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NEWS

Damschroder: Hedge fund managers can't lose with public pensions

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If I don't do this no one else in Ohio media will. So begins yet another column on the transfer of wealth from beneficiaries of the five state public pension systems with combined assets of $204.4 billion, to the fund managers entrusted with protecting and growing that ocean of capital.

For perspective on the size of Ohio's public pensions, the large banks have less than half the in-state deposits as the pensions do. Drilling down to the asset category of hedge funds, Ohio pensions' $17.6 billion in this investment would make it the seventh largest bank in the state.

Seemingly this would make it hard to ignore an Ohio State University news release proclaiming "hedge fund investors get a raw deal from incentive fees." Following the study of nearly 6,000 funds for more than 20 years, two Ohio State University finance professors find 64 cents of every investment dollar earned in the hedge funds lands in the manager's account. Professor Itzhak Ben-David said in the release, "as a hedge fund manager you cannot lose."

The Ohio State-driven study for the National Bureau of Economic Research quantifies the results of management fees paid all the time, incentive fees paid when the fund earns money, and the inability of claw back payments when the fund loses money. The research finds rather than give back gains and keep trying, hedge funds simply close when they lose, making shared risk a fool's promise.

I asked the Ohio pension funds for comment on the OSU news release but none responded.

I reached out to professor Ben-David asking if the 1.12% higher management fee the Ohio Public Retirement System pays hedge fund managers makes it an even worse performer than other investors, or whether the change in Ohio law that opened the door to public investment in hedge funds was a bad decision. I was met with a prompt and polite reply devoid of answers or useful policy prescriptions. The descent from 50,000 feet view of the industry to real applications on the ground in Ohio is apparently too dangerous.

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But in reality the answers are pretty obvious. A look at the OPERS website indicates the powers that be ought to be thinking about the capital they've lost to optimistic assumptions since 1994.

The hedge funds that are supposed to reduce portfolio volatility and enhance returns have instead lost more than 8% so far this year. And of course that is before the 2.52% management fees OPERS pays is added to the loss.

Thanks in large part to a 5,660% explosion in fees paid by OPERS to Wall Street fund managers since 2001, when the state's largest public retirement fund had a surplus, the fiduciary audit released last fall gives OPERS less than a 50 percent likelihood of meeting the investment return assumptions needed to pay full benefits.

The elements of a perfect financial storm are coming into formation. Ohio is one of the dozen states where public employees don't pay into Social Security, where tens of billions of dollars are invested through fund managers in unobservable, illiquid markets and where sovereign immunity protects officials making these dangerous investments from lawsuits claiming breach of fiduciary duty and from criminal provisions of the federal Employee Retirement Income Security Act-ERISA.

In opening the door to hedge fund managers "who can't lose," Ohio has created retirement funds that cannot win. Why would any politician put Wall Street money managers over public system retirees spending on Main Street in Ohio? John Kasich's presidential campaign finance reports tell us why. The largest source of funds by far came from "can't lose" money managers. It won't stop until someone besides me and the Fremont News-Messenger make it more than an academic issue.

John Damschroder, a Fremont native who worked in Gov. George Voinovich's administration, writes about business and economic development in Ohio.