

The Seamy Side of Pension Funds

A consultant is supposed to be a pension manager's best friend. But just how two-faced is your fund's pal?

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Imagine a research analyst imbroglia lacking scrutiny from the Securities and Exchange Commission, Eliot Spitzer, President Bush, or Congress. Now you've got a hint of what the nation's pension plan managers are up against and what has made David Manning so angry.

Three years ago the 52-year-old finance director for Nashville listened to investment consultant UBS PaineWebber outline a major asset-reallocation plan for the city's \$1.34 billion pension fund. It would decrease the fund's expected return and increase risk. Manning was suspicious and launched a review of PaineWebber's performance. Good idea. It turned out that its own brokerage arm was executing 95.8% of the fund's domestic stock trades--a hugely disproportionate share, say industry watchers, who note that a fund that size would typically have dozens of brokers handling its trades. As a result, PaineWebber--the pension consultant--was raking in more than \$1 million a year in trading commissions; the new plan it proposed would have netted it \$300,000 more. "The conflicts of interest were incredible," says Manning.

Two years of legal wrangling ensued in which the Nashville team accused the firm of charging excessive fees and providing misleading investment advice. In April, PaineWebber, while denying any wrongdoing, settled the quarrel for \$10.3 million. "We chose to amicably resolve an honest dispute over compensation," says spokesman Paul Marrone. It's common practice, he says, to offset consultants' fees with commissions.

That's precisely the problem. Even if PaineWebber did nothing wrong in Nashville, watchdogs say the potential for conflict is huge and the stakes are mind-boggling: Pension funds hold \$9 trillion in retirement savings for 75 million Americans. By some estimates, as much as \$1 billion a year is being siphoned from the plans in inappropriate dealings. "The industry is riddled with conflicts," says Jennifer Cooper, a former executive director of the \$1.7 billion Houston Firefighters' Relief and Retirement Fund. She now heads Cooper Consultants, a Berkeley firm that evaluates pension consultants.

How could that be happening? The answer lies in understanding the roles of consultants, the powerful yet little-known gatekeepers who influence trillions of dollars in pension funds. They seemingly provide a valuable service: advising pension managers on everything from allocating assets to selecting stock pickers and the other money managers who actually invest the plans' assets. (Most pension funds don't have the expertise to carry out those functions alone.) Consultants typically charge a fixed fee for the advice--the tab for a \$1 billion public pension plan might be \$150,000--but they can earn millions more by moonlighting.

It's those extracurricular activities that can cause trouble. Take brokering. Critics say that consultants who pull double duty as brokers frequently compromise their objectivity by favoring money managers who kick back trading commissions. "Consultants regularly bring in ten times more revenue from brokerage than from providing advice to their pension clients," says Edward Siedle, a former SEC attorney who helped investigate the Nashville case.

And when money managers toss brokerage business back to the pension consultant, it's often at sky-high commissions that come straight out of a pension plan's assets. The city of Nashville, for example, paid 6 cents a share for trades going through PaineWebber. Since replacing the firm, Manning says the fund pays an average of 2.6 cents a share, a savings of

about \$685,000 a year. One equity manager, who requested anonymity, says his firm's refusal to pay excessive commissions to consultants has cost it business. "We tell them that we trade at 2 to 3 cents a share," he says. "That usually ends the conversation."

Consultants also rake in millions by selling advice to money managers--the same people that pension funds pay them to evaluate. Cooper says it's not uncommon for a consultant to charge a money manager \$200,000 or more for advice on how to impress the consultant's clients. Then there are conferences, like those thrown by consulting giants Mercer Investment Consulting and Callan Associates, where money managers pay to mingle with the consultants' pension clients. The price of admission: \$50,000 and up.

Not surprisingly, those activities don't go over well with the more scrupulous pension plan directors. For starters, they're afraid that the extra fees money managers pay to curry favor with consultants are simply tacked on to what the managers are already charging. More important, they worry about not getting access to the best investing talent. "You may be hiring gatekeepers who are getting a significant amount of money from the people they recommend," says Gary Findlay, executive director of the Missouri State Employees' Retirement System.

Consulting firms acknowledge the possibility for dicey practices. "**There are potentials for conflicts of interest that you have to manage**," says Barry McInerney, head of Mercer's U.S. practice. He and others say they thwart wrongdoing by erecting firewalls between their pension consulting, brokerage, and money manager advisory units.

Those who are suspicious of their consultants don't have much recourse because the SEC doesn't require consultants to break out revenues from various sources. Likewise, money managers don't have to reveal how much cash they fork over to consultants. "Complete transparency is the answer," says Billy Williams, CEO of STW Fixed Income Management, which manages about \$8 billion for pension funds and other institutional investors. "If the pension plans don't demand it, they're not doing the best for themselves."

That's exactly what Jack Silver, a trustee for the \$10 billion Chicago Public School Teachers' Retirement Fund, is trying to do. He has asked the plan's consultant, Mercer, to disclose the revenues it generates from the money managers it recommends. So far, no luck. Mercer's McInerney, who claims that more than 90% of the firm's revenues come from pension fund clients, says he won't hand over a detailed break-down because the full Teachers' board hasn't asked for it. Silver says if he doesn't get what he wants, he'll ask the Fund's 40 or so money managers himself. "I feel it's my due diligence as a trustee," he says. "One day I'm going to be a retiree too."

Avoid Poison Pensions

1. What is your consultant's fee?

If the fee isn't fixed, then your consultant might be compromised.

2. How much does your consultant receive from money managers?

Ask for a total that includes brokerage, conference, and other service fees.

3. Does your consultant run a brokerage?

If so, what percent of the fund's trades does it execute? Red flag if the answer tops 10%.

4. What does your fund pay in commissions?

If it's more than 3 cents a share, beware.

5. Does your consultant hold conferences?

If so, which of the fund's money managers are attending them?