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Why Do They Sneer at Shipione?
By Don Bauder

Federal examiners are looking into possible "pay-to-play" shenanigans in the pension-consulting business. And one of the pension consultants being studied is Callan Associates, the San Francisco-based firm long used by the woe-beset San Diego City Employees' Retirement System.

Former Securities and Exchange Commission chairman Arthur Levitt says that the "pay-to-play" issues are "very, very serious and very widespread -- they are all related to conflict-of-interest questions."

As it turns out, long before the Securities and Exchange Commission began its inquiry into the pension-consulting industry, the San Diego pension board's whistleblower, Diann Shipione, was asking her colleagues tough questions about Callan's potential conflicts of interest.

She was dismissed as cavalierly then as she was later when she pointed out that San Diego's deliberate underfunding of the pension plan was a road to perdition. She has been vindicated on the latter point -- although she is still under attack -- and, if local officials truly want reform, she will eventually be appreciated for raising good points on potential "pay-to-play" matters. But the pension board is still disregarding her diligence, as will be seen below.

First, what's this "pay-to-play" all about? Well, about $2 trillion reposes in state and local government pension funds. Those funds hire consultants, such as Callan, Mercer Investment Consulting, Frank Russell Co., and Watson Wyatt, to help select the money-management firms that will invest the funds. For example, one money manager -- say, San Diego's Nicholas-Applegate Capital Management -- might be deemed best to manage a portfolio of U.S. stocks, and another would be considered better equipped to steer money into foreign stocks. Or bonds. Or real estate. The consultant comes up with purportedly objective performance measurements so that it can make the recommendations for each kind of investment manager.

And that's where "pay-to-play" comes in. The consulting firms rake in profits from money managers, too -- the very firms whose performance they are rating. So regulators have questions. Do the consultants take money directly from the money managers, and, as quid pro quo, tout them as savvy investment pickers to the pension funds? That would be playing both sides of the street -- making money on both ends.

More than likely, the connection is indirect. The pension consultants sell services -- seminars, software, sales promotion materials -- to the money managers. What's to stop the consultant from making a bundle of money selling software to a money manager, and then recommending that same money manager to the pension fund? That's what the Securities and Exchange Commission wants to know.

On February 19, Callan's president, Ronald D. Peyton, wrote the firm's clients to update them on the government's probe, which includes Callan. "It appears that at the heart of this examination is the manner in which consultants are compensated," wrote Peyton. Callan has provided "tens of thousands of pages of information and electronic documents" to the securities agency, he said.

The San Diego board passed the letter on to its members, but Shipione wanted the issue to be discussed publicly at a March 19 board meeting. But it never came up until she asked about it. Then it was only mentioned in passing. Two days after that meeting, she wrote a letter to the board, demanding that it write its agendas in plain English, publicly discuss critical issues such as the government probe, and fully disclose any conflicts of interest of trustees, staff, attorneys, and consultants.

In her letter, she pointed out that the government is now probing the same kinds of issues that she had raised earlier, particularly in a letter to Mayor Dick Murphy two years ago. Among those issues is "the 'pay-to-play' practice that involves Callan's recommendations of investment managers (even when they are gross underperformers or inexperienced), possibly because those managers compensate Callan for doing so," she said in her March 21 letter.

In her 2002 letter to Murphy, and in subsequent correspondence with Richard H. Vortmann, another pension- fund trustee, Shipione did what trustees are supposed to do. She raised questions based on copious research. Callan had formerly had a broker-dealer affiliate. Money managers were encouraged to steer their trades to Callan's affiliate. Thus, Callan raked in commissions. In 1998, Callan's broker affiliate was sold. In its filing with the government, Callan noted that it had appointed the brokerage as its "exclusive agent for the conversion of brokerage commissions paid by Callan's clients," and "Callan is obligated to advise all of its investment manager clients of the availability of such arrangement," and, further, Callan was obligated to introduce its other clients to the new owner of the former affiliate.

As a barbershop quartet would hum in its warm-up, "*Hmmmmmm*." This was clearly a conflict of interest. Shipione wanted to know if Callan was still steering its money-manager clients to this brokerage, and, critically, whether under the terms of the sale, Callan might still be making money from those brokerage commissions.

This was essential information because Shipione was puzzled about Callan's enthusiastic recommendation of a money manager that had badly underperformed for three years. Callan didn't deny the sorry performance but said that the manager "would work through this period," according to a Callan memo to the pension board.

"It turns out this investment manager had agreed to place trades through a Callan-affiliated brokerage firm generating big commissions from trades done in the [San Diego pension system] account alone," Shipione says. As the barbershop quartet hums, "*Hmmm*."

I asked Callan about its past brokerage affiliation and whether it was still reaping benefits from it. A spokeswoman would only say, "Callan does not have a broker-dealer affiliate nor do we have arrangements for any brokerage compensation from any broker/dealer." Callan's president used similar language in his February 19 letter to clients.

But according to San Diego City Employees' Retirement Systems records, this brokerage raked in $152,394 in commissions in 2002 -- 11th on the list of brokerages making money off trades by the local pension fund.

Murphy never responded to Shipione's 2002 letter. Vortmann scolded her for not raising the issue at a board meeting before sending it to the mayor. "Confronting the Callan representatives publicly rather than raising your issues with the board and staff without Callan present, I believe, leads to less dialog and understanding of your concerns," Vortmann wrote to her, somewhat disjointedly, although he agreed that Callan was "slow and inadequate" in answering her questions. It was the old San Diego penchant for secrecy at work.

In her 2002 letter to Murphy -- outlining her concerns about Callan and other matters -- Shipione requested a comprehensive audit of the entire pension system. Frederick W. Pierce IV, president of the pension board, then wrote Murphy about Shipione's audit request. "I, as well as an overwhelming majority of the board, do not share Ms. Shipione's concerns regarding the integrity of the retirement system," wrote Pierce indignantly. "Mayor Murphy, I can assure you that the retirement system is operationally and financially sound. There are significant safeguards in place to regularly monitor and audit all retirement system activities."

But after she challenged the accuracy of city-bond prospectuses in September of last year, and the city confessed to cooking the books early this year, an audit is finally underway.

However, the pension-system board continues to sneer at Shipione's questions about Callan and belittles her role in bringing the underfunding problems to the fore. Would you expect anything else from a San Diego institution?

Callan acknowledges that it takes money from its money-manager clients as well as from its pension-fund clients. For example, its Callan Investments Institute provides educational services and is a big moneymaker for Callan. Each money manager is informed that "membership in the Callan Investments Institute does not entitle the member to any preferential treatment in manager search activities conducted by Callan Associates," insisted Peyton in his February 19 letter. "Callan has never engaged in any pay-to-play practices."

Maybe. But Callan, along with other pension consultants, has inherent conflicts of interest. And any pension-fund boardmember that doesn't ask questions is not doing his -- or *her* -- job.

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