclosure of all brokerage practices and relationships." Money manager recommendations would be "based upon performance rather than revenue," he said, according to the complaint.

Mr. Phillips ultimately lost the Chattanooga account to the Consulting Services Group of Nashville, an independent consultant with no brokerage firm operations.

A spokesman for UBS said that the firm believes the case has no merit. "We are defending ourselves vigorously," he said.

A Morgan Stanley spokeswoman said: "The Chattanooga Pension Board was a sophisticated and knowledgeable investor that was advised by its own counsel about all aspects of its relationship with us. Morgan Stanley acted properly and is confident that the board's claims will be rejected by the arbitrators."

The compensation of consultants is so complex because it can come from many sources. "There are more ways for people to be compensated in the financial business than most people realize," said Joseph Bogdahn, principal of Bogdahn Consulting L.L.C., an independent consultant in Winter Haven, Fla. "The only way that you can determine if your consultant is truly independent is to audit their tax returns and their financials."

Mr. Bogdahn said he recommends that pension fund trustees ask their consultants to open up their books to show how they are paid, and by whom. He says he makes his financial statements available to his clients.

Because they have a fiduciary duty to their clients, consultants are required to disclose any potential conflicts of interest in their operations. But when they have affiliations with firms that conduct trades for the pension funds they advise, these relationships can undermine the fiduciary duty. Some consultants try to get around this by hiring money managers who agree to direct their trades through the brokerage firm with which the consultants are affiliated.

Arrangements like the one in Chattanooga are the most common method used by pension consultants to ensure that commissions will go to them. In their contracts, they require the pension funds to pay their fee through commissions on trades steered to their brokerage units. This is known as directed brokerage,

commission recapture or a soft-dollar arrangement.

Ultimately, pension experts say, the commissions steered to the brokerage firm in such an arrangement are often worth far more than the upfront fee that is typically quoted by the consultant for his services. Pension fund trustees do not always receive a full accounting of the transactions and the commissions they generate. So the trustees do not know how much more they are paying as a result of the arrangement.

For example, during its years with Mr. Phillips, Chattanooga wound up paying his firm \$2 million in commissions and cash payments, an average of \$270,000 annually. If it had paid the upfront fees quoted by Mr. Phillips, the fund would have paid \$154,000 a year, on average, the lawsuit said. As a result of the commission arrangement, Mr. Phillips and his colleagues misappropriated more than \$870,000 in undisclosed and unjustified fees, according to the complaint.

When consultants steer trades to a particular firm, a pension fund can pay dearly in other ways, too. Money managers are supposed to provide best execution - the most favorable price - on their clients' trades. But when a brokerage firm is guaranteed to receive most or all of a fund's trades, it need not work as hard on the execution of those trades as a firm that is competing for the business. Execution costs can skyrocket.

A letter sent to a public pension client last January by Rittenhouse Asset Management Inc., a money manager in Radnor, Pa., described the matter succinctly: "Because we trade through your advisor, we have not selected broker-dealers or negotiated commission rates for your account and cannot actively ensure that directed brokerage terms are in your continuing best interests. Although cost is only one component of best execution analysis, many directed brokerage accounts pay effective rates of commissions that are higher than client accounts that do not have directed brokerage arrangements."

Rittenhouse said it made this disclosure because industry practices were changing and the firm wanted to remind its clients of their specific arrangements.

The potential for conflicts is driving some pension fund trustees to switch to independent consultants who have no brokerage firm affiliations and are therefore not tempted to ask money managers to steer trades to them. Michael Brown is a battalion chief of the fire department in Dania Beach, Fla., and a member of the police and fire pension board; the funds had \$22.6 million in assets as of last December. For many years, the board employed Merrill Lynch Consulting Services in Jacksonville, Fla., as its pension consultant. But earlier this year, the board replaced Merrill with an independent consultant that did not have a brokerage unit in its operations.

"I think they did a good job," Mr. Brown said, referring to Merrill. "But a lot of stuff had come out over the last year with reference to your big corporate money managers and consultants being at the same company. We thought it would be a better idea to have an independent consultant."

Merrill Lynch Consulting Services in Jacksonville counts almost 100 pension funds in Florida as its clients. At the end of 2003, they included the \$80 million fire and police funds of Cape Coral, the \$40 million police fund of Fort Myers, the \$26 million police fund of Miramar and the \$27 million fire and police funds of Vero Beach.

Pension consultants sometimes recommend that their smaller clients buy mutual funds. What a pension's trustees may not realize is that their consultant can receive compensation from the mutual fund companies on these trades.

In 2000, at the advice of Merrill Lynch Consulting, the city of Sunrise, Fla., put \$10.4 million of its pension assets into three international mutual funds with similar stock holdings. The pension fund bought shares worth \$3.7 million in one fund, \$3.1 million in the second and \$3.6 million in the third.

Merrill Lynch Consulting received commissions of 1 percent on each purchase from the mutual fund companies. But mutual funds often discount their commissions on larger trades, so if the fund had put all \$10.4 million into one of the international mutual funds, Merrill Lynch Consulting would have received 0.69 percent.

"Sunrise, not Merrill Lynch, selected the money managers from recommendations we provided," said Mark Herr, a Merrill spokesman. "During the five years we provided consulting services, Sunrise finished in the top quartile or quintile for results when compared to its peers."

Brokerage commissions are not the only source of revenue for many pension consultants. They also receive payments from money managers who attend annual conferences at luxurious resorts set up by the consultants. The conferences are billed as opportunities for money managers to meet pension plan officials, but critics describe them as pay-to-play mechanisms. They contend that the money managers recommended by consultants to pension funds tend to be only those who paid to attend the conferences.

Earlier this year, CRA RogersCasey, an investment consultant in Chicago, held two conferences, one at the American Club in Kohler, Wis., near two famous golf courses, and the other at the Kingsmill Resort in Williamsburg, Va. Celebrities often appear at CRA RogersCasey conferences: past speakers have included Gen. H. Norman Schwarzkopf; James Carville, the political consultant; and Robert B. Reich, the former secretary of labor. The cost to attend varies. At the conferences this year, "new members" paid \$40,000 while return guests were charged \$35,000 to \$37,500.

MONEY management firms that have attended past conferences of CRA RogersCasey include AIG Global Investment, [Citigroup](#) Asset Management, Strong Capital Management, Putnam Investments and Bear Stearns Asset Management.

Matt McCormick, director of marketing at CRA RogersCasey, said that it would continue to sponsor conferences. "Our clients tell us that they add value," he said. "They tell us they have a very good comfort level that there is no impact or influence on our independent advice."

Earlier this year, Mercer said it would stop conducting conferences. Callan Associates said it was continuing to hold its meetings. "An important part of our business model is educating all clients on their fiduciary responsibilities," a Callan spokeswoman said.

Pension consultants aren't the only ones holding conferences where money managers can hobnob with pension officials. Robert D. Klausner, a lawyer at Klausner & Kaufman in Plantation, Fla., whose firm provides legal counsel to many pension funds in Florida and elsewhere in the south, runs similar meetings.

Klausner & Kaufman's sixth annual client conference was in March at the Hyatt Regency in Fort Lauderdale, Fla. Among the eight companies that paid to sponsor the 2003 conference were Merrill Lynch and Davis Hamilton Jackson & Associates, a money manager based in Houston that Merrill often recommends to its pension clients.

According to documents detailing the various advisers to police and fire pension funds in Florida, Mr. Klausner's firm provides legal advice to 19 funds. Twelve of them employed Davis Hamilton as a money manager, or Merrill Lynch Consulting as a consultant, or both. Mr. Klausner did not return calls seeking comment.

Davis Hamilton appears often among the pension fund clients of Merrill Lynch Consulting, even though the firm has produced less-than-stellar returns in recent years. Davis Hamilton has managed the Lake Worth Police Officers' Pension Fund, for example, and for the six years ending in 2003, it beat its benchmark index only one-third of the time. For the year ending 2003, the police fund's overall return, including both stocks and bonds, ranked in the bottom 26 percent of the peer group used by Merrill.

A trustee at a public fund in Florida, who asked for anonymity because he feared reprisals from the firms involved, said his fund is advised by Merrill Lynch and has employed Davis Hamilton. Although the money manager's performance has been lackluster in recent years, this trustee said Merrill Lynch continued to recommend that the pension fund retain Davis Hamilton. The trustee said he was concerned that Merrill's support of Davis Hamilton had to do with the fact that Davis Hamilton steers "virtually all" of the pension fund's trades to Merrill.

Davis Hamilton did not return calls seeking comment. Merrill's spokesman said: "We do not require any client or any manager to direct its trades to us. The choice always belongs to the client."

The Merrill spokesman added: "We don't pay to play. We don't have conflicts of interest that injure or work against our clients. We fully disclose our fees face up on the table. The only reason we do well is because we provide excellent work for our clients."

Trustees of the city retirement system in San Diego are in a battle over the practices of Callan Associates, one of its consultants. Diann Shipione, a volunteer trustee and a financial adviser, has called for the

consultant's resignation because of payments Callan has received from money managers it has recommended to the fund.

For example, Ms. Shipione said, one of the money managers recommended by Callan had only two full years of experience and a performance ranking in the bottom 30 percent of its peers nationwide. Only after she questioned the recommendation did it emerge that Callan had a significant economic relationship with the money manager, she said.

Callan's spokeswoman said the performance of the San Diego pension fund spoke for itself. For the five years ended Sept. 30, she said, "San Diego was in the top 1 percent of our public fund universe and was in the top third in each of those five years." She added that in a typical year, less than half the investment managers recommended by Callan were its clients.

But Ms. Shipione said: "These pay-to-play practices are systemic. A consultant's advice should come in the form of an objective recommendation, but in reality it may be the result of self-serving economic gain. Pension trustees need information about the business of investment consultants and their sources of revenue. It would at least give us information with which to test the consultant's objectivity."

Indeed, among the documents requested of pension consultants by the S.E.C. in its investigation are a full accounting of the compensation received by consultants, not only from their pension plan clients, but also from the money managers they recommend.

Mr. Siedle, who investigates money management abuses on behalf of pension fund clients, said these funds could be easily defrauded because they had no procedures in place to detect and prevent wrongdoing. "The greatest threat to pensions today is the widespread unwillingness to confront the truth about how investment firms have profited at the expense of funds and take corrective action," he said.

Gary Findlay, executive director of the Missouri State Employees' Retirement System, said his organization had tackled the problem of conflicted consultants by using a consultant that receives no revenue beyond the direct fees it charges the fund.

"Our consultant has no relationship with a broker dealer and they sell no services to money managers," Mr. Findlay said. "One of the things that we rely on from our consultant is to provide us with guidance on the basis of undivided loyalty. Their interests are aligned with our interests only, and I do believe that's what it's all about."