Remarks Regarding The S.C. Investment Commission

by

State Treasurer Curtis M. Loftis, Jr.

January 31, 2012

A. The Investment Commission Infrastructure is very weak

A.1. The commission has incurred a high degree of risk in its daily operations and its investment practices and portfolio and that risk is still with us now.

The Deloitte & Touche September 2011 strategic assessment disclosed 7 areas of *high risk*[1]:

- Data Management, Reporting & Technology;
- External Manager Oversight;
- Risk & Compliance;
- Service Provider Oversight;
- Internal Communication & Coordination;
- Key Person;
- Financial Statement Risk.

There were also 4 areas of *medium risk*:

- Internal Control Design & Effectiveness;
- Talent Management;
- Legal Risk;
- Portfolio Risk.

Deloitte found *no* area of operations to have a low risk.

The commission has never been audited as an independent entity, but only as part of the Retirement Systems audit, and has never had an independent outside auditor express an opinion of the commission's financials. The independent auditor who audited the Retirement Systems recently expressed his doubts that the Commission could pass a SAS 70 audit, the recognized standard for auditing service organizations[2].

[1] Pages 6 and 7, *Strategic Assessment Report*, Deloitte & Touche, LLP, September 2011
[2] Telephone conversation with the SCRS auditors.

A.2. Recently Resigned CIO's Comments During commission's November 16-17 Commission Meeting.

The CIO, as part of his justification for recommending that the Commission invest in Lighthouse's fund management "platform", stated on several occasions that because of the manual reporting methods currently in use, he could not be sure the Commission knew what it owned[3]

[3] Wampee Retreat, November XX, 2011

A.3. Very significant and unquantifiable risk is present in the daily operation of the Commission and in the $26b portfolio.

Deloitte identified the following as risks in the portfolio[4]:

- No consolidated source of investment information or data although this is a common investment management practice.
- The Strategic Partners manage the Commission's assets but the investment data and records are not integrated into the Commission's data and records
- Need for increased transparency across asset classes.
- Need for improved portfolio management reporting and stop relying on manual data entry.
- Insufficient access to appropriate market data.
- Strengthen the investment process roles for the Investment Committee and the Investment Commission.

It should be noted that the Commission hired its first Risk Officer within the last 30 days and the Commission was advised by the Interim CIO that it will take up to 2 years to fully assess the risk in the portfolio.

The Commission has rapidly and highly diversified the portfolio without implementing meaningful information systems, reporting and internal controls.

At the commission's budget hearing before the House Ways and Means Subcommittee last week, commission staff said the following

- We are missing controls "to make decisions. We are "not collecting all of the data" needed to make the right investment decisions.
- Most of our technology and other needs are "not to do better, but to protect" the assets of the SCRS.
- We have "holes in our operational infrastructure.

The commission is now just beginning to address these longstanding deficiencies in a meaningful way—and a long way remains to go.

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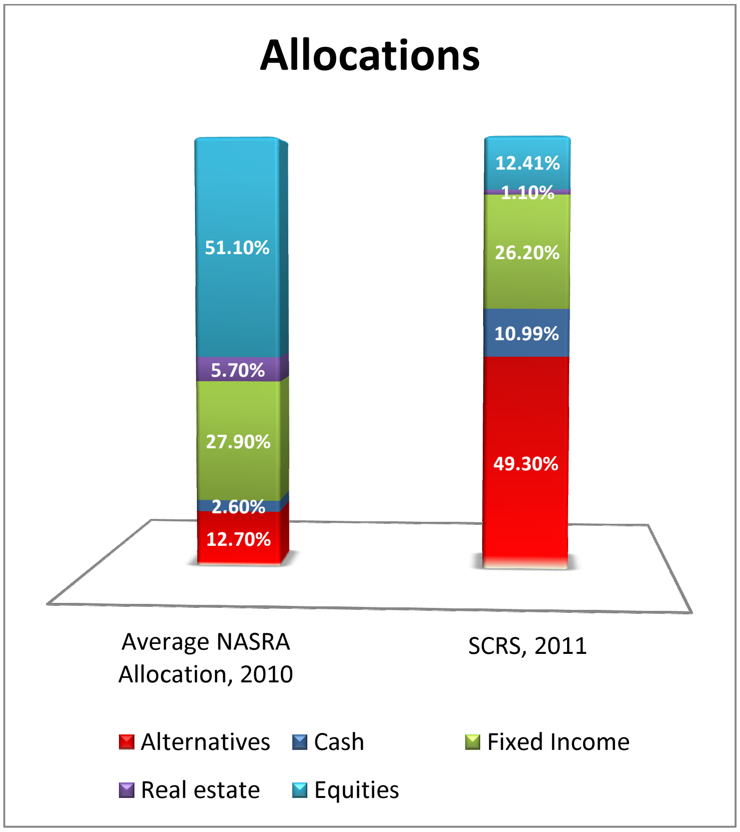
[4] *Strategic Assessment Report*, Deloitte & Touche, LLP, September 2011

B. Current investment strategy is underperforming, is expensive, and is not subject to proper internal controls.

B.1. Retirement Systems portfolio is excessively diversified compared to peers

This graph compares the SCRS's allocations with the average the average allocation reported by the National Association of State Retirement Administrators[5]:



Note that the average NASRA allocation is 51.1% equity and 12.7% alternatives, while the RSIC's holdings consist of 12.4% equity and 49.30% alternatives[6].

[5] Page 7, Public Fund Survey of Findings FY 10, December 2010

[6] The RSIC reported alternatives of 50.4% in the SCRS CAFR. The RSIC classifies its real estate holdings as an alternative. NASRA reports real estate in its own category. For comparability, the RSIC's 1.1% real estate have been removed from alternatives and placed in its own category.

Without adequate due diligence, the RSIC rapidly expanded alternative holdings[7]. Alternatives include derivatives, private equity, opportunistic credit, real estate, hedge funds and commodities.

RSIC Alternatives Growth

Year	Amount	Percentage
2008	8,245,843,000	31.25%
2009	8,784,836,000	41.99%
2010	10,474,603,000	45.95%
2011	13,508,662,000	50.40%

Note: There were no alternatives until 2008.

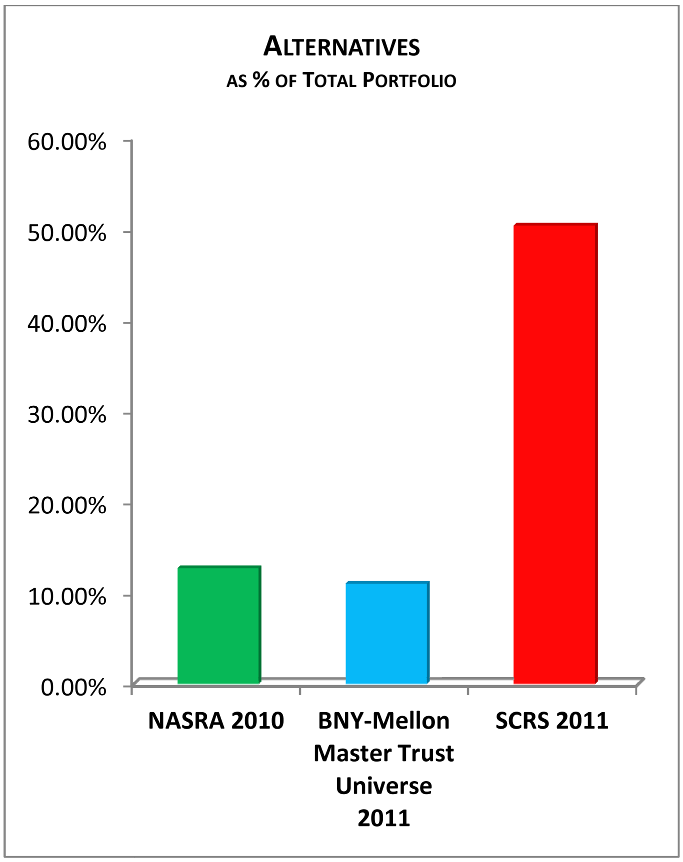
Some of the alternative holdings are "*valued in good faith*."[8] Such values are presumably reported by the same investment managers who make commissions on the values they report.

[7] Schedule of Total Asset Allocation for All Systems, *Comprehensive Annual Financial Report*, South Carolina Retirement Systems 2008--2011

[8] Page 42, SCRS CAFR, 2011

B.2 *Excessive Diversification is (1) underperforming its peers and the prior conservative 60% fixed income/40% equity allocations[9] target in place before diversification[10], and (2) placing an excessive amount of trust's assets into alternative investments, compared to peers.*

The diversification has resulted in a percentage of alternatives that is seriously out of line with peers[11].



[9] This ratio is described as the "targeted ratio" in the 2005 SCRS CAFR.
[10] Page 56, SCRS CAFR, 2005
[11] Page 7, *Public Fund Survey of Findings FY 10*, December 2010 *and* BNY-Mellon press release, August 11, 2011

The SCRS allocation percentage for alternatives surpasses the average by a multiple between 4 and 5 times over the average.

The commission's 2011 return on assets was below the U.S. Master Trust Universe's average reported return of 21.1% for public plans.[12].

The commission pays an inordinate amount of investment manager fees for a portfolio its size. The following table compares South Carolina Retirement System Virginia Retirement System[13]:

INVESTMENT FEES

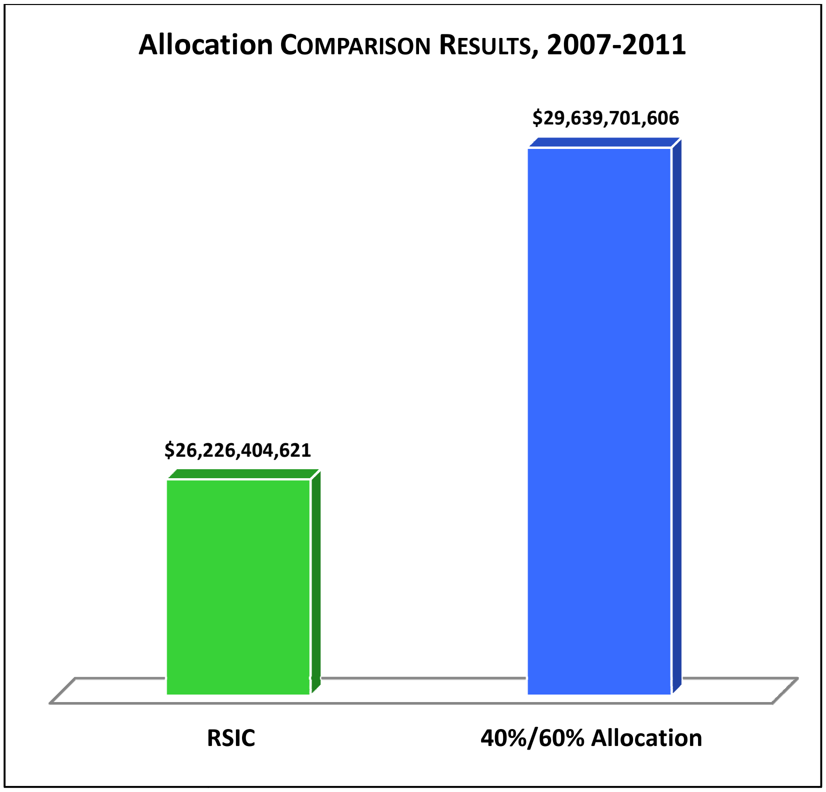
	South Carolina	Virginia
Total Assets	**$26.2 billion**	**$54 billion**
2011 Return on Assets	**18.3%**	**19.1%**
Investment Management Fees Paid	**$343 million**	**$303 million**
Investment Management Fees as a % of Total Assets	**1.3%**	**0.6%**

Virginia has twice the assets of South Carolina; one would expect Virginia to pay more in fees but at a slightly lower rate. The table indicates that South Carolina pays much more in fees, and Virginia's rate is not slightly lower, but less than half.

[12] BNY-Mellon Universe of Public Funds

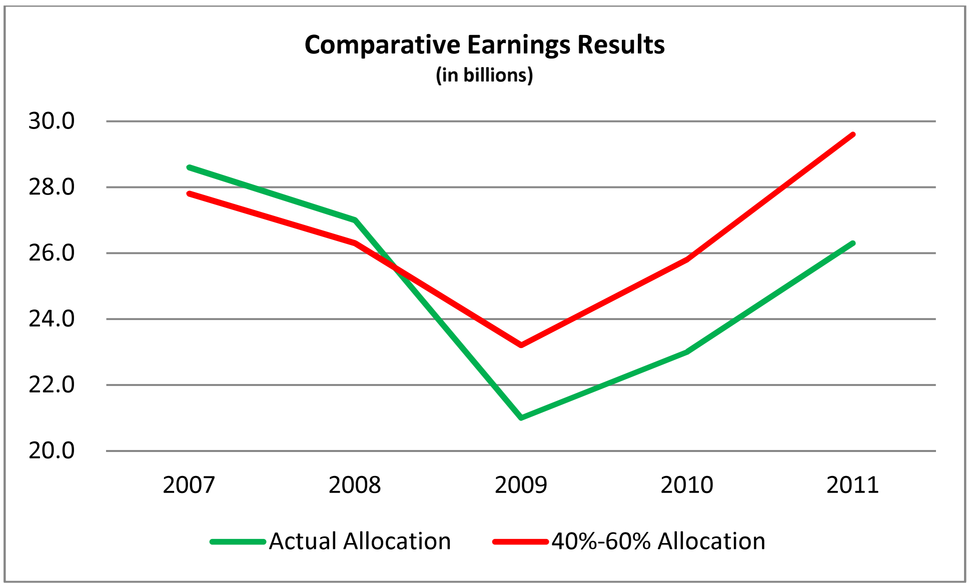
[13] Page 43, RSIC Annual Report and Pages 39 and 40, Comprehensive Annual Financial Report, Virginia Retirement systems.

The targeted ratio mentioned in the 2005 SCRS CAFR was 40% equity and 60% fixed income. Not only is this ratio considerably less expensive in terms of fees, but when this allocation is projected from 2007 through 2011, this allocation results in additional earnings of $3.4 billion above the commission's current allocation.



Comparative Results, 2007 - 2011	
40%/60% Allocation:	$29,639,701,606
Current Allocation:	26,226,404,621
Difference:	$3,413,296,985

The following graph best illustrates that a 40% fixed income/60% equity portfolio allocation would have performed better than the actual portfolio allocation during the sharp market decline of 2008 and 2009. Overall from 2007 to 2011, the 40%/60% portfolio performed better.



If South Carolina had incurred investment management fee expense at the same level as the NASRA median rate of .21% in 2010 instead of the 1.3% paid by South Carolina, South Carolina's investment management fees would have been $287,925,400 less than the $343,000,000 actually paid.

If this $287,925,400 were placed in the retirement systems trust fund each year and remained there earning 4.5% over 30 years, the retirement systems trust fund would have $4,689,984,750 more than it otherwise would have, on a present value basis.

B.3 Excessive diversification increases the lack of transparency in the total portfolio.

With multiple hedge fund managers holding hundreds of positions and the Strategic Partners also holding diverse portfolios, transparency does not exist.

This risk was identified in the Deloitte risk assessment.

Meaningful and timely information regarding due diligence on the investment opportunities, risk, timely information on strategic partner investments, timely and consistent reporting from fund managers, etc, is not available to the Commission, the employees, the retirees, and the public.

The Investment Commission does not make the investment decisions for a very large part of the portfolio. For example, 3rd party hedge fund managers make the decisions on the Commission's $5.4b hedge fund portfolio.

B.4 Strategic Partnerships operate "Behind the Curtain" and only the former CIO had knowledge of operations and investment details.

More than 75% of a $14 billion allocation of the retirement systems' assets is committed to strategic partnerships managed by third-party investment managers, where the commission is generally a limited partner. Although the Investment Commission may own up to 98% of the partnership, the third-party manager makes and manages the investments without commission approval.

More troubling, the commission's recently departed Chief Investment Officer was the only person knowledgeable of the structure and details of these partnerships and the only person within the commission having personal input into each strategic partnership's investments. None of the members of the commission, its consultant, or the remaining staff had any working knowledge about the strategic partnership arrangements. The commission staff and its consultant are just now meeting with each strategic partner to gain and document an understanding of how each arrangement works, the types of investments managed under each partnership, and ongoing reporting. The commission has needed so much help understanding these strategic partnerships that an outside consultant has been engaged to assist with this study and has been on site full time in the commission's offices for the last three weeks.[14]

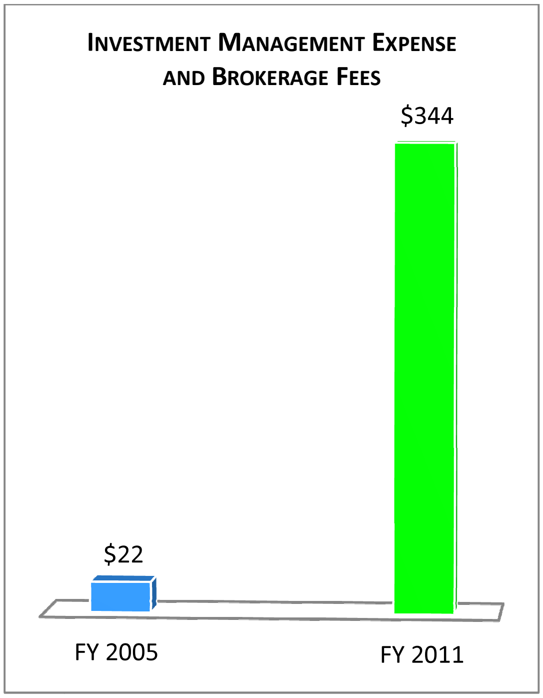
[14] Discussion at January19,2012, meeting.

B.5 Excessive diversification has dramatically increased fees paid to 3rd party investment fund managers.

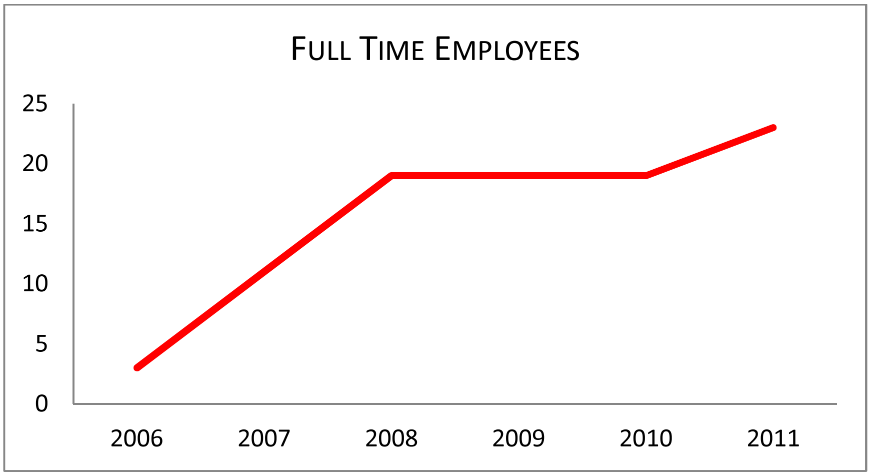
In 2005, with the allocation of 40% domestic equity and 60% domestic fixed income, investment fees were much lower. The following table and graph offer a comparison of investment expenses in 2005 and 2011:

	FY 2005	FY 2011	Change
Total Plan Assets	$ 24,808,447,000	$ 26,226,405,000	
Investment Management Expense	$ 22,406,000	$ 343,621,000	$ 321,215,000
Fees %	0.09%	1.3%	1.22%

Fee expense has increased by a multiple of 10.

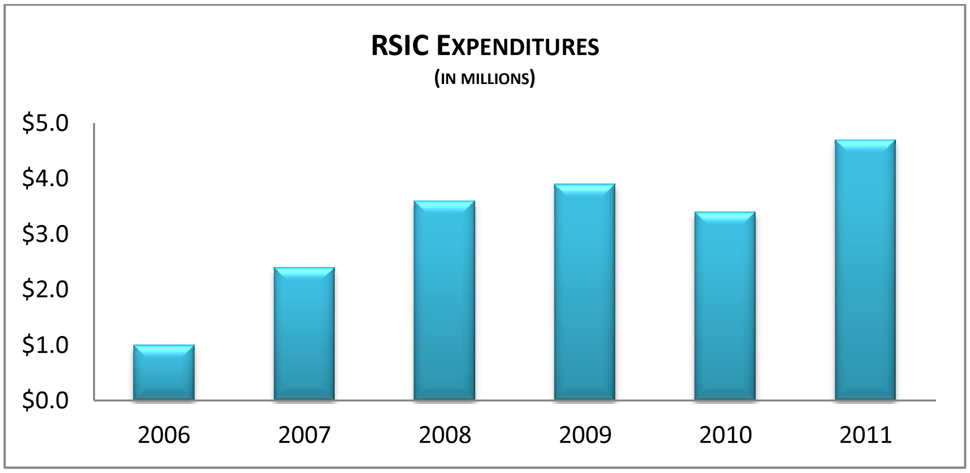


B.6. Excessive diversification also increases the overhead costs of the Commission



FULL TIME EMPLOYEES

2006	2007	2008	2009	2010	2011
3	11	19	19	19	23



RSIC EXPENSES
(in millions)

Year	EXPENSES
2006	**1.0**
2007	**2.4**
2008	**3.6**
2009	**3.9**
2010	**3.4**
2011	**4.7**

For the current fiscal year, a budget of $10.2 million has been approved, and for fiscal year 2013, the RSIC has requested $19.0 million[15]

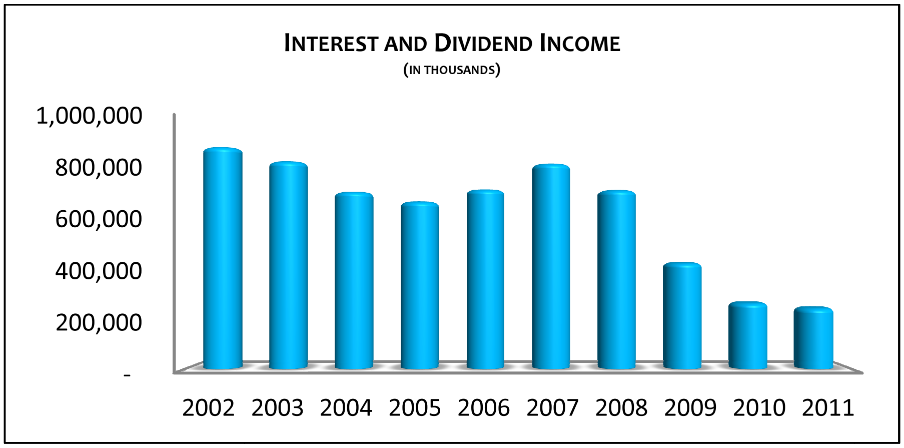
[15] Page 7, RSIC—FY 13 Budget Proposal

B.7. Excessive diversification has sharply reduced state required custody of retirement funds—today 70% of funds are not in the custody of the State Treasurer or his appointed custodian bank.

Approximately 70% of $26 billion in the retirement systems' public trust funds have been transferred by the commission from the state's custodial bank to other entities that no state agency controls. Additionally, these other entities do not provide consistent and timely reporting to the state's custodial bank. The state's custodial bank and the Treasurer's Office are in the process of resolving this reporting deficiency and I have begun the process to restore custody of these assets to the State Treasurer's Office and the State's custodial bank, in accordance with state law.

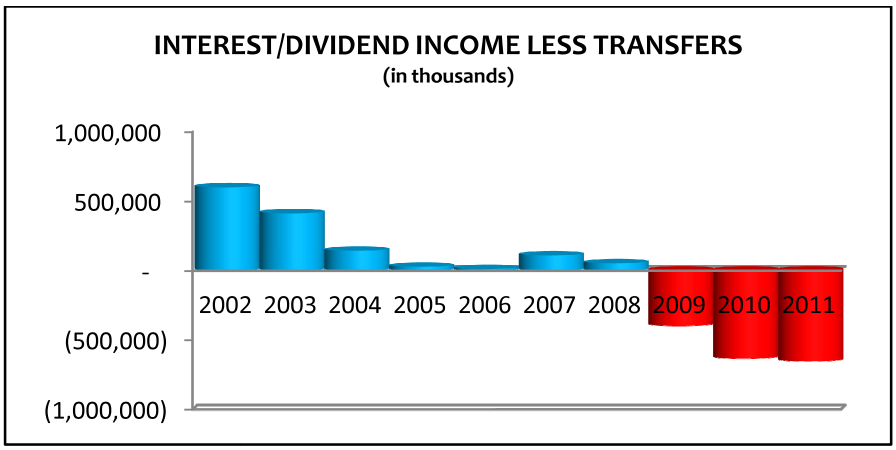
B.8. Excessive diversification has resulted in a sharp decline in interest and dividend earnings

Retirement funds have been utilized to pay retirement benefits **and** Retirement System and Commission expenses to some extent since 2002, however, the utilization has increased sharply since interest and dividend income has been declining as a result of the RSIC's 50.4% alternative allocation[16].



[16] Statement of Changes in Net Assets, SCRS CAFR, 2002--2011

Excessive diversification began in 2008. The following graph indicates that beginning in 2009, the commission could not meet transfers for benefit payments with interest and dividend income alone; therefore, increasing amounts of Retirement Systems funds have been drawn down from the principal to pay these costs[17].



[17] June 30, 2011 Quarterly Report, RSIC (the source of the yearly transfer amounts)

B.9. Due diligence on 3rd party managers and investments has been insufficient

The Deloitte Risk Assessment recommended:

> **Expand and implement standard due diligence processes and practices.** The operational and technology infrastructures are important components to an investment manager's business model and investment activities. Accordingly, the initial or ongoing due diligence of an investment manager should include an assessment of not only the investment processes, but also the legal, accounting, reporting, record keeping and other operational aspects as well as technology architecture, platforms and systems in place to support and facilitate the investment manager's investment activities. The Commission should consider looking to develop (or hire) operations and technology resources to supplement the investments due diligence performed by the investments team.

In addition, the auditor for the Retirement Systems advised the Treasurer's Office that he had looked through the commission's due diligence files and found them to be in various stages of completeness.

The appearance that the RSIC has invested in alternative investments without complete due diligence is especially troublesome.

C. Lack of Transparency Raises Suspicions

C.1. RSIC staff has been unwilling to freely share information

- The RSIC Staff did not promptly and readily provide requested information to the State Treasurer, who is a trust fund fiduciary, a trustee of the Retirement Systems, and a commission member.
- The State Treasurer had to resort to submitting FOIA requests to get the information, only to discover it was incomplete, ambiguous, and in a format quite different from the prior year.
- Straight answers have not been forthcoming.
- The former CIO resigned on December 2, 2011.

C.2 Former CIO resigns after questions raised.

State pensions official resigns

Investments chief Borden clashed with S.C. treasurer[18]

By ADAM BEAM

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The man in charge of investing South Carolina's $25 billion pension fund resigned Friday to take a job with a private investment firm in North Carolina.

Robert Borden, who has been the pension fund's chief investment officer since 2006, will become a managing partner and chief investment officer for FTA Partners, a new firm scheduled to launch in February with 30 employees and about $1 billion in assets.

Borden's resignation comes as the S.C. Retirement System faces a $13 billion deficit, prompting state lawmakers to call for a massive overhaul of the system. It also comes as state Treasurer Curtis Loftis has been asking questions about Borden's travel and entertainment expenses — expenses Loftis says have not been publicly vetted.

"(I have) been asking questions for the last three or four months, and I've not been getting satisfactory answers," said Loftis, who is one of five members of the S.C. Retirement Investment Commission, which oversaw Borden. "Mr. Borden will be well served by being in private business. ... I thank him for his service, and we need to move forward with somebody who is going to be more respectful of the public space."

[18] *The State*, December 3, 2011

D. Recommended Legislative Actions

D.1. Demand increased transparency, accountability and openness by the investment commission and investment commission staff.

Accountability has fixed many problems all by itself. Increased transparency will likewise have a positive effect.

D.2. Restore all Retirement Systems assets under the custody of the State.

D.3. Do not change the organizational location, structure or composition of the commission.

- This could prove to be catastrophic
- Focus on fixing the shortcomings and deficiencies cited above.
- Moving the commission will not fix it; fixing the commission will fix it.