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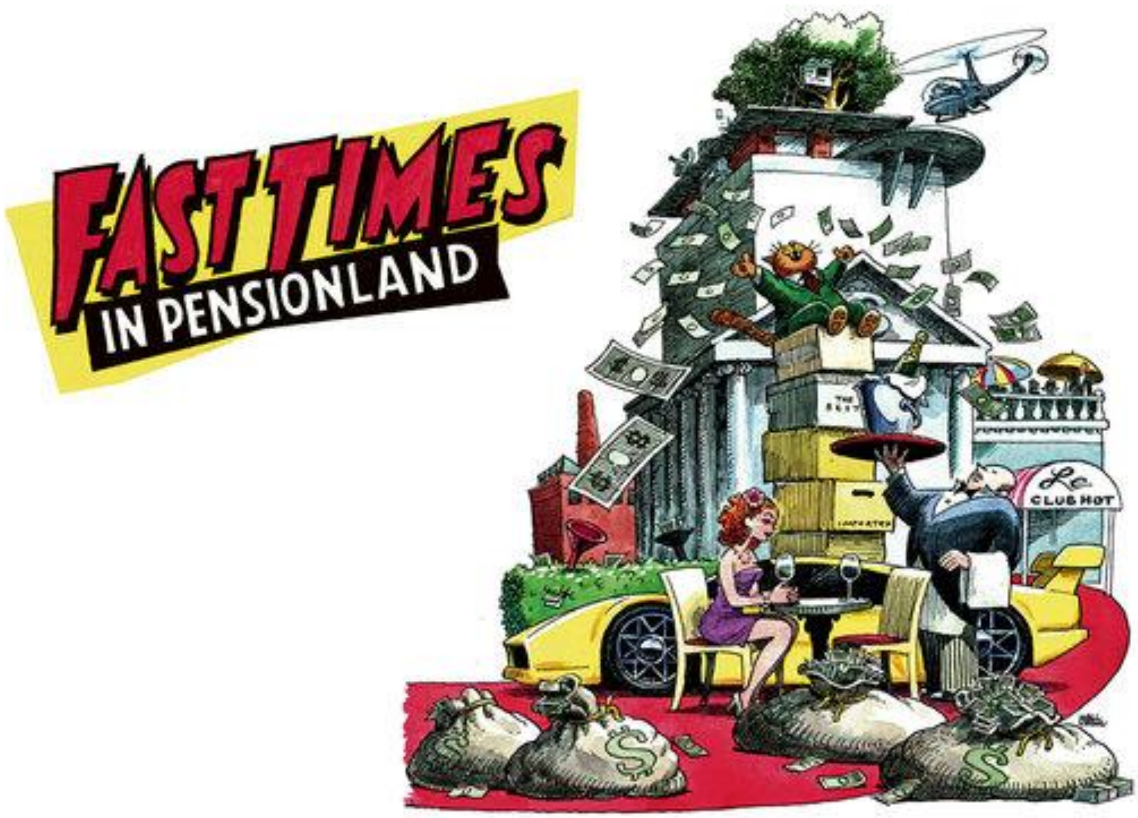
South Carolina’s Pension Push Into High-Octane Investments



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Columbia, S.C.

Curtis M. Loftis Jr., South Carolina’s treasurer, says he worries that state pension officials have had their heads turned by Wall Street players who stand to benefit from state money. “This is a world where people have private jets, massive apartments overlooking Central Park, people who live exotic lives,” he says.

Sam Griswold, of the State Retirees Association, says a plan for an independent firm to manage the state's private equity investments failed partly because it was "sprung on everyone."

The grand interior of the State House.

MANY mornings, the yellow Lamborghini would swing into view, sweep past tree-softened streets with a low, smooth rumble and throttle down outside an office near the State House downtown.

Behind the wheel was a financier named Robert L. Borden. Around Columbia, a city decidedly more Ford than Lamborghini, his exotic supercar gave him the air of a Wall Street hotshot. In truth, Mr. Borden was a civil servant — a very highly paid one. Until recently, he was the investment chief of South Carolina's giant public pension system.

It turns out that Mr. Borden liked his investments the way he liked his cars. Which is to say, *fast.* With the help of some big names on Wall Street and a nod from officials here, he transformed this state's go-slow public pension system into one of the most high-octane in the nation. So far, though, the results have been mixed. The long-term consequences — for retirees, public workers and taxpayers here — are as yet unknown.

What is sure is that while he was running things, South Carolina ended up paying hundreds of millions of dollars in fees — $344 million last year alone — to a Who's Who of hedge fund managers and private equity deal makers. In return, it got a trove of investments that haven't really provided the bang that people here had hoped for. Today, the pension fund has a higher share riding on private-equity and hedge-fund plays — called "alternative investments" in some circles — than almost any other state's: $13 billion, or more than half its total.

What is also certain is that Mr. Borden is long gone. Mr. Borden, who resigned last December to join a private investment firm, says he is proud of what he accomplished in his nearly six years at the helm of the $24.5 billion South Carolina Retirement Systems.

Still, like other pension funds across the country, South Carolina's faces a shortfall — in its case, an estimated $14.4 billion. But, as in other states, the scary thing is that no one really knows how bad this could get. A firestorm over pensions and other benefits for public workers is raging nationwide. It reared up with new fury last week, with the failed recall election of Gov. Scott Walker of Wisconsin, and votes in two big cities in California, San Diego and San Jose, to sharply cut pension payouts.

But here in South Carolina, the state treasurer, Curtis M. Loftis Jr., is worried that pension officials have had their heads turned by Wall Street players who stand to benefit from the state's money. "This is a world where people have private jets, massive apartments overlooking Central Park, people who live exotic lives," said Mr. Loftis, reclining in a chair in his baby-blue office at the State House, as his black Labradoodle, Camey, snoozes nearby.

It all sounds like one of those classic tales of a lot of public money meeting a little private greed, of locals wooed by big-city slickers. And Mr. Loftis provides some juicy tidbits, including meetings with Wall Street types within the black-lace covered walls of the Provocateur nightclub in the meatpacking district of Manhattan — and even a dinner with a centerfold model.

But the most remarkable thing about this story is that it could have unfolded — and, indeed, has unfolded — to greater and lesser degrees at pension funds across the nation. Hedge fund and private equity firms are selling, and taxpayers — in the form of public funds — are buying, and buying big.

FOR years, states and localities have scrimped on pension funds, which are now alarmingly short of the money needed to pay future claims. Nationwide, these deficits are estimated to total $1 trillion to $3 trillion.

Because of that gap, many funds have been scouring the more exotic corners of Wall Street, seeking the returns needed to keep promises to retirees. By the end of 2011, retirement systems with at least $1 billion in assets had raised their stake in real estate, private equity and hedge funds to 18.3 percent, from 10.7 percent in 2007, according to the Wilshire Trust Universe Comparison Service.

But hedge funds and private equity stakes don't come cheap, and their returns are not guaranteed. Funds like South Carolina's are now left with many high-cost investments that in many cases have fared worse than old-fashioned stocks and bonds. The South Carolina fund earned 3.1 percent, annualized and before fees, in the three years through last June, the end of its fiscal year, versus 4.6 percent for all public pension funds tracked by Wilshire TUCS. (But the fund would fare better in the next six months, besting the national average for the three years through December.)

A Republican who took office in January 2011, Mr. Loftis is the only elected official on the state fund's six-member investment commission, which oversees pension investments. And he says he has seen up close the way Wall Street tries to lure state money.

He recalls attending a dinner with hedge fund executives one evening last fall in New York, when he was asked to sit next to a centerfold model. And on another visit to New York, Mr. Loftis says, he found himself with a hedge fund group in a banquette at the Provocateur, at the stylish Hotel Gansevoort, where bottles of liquor were passed around the table. (He says he personally paid his share of the bill.)

But Mr. Loftis — who calls himself "Don Quixote with a Southern accent" — says he doesn't want to get chummy with Wall Street. He says he wants more information about the fees that hedge funds and private equity firms are charging, and about the investments themselves. Many hedge funds, for instance, require confidentiality agreements that prevent public officials from disclosing details of investments, or even their performance.

He says he was shocked to discover recently that most of South Carolina's pension assets are not held by its custodial bank but by other banks and private investment firms — though officials in the retirement system say this arrangement is typical nationwide. Mr. Loftis says private investment firms may have accounts almost anywhere.

"Where is the money? The Caymans? Guernsey?" he asked. He has decided to stop writing checks for most new alternative investments.

Around the State House here, some wondered whether Mr. Loftis is trying to ride the pension issue — and the broader anger at Wall Street after the 2008 financial crisis — to higher office. He waved aside suggestions that he might run for governor, saying he was focused on changing the way pension funds interact with Wall Street.

For instance, Mr. Loftis decided to take a closer look at the fees charged by just one of the state's dozens of outside fund managers. The examination reduced the state's fees by $18.1 million, Mr. Loftis said. He added that the fund manager called the difference a "reporting error."

"When I go to Cracker Barrel for lunch, you give them $8, and they give you lunch and a receipt," Mr. Loftis said. "But in this world, we're prepared to pay millions of dollars in fees at somebody else's word, and we ought to do better than that."

THE South Carolina Retirement Systems fund manages money for 530,000 public employees, retirees and their beneficiaries. It owes these people $38.8 billion.

Not long ago, this fund was about as boring as it gets. Before 1999, it was largely invested in a mix of United States Treasuries and corporate bonds. The fund moved into equities just before the technology bubble burst in 2001. By 2005, some state leaders were pushing to give the fund more leeway, arguing that South Carolina's money should work harder. State laws were changed in early 2007 to let the fund put money in a broad mix of private investments.

But to make that work, pension officials needed a money manager wise to the world of private investments. That's where Bob Borden came in.

A fighter pilot's son who grew up on military bases all over the world, Mr. Borden would acquire experience in managing investments before heading up the Louisiana State Employees' Retirement System, commonly known as Lasers, from 1995 until early 2006. There, he would move 11 percent of the fund's assets into alternative investments. In the three years through fiscal 2006, the fund's annualized return was an enviable 13.3 percent.

The South Carolina fund hired him in spring 2006, and he began working closely with its investment commission to shift a large portion of the fund's money into new kinds of investments. It didn't take long. By the summer of 2008, South Carolina had invested $8.5 billion in private equity and several well-known hedge funds. Among them was the giant Bridgewater Associates, which buys and sells financial instruments all over the world — as varied as oil futures and Indian stocks. It also invested in D.E. Shaw & Company, a redoubt of math-loving quants.

Those investments carried an enormous price. In 2005, South Carolina paid $22 million in management fees. By last year, that figure had soared to $344 million, including performance fees.

Buoyed by a long-running bull market, state officials voted to give state employees a 2 percent cost-of-living adjustment in their pension benefits. The adjustment was tied to a decision to raised the projections of future returns to an exuberant 8 percent a year.

"I remember going wild," recalled former Gov. Mark Sanford. South Carolina piled into the stocks, as well as hedge funds, private equity and other alternative investments, at the top of the market. It raised its projected rate of return in July 2008 — just before the worst of the financial crisis hit. "South Carolina," Mr. Sanford said, "is the dumb investment state."

As the overall market plunged in the fall of that year, South Carolina's pension fund was no exception. It would drop 28.7 percent for the year as a whole. (Gov. Sanford's political career would later be derailed by a scandal over an extramarital affair.)

IN early 2009, citing the sweeping changes made to South Carolina's fund during Mr. Borden's tenure, Institutional Investor magazine named it as its "Large Public Plan of the Year" Mr. Borden flew out to California to accept the award.

But as his star rose in the financial world, Mr. Borden was raising eyebrows in Columbia. He was too flashy, people said — just look at that Lamborghini. He would eventually be making nearly half a million dollars a year — a pittance by Wall Street standards, but big money for a state employee.

"The guy you want running a state pension fund is in green eyeshades with an old-time adding machine, crunching numbers, not a guy driving around town in a yellow Lamborghini," said Richard Harpootlian, a Columbia lawyer who has sued the pension fund multiple times on behalf of state employees.

Sam Griswold, the president emeritus of the State Retirees Association of South Carolina, said that before Mr. Borden's arrival, he had "never seen a Lamborghini on the streets of Columbia, and I've lived here for 40 years."

As the pension system dived deeper into alternative investments, its bill from Wall Street kept growing.

So in the autumn of 2010, the investment commission and Mr. Borden devised a plan to create a separate, independent firm to manage South Carolina's private equity investments, as well as earn fees itself by managing such investments for other entities. The idea was that this would reduce the state's pension expenses.

Mr. Borden, the investment commission suggested, should run the new firm. But some state leaders balked, viewing the proposal as a power grab. The commission abandoned the plan.

"The economic argument made some sense," Mr. Griswold said. "But the way in which it was proposed to the state just absolutely destroyed any possibility of this happening, even if it was the best invention ever, because it was done behind the scenes and sprung on everyone."

And, for Mr. Borden, things were about to get even worse.

IN the summer of 2011, Mr. Loftis made what he thought was a simple request: he asked to see Mr. Borden's business calendar.

The two men had been cordial when Mr. Loftis became treasurer. Then, that summer, Mr. Loftis was planning to go to state lawmakers and ask for an increase in the retirement system's budget. He thought it would help to have Mr. Borden's calendar, to show how busy he was with high-powered meetings.

Weeks passed, and no calendar arrived. Mr. Loftis filed a Freedom of Information Act request. The calendar he got was largely empty. Mr. Borden's assistant, he was told, used the calendar mostly as a "planning tool."

"You're telling me a guy who is running a $26 billion fund that has investments on every continent on the world doesn't have a calendar?" Mr. Loftis recalled thinking. "It didn't pass the smell test."

Commission officials say Mr. Borden was never required to keep a calendar. During an interview in April, Mr. Borden said his calendar represented less than 10 percent of his meetings and calls. He memorized the rest, he said.

"I could write out my next week's set of meetings, which are 12 different meetings in three different cities, but I don't have to. What can I say?" he said, shrugging his shoulders.

In the midst of all this, Mr. Borden told the South Carolina investment commission that he was being considered to run Virginia's retirement system. The commission, including Mr. Loftis, voted to give him a 37 percent raise, bumping his pay up to $485,000.

Then Mr. Loftis noticed the date that the raise went into effect: June 30, 2011. That was one day before the end of the fiscal year — which would mean that Mr. Borden would get an extra $65,000 as that year's bonus. Mr. Loftis urged the commission to rescind the bonus, setting off a loud debate. In a split decision, the panel voted against the bonus.

Mr. Loftis, meanwhile, using data from the pension system's own consultants, discovered that the fund's returns ranked in the bottom 40 percent of public pension funds over the last one, three and five years through last June. State retirement officials say that peer rankings are extremely volatile, and that the fund was in the top quartile for the three-year ranking ended in December.

A report released last fall by Deloitte & Touche identified several risks in the fund's operations. It also said the fund did not have a standard process for analyzing new managers and did not review some fees.

During an interview in April, Mr. Borden said attacks against him were borne of petty jealousy.

"What is frustrating is that all of the value that was generated, all of the hard work that was done with little resources, do you think we could have built this portfolio up with as few people as we had by phoning it in?" he asked, throwing his hands up in the air. "The amount of work that was done here was staggering."

Mr. Loftis has been bruised by the battle as well. He survived an attempt by his political foes to throw him off the investment commission and says he spent thousands of dollars defending himself when the state looked at allegations of pay-to-play deals involving the pension fund. The state eventually ended the matter without bringing charges against anyone.

Mr. Loftis says he remains deeply worried that the state is investing with private firms whose operations are opaque. He says that he recently asked for paperwork on a timber investment, and the investment firm redacted basic information like names and addresses — information that is easily available at a local courthouse.

But Mr. Borden says that if state pension funds want to earn the higher returns needed to pay benefits to future retirees, they have to play in the pricey and secretive world of hedge funds and private equity.

"Everybody wants their cake and to eat it too," Mr. Borden said. "They want high returns at low risk and low cost."

Asked if he thought that he had made any mistakes in South Carolina, Mr. Borden paused, and then replied, "I have an entrepreneurial spirit, and I was in a bureaucratic job."

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