



Stacy Garrity, Pennsylvania Treasurer

June 10, 2021

Via Email Transmission

Christopher SantaMaria, Chairman
Board of Trustees
Pennsylvania Public School Employees' Retirement System
5 North 5th Street
Harrisburg, Pennsylvania 17101-1905

Dear Chairman SantaMaria:

As members of the Board of Trustees, we write to express our loss of trust and confidence in the ability of the Executive Director and the Chief Investment Officer to effectively manage and administer the retirement fund. PSERS' investment underperformance over the past 10 years is beyond dispute, resulting in higher payroll deductions for nearly 100,000 public school employees. Those who have dedicated their career to public education, people who are the heart and soul of this Commonwealth, deserve better.

As fiduciaries possessing a duty of loyalty to the beneficiaries of the retirement fund, it is our intention to request the immediate termination and replacement of the Executive Director and the Chief Investment Officer at the next meeting of the Board on June 11, 2021. To this end and having been unsuccessful in our efforts to reach a mutually amicable separation, we respectfully request the Board's agenda reflect – 1) our intention to conduct a no confidence and termination vote, 2) the selection of an interim Executive Director, and 3) an expanded use of Verus Investments as a temporary outsourced CIO. Your support for this necessary change, and the support of each Trustee in receipt of this correspondence, is respectfully requested and sincerely appreciated.

Fiduciary Responsibility

The Public School Employees' Retirement Code explicitly grants to the Board of Trustees the "exclusive control and management" of the retirement fund.¹ Accompanying this authority is the responsibility of each Trustee to act in the sole beneficial interest of the participants of the retirement fund. The Retirement Code imposes a statutory obligation upon each Trustee to "invest and manage the fund for the exclusive benefit of the members of the system."² This mandate is to be exercised

¹ 24 Pa.C.S.A. §8521(a) (Emphasis added).

² 24 Pa.C.S.A. §8521(e).

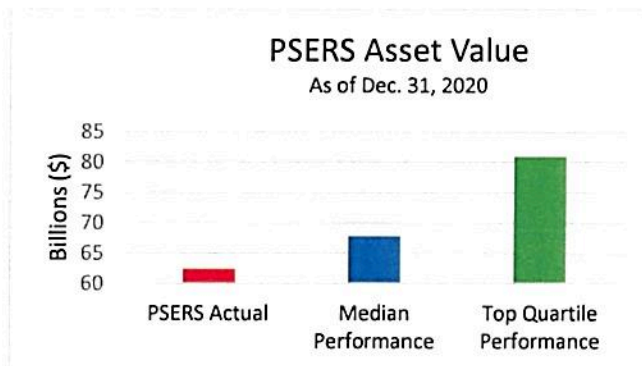
independently for the sole and exclusive benefit of fund participants and does not extend any obligation or duty owed to management or management interests.³

A Trustee's oversight responsibility extends to ensuring that management is acting properly, is effectively executing its administrative and operational responsibilities and that the Board is fully, accurately and timely informed with respect to the performance of the fund. As evidenced by the Board's recent certification of its 9-year investment returns that underperformed the statutory shared-risk threshold, combined with management's failure to adequately and promptly acknowledge strategic investment shortcomings, it is incumbent upon the Board to prudently and timely respond – in particular, to initiate necessary management changes.

Anticipating the desire of the board members to act in accordance with this fiduciary obligation, a legal memorandum addressing the authority of the Board to terminate management upon a loss of confidence was requested and is attached for your consideration.⁴ The memorandum concludes that “. . . once Board members are aware that management is underperforming, Board members are permitted – and, in fact, are required – to take action including terminating management.”

Poor Investment Performance

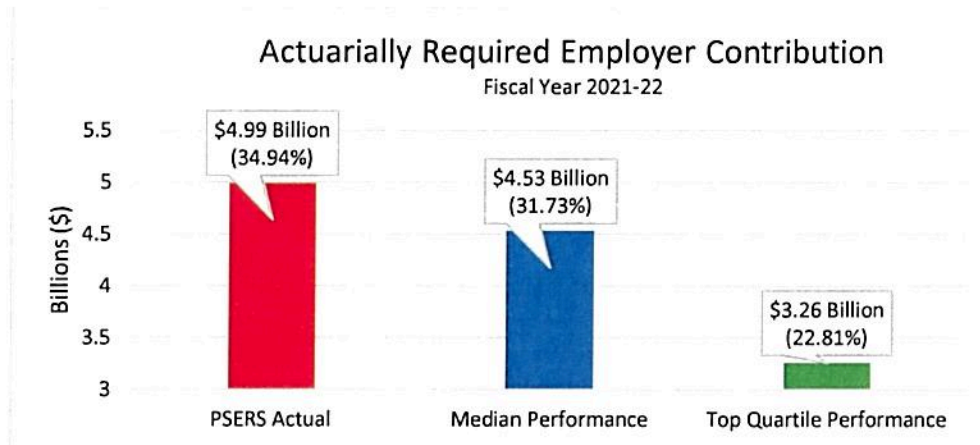
On Dec. 31, 2020, PSERS' pension investments stood at \$62.4 billion. If PSERS' investment performance had been as good as the best public plans over the last ten years, those assets would now be approximately \$80.87 billion. If PSERS' performance had simply been average, those assets would now be approximately \$67.73 billion.



Moreover, PSERS' poor investment performance has increased the amount employers are required to contribute to the plan. In Fiscal Year 2021-22, the employer contribution rate to PSERS will be \$4.99 billion. Instead, if PSERS' current net position reflected the asset growth that better performance would have provided, the Fiscal Year 2021-22 employer contribution would have been approximately \$460 million or \$1.73 billion less, under median and top quartile performance, respectively.

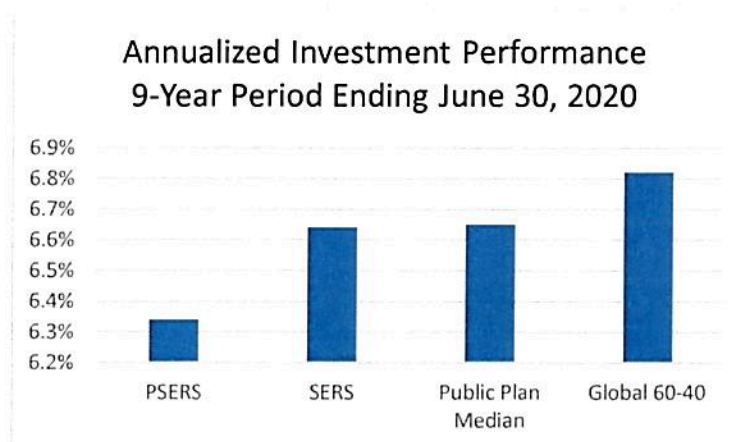
³ Pennsylvania law requires a fiduciary's actions be intended *solely* to benefit the beneficiaries. *Estate of McCredy*, 323 Pa.Super. 268, 290, 470 A.2d 585, 597 (1983) (“In general, “[t]he trustee is under a duty to the beneficiary to administer the trust *solely* in the interest of the beneficiary.”) (Emphasis added).

⁴ Cozen O'Connor Legal Memorandum (June 1, 2021); Attached.

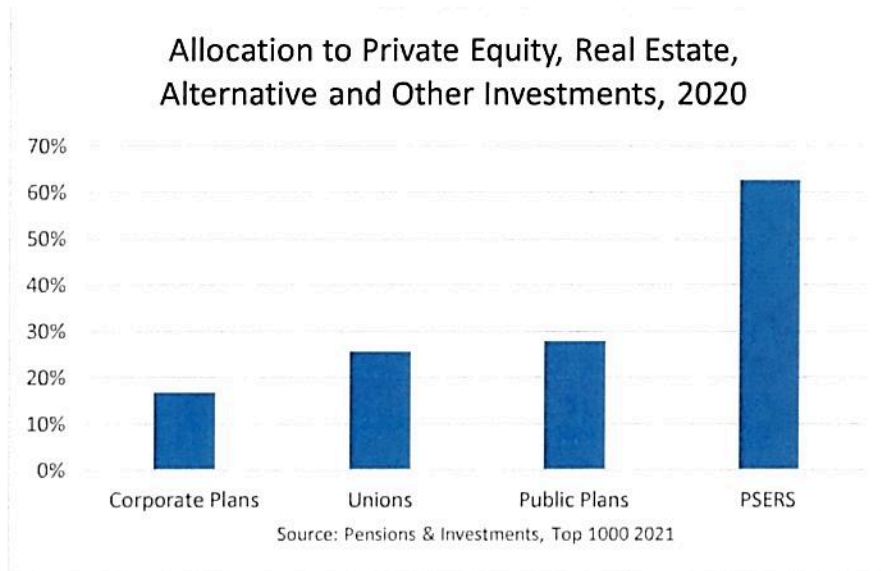


PSERS' investments have consistently underperformed a variety of more common strategies - including a low-cost 60/40 stock/bond portfolio, the asset allocation of its sister fund SERS, and strategies more commonly used by peer public funds. Any of these more common strategies would have easily exceeded the shared risk threshold over the 9-year period.

Indeed, PSERS' investment underperformance as overseen by management was the *sole* factor that triggered the statutory shared risk threshold, *not* a consultant error. Regardless, throughout this same period, management repeatedly assured the Board that the Fund's strategy was adding value and that performance was exceeding expectations.



Since 2009, PSERS has pursued an investment strategy that made disproportionate allocation bets on illiquid alternative investments, and more recently leverage, through a strategy purported to be more risk balanced than traditional stock and bond investments. As the following chart shows, its allocation of 62.6% to alternatives – investments other than publicly traded stocks and bonds – is more than double the size of other plans: Public (27.9%), Union (25.6%) and Corporate (16.8%).



As implemented by PSERS management, this strategy has failed to capture market gains experienced by peers over the long-run, while also falling short in providing the anticipated downside protection, including when most needed in early 2020 – months before the end of the shared risk measurement period. As a result, management’s consistent underperformance has caused an increase in contributions affecting nearly 100,000 employees who now must shoulder the financial consequences.

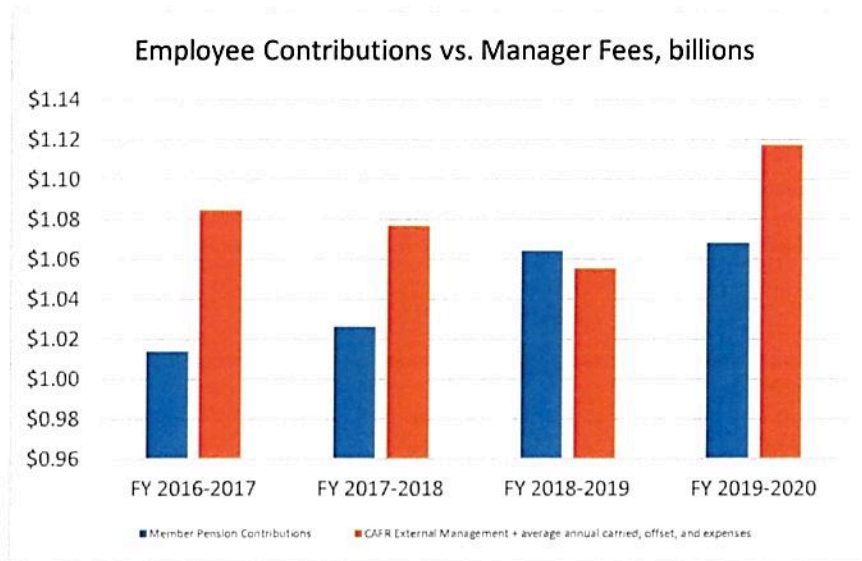
The impact on public school employees is real and significant. Over the next 3 years, more than 80 million additional dollars will be taken from their paychecks.

	Members as of June 30, 2020	Old Contribution Rate	New Contribution Rate
Class T-E	64,658	7.50%	8.00%
Class T-F	14,559	10.30%	10.80%
Class T-G	15,122	8.25%	9.00%
Class T-H	91	7.50%	8.25%
Affected members as of June 30, 2020	94,430		

Fees and Costs

Despite a stated commitment to control investment fees, management actively opposed specific legislative and Board member transparency proposals – claiming that the fund would miss out on high-performing manager opportunities and arguing that if enacted, would increase taxpayer

contributions by nearly \$30 billion.⁵ Over the past four fiscal years, PSERS has paid over \$4.3 billion in external investment manager fees, carried interest and other fund expenses. Particularly startling, as demonstrated by the chart below, this eclipsed all of the \$4.172 billion in contributions made by public school employees during that same period.



Governance Failures by Management

PSERS management has mishandled its relationship with members of the Board. Over time, PSERS management has taken several actions that have limited the Board's oversight, including:

- Chronic last-minute posting of necessary Board materials prior to scheduled Board meetings.
- Co-opting the independent Board consultant selection processes to ensure management controls and influences the selection and use of consultants.
- Retaining and hiring key executive management personnel without prior knowledge, direct involvement, or approval of the Board.
- Failing to adequately staff an internal audit office.
- Continuing to approve investment staff salary raises following incorrect December 2020 Board investment performance certification.
- Conducting media outreach efforts to criticize and question the motives of Board members who, in the exercise of their fiduciary obligations, have challenged investment strategy and performance or who have otherwise advocated reforms.

⁵ <https://www.psers.pa.gov/FPP/Publications/General/Documents/BudgetHearing/2020%20POP%20FINAL.pdf>
http://www.ifo.state.pa.us/download.cfm?file=Resources/Documents/Actuarial/ALTR_HB1964_PN2765.pdf

Equally troubling are instances in which executive management has advocated for or opposed specific system governance changes without written notice to or formal approval by the Board, as demonstrated by the following examples:

- Advocating for the exemption of PSERS' executive director salary from the required statutory approval of the Pennsylvania Executive Board.
- Advocating for the exemption of PSERS employee compensation from statutory limitations on the payment of bonuses.
- Advocating for the exemption of PSERS employee complement and general operating budget from Budget Office oversight.
- Opposing fee and cost transparency legislation proposed by members of the General Assembly.
- Advocating legislative proposals that would permit PSERS' assumption of SERS' investment operations.

Considered together, these actions by PSERS management illustrate an agency divorced from a Board that is statutorily charged with the "exclusive control and management" of the retirement fund.

Timing

Continuation of the status quo is not a reasonable option and is contrary to the Board's responsibility, at all times, to protect the interests of the participants in the retirement fund. Despite being compelled to recertify the shared risk measurement, confirming 9 years of investment underperformance, and growing Board member criticism of an over-allocation to private market investments, management continues to pursue a business-as-usual approach. The meeting agendas for June 10-11th not only include an "educational" presentation by a large hedge fund manager to whom PSERS has paid over \$560 million in fees, but management has also recommended the approval of 6 different alternative investment proposals (totaling nearly \$1.2 billion). These 6 proposed mandates are accompanied by investment fees that exceed \$61 million during their initial investment periods and may exceed more than \$100 million over the life of the contracts. The current Board agenda belies the seriousness of the financial and governance challenges facing PSERS.

Some may argue that it is premature to make management changes prior to the completion of either the internal Board-directed investigation or the external federal Grand Jury investigation. We respectfully disagree. Though there is no dispute that the events which preceded the investigations have brought greater critical focus to the actions of PSERS, there is also no question that PSERS' underperformance, compared to peers and expectations, is not a recent development and is unrelated to the claimed calculation error. With each fiscal quarter that passes without remedial action, the financial risk to the fund increases.⁶

⁶ In fact, recent reporting data suggests that PSERS' investment performance will not significantly improve in the near future. As provided by Aon to the Board this month, PSERS' total fund performance for the 1st, 2nd and 3rd quarters ending March 2021, remains among the lowest of peer group public pension plans. The 1-year investment performance for the period ending March 31, 2021 was worse than 93% of comparable public pension funds, the 10-year performance was worse than 76% of comparable plans. See Aon, 2021 1st Quarter PSERS Total Fund Performance Report, at 11 (June 2021).

To be clear and to avoid any suggestion to the contrary, our advocacy for this management change should not be interpreted to suggest that individual wrongdoing, as it relates to the Federal investigations, has occurred. Instead, we believe a management change is the necessary response to correct an irrevocable loss of trust and confidence that is a consequence of persistent underperformance and repeated governance failures over the past 10 years.

With evidence of significant and persistent underperformance in hand, we believe that new direction and leadership at PSERS is necessary and in the best interest of the plan members – those to whom we owe our fiduciary duty. Maintaining our members' ability to retire with the peace of mind that this security is in-hand should be our primary objective. We owe it to them to take action now.

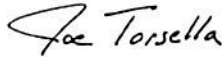
Sincerely,



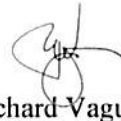
Stacy L. Garrity
State Treasurer



Noe Ortega
Acting Secretary of Education



Joseph M. Torsella
Former State Treasurer



Richard Vague
Secretary of Banking and Securities



Katie J. Muth
State Senator



Nathan G. Mains
Chief Executive Officer
Pennsylvania School Board Assn.

Attached Legal Memorandum

cc: All members of the Board of Trustees.