FPPA | Fire & Police Pension Association of Colorado

# Active vs. Passive Investment Approaches

A response to requested information from the Pension Review Commission

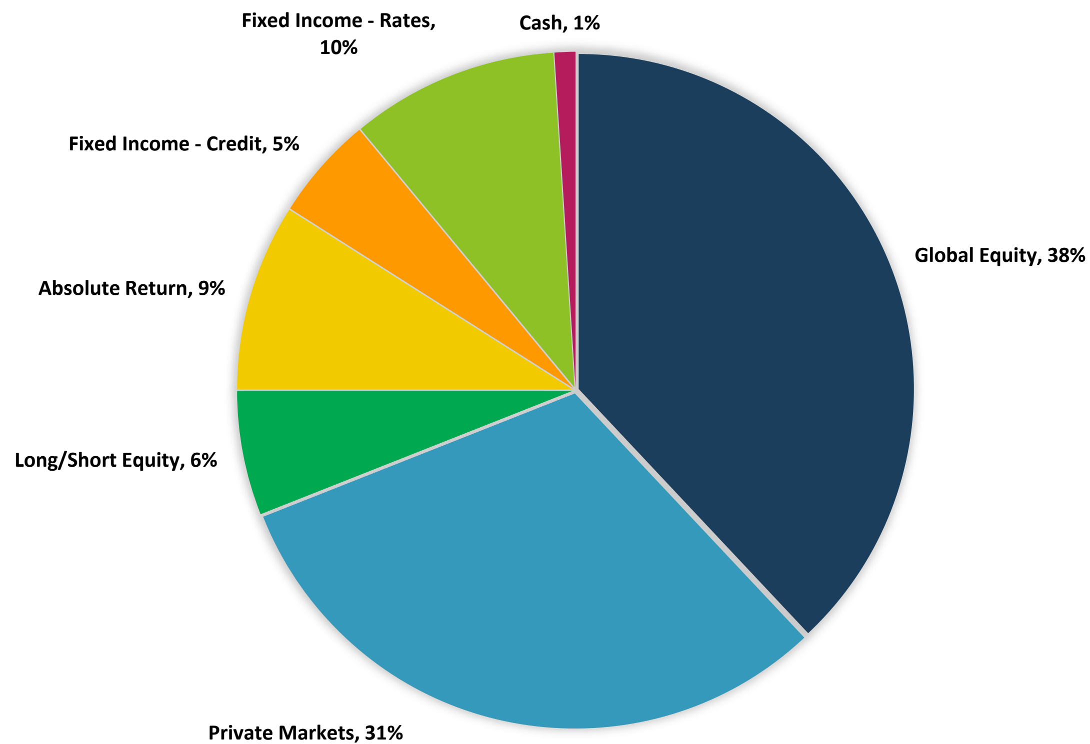
# Summary of Request

- Compare advantages and disadvantages (costs and asset allocations) of current active investment approach to passive investment approaches
- Compare current active investment approach to other statewide retirement plans, including Nevada
- Costs to transition to a passive investment approach
  - Impact on retirement benefits
  - Impact on ability to fully amortize unfunded liabilities

## Acknowledgment

- It's a reasonable and common request
- We utilize and regularly measure our investment approach to passive options
- We are here to be transparent and educate

# FPPA Target Asset Allocation



# It's Not Just About Returns
# It's Also About Managing Risks

**As fiduciaries, our primary job is to manage risks**

- Liabilities, contributions, funded status, liquidity

**FPPA has strong governance and regularly undergoes a thorough asset liability study process to assess risks and determine an appropriate asset allocation and portfolio construction**

**Resources utilized:**

- Actuary (GRS)
- Investment Consultant (Cambridge Associates)
- FPPA Staff
- Board of Directors

**Unique from most public pension plans, FPPA manages different investment pools to more appropriately match the risks of its underlying plans**

**Risks need to be considered when trying to achieve differentiated returns**

# Comparison to Other Public Funds

**Every state public retirement plan has some degree of active investment management, including Nevada**

- RVK Survey of 72 public funds (0 are all passive, 3 are all active)

Nevada CIO Steven Edmundson would emphasize … *"Every pension fund is unique and needs to be implemented to its own circumstances. Unique to its own liabilities, contributions, funded status, liquidity and resources."*

**Nevada is Underfunded with Negative Cash Flow**

- Nevada needs to be more liquid and take more concentrated risks in the public markets
- FPPA is fully funded and has positive cash flow[1]

**Nevada has Legacy Restrictions on Investment Staff Resources**

- Nevada needs to outsource private equity and real estate fund implementation
- FPPA internally implements private equity and real estate fund implementation

# Active vs. Passive (Theoretical)

| | Active | Passive |
|---|---|---|
| **Implementation** | Complex | Simple |
| **Fees** | Higher | Lower |
| **Return Enhancement** | Higher | Lower |
| **Risk Management / Diversification** | Higher | Lower |
| **Institutional Access** | Higher | Lower |

**KEY:** Advantage / Disadvantage

# FPPA vs. Passive (Historical)

**Assumption Driven – Outcomes (therefore conclusions) will vary depending on assumptions**

**Primary assumptions for a passive approach are:**

| | |
|---|---|
| Equity / Fixed Income Split: | 70% / 30% |
| Choice of Passive Indexes: | |
| Global Public Equity: | MSCI ACWI IMI[1] |
| Fixed Income: | Bloomberg Aggregate Bond[2] |
| Time Period: | 10 years ending 7/31/2023 |

1. Current long-term policy benchmark for Global Public Equity
2. Current long-term policy benchmark for Fixed Income

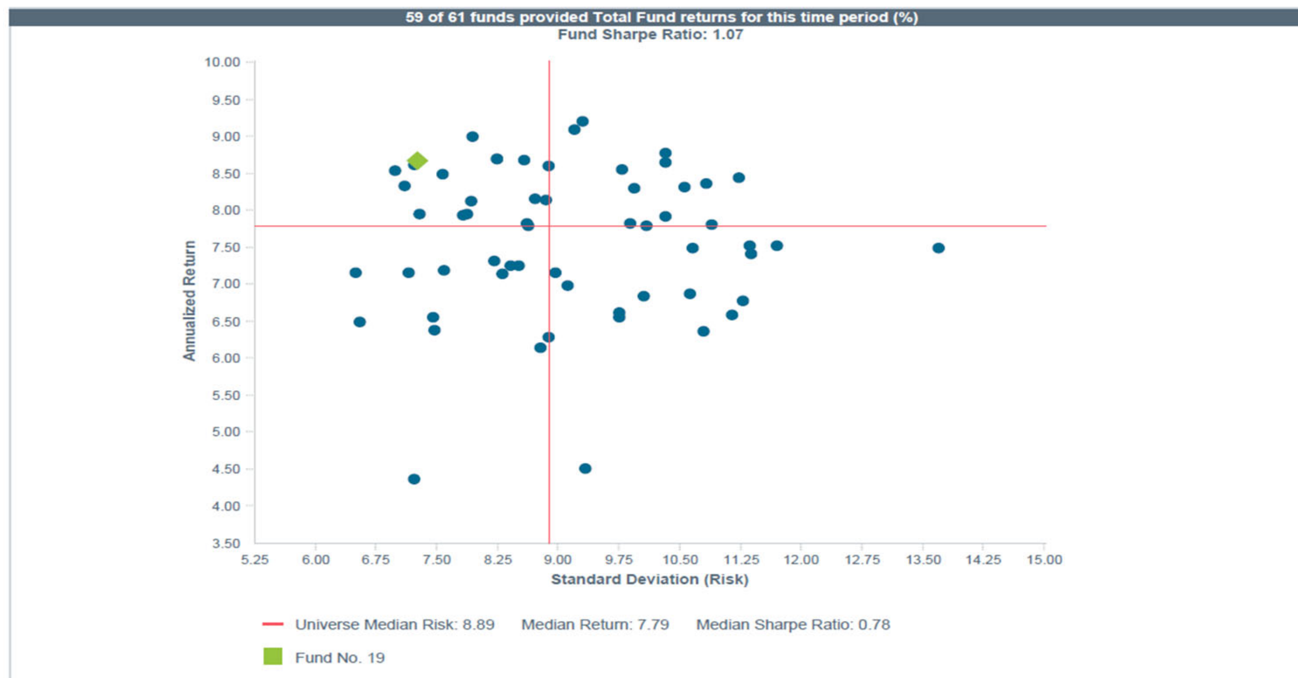
**FPPA outperforms its passive option by 1.23% annualized (7.88% vs. 6.65%) with less volatility risk** *(see following chart)*

FPPA

# FPPA vs. Passive (Risk & Return)

**Desired quadrant is upper left (higher returns with less risk)**

**FPPA is Fund No. 19**




Funds with less history than the specified time period will not appear in the chart.

# Transition Costs

**Liquidation / transition of asset classes can be done with minimal transaction costs under following timelines:**

| ASSET CLASS | TIMING |
|---|---|
| Cash | Days |
| Fixed Income (Rates) | <1 Month |
| Global Public Equity | <1 Month |
| Fixed Income (Credit) | <3 Months |
| Real Estate | 6-12 Months |
| Long/Short Equity | <2 years |
| Absolute Return | <2 years |
| Private Equity | 15+ years |

- Long/Short Equity and Absolute Return could be liquidated sooner by incurring fees of approximately 3% or $28 million
- Private Equity could be liquidated sooner through a secondary sale incurring a discount of approximately 20% or $355 million

# FPPA vs. Passive (Prospective)

**Via FPPA's most recent asset liability study process (2023), capital market expectations were utilized to determine a long-term expected rate of return**

- FPPA's current long-term asset allocation has a 7.63% expected rate of return[1]
- A passive 70% (equity) / 30% (fixed income) portfolio has a 7.04% expected rate of return[2]
- A decrease of 0.59% in expected rate of return, the liabilities of the plan would increase by approximately $571 million and would drop the funded status from 100% to 91%[3]
- These changes would have a significant negative impact on FPPA's ability to pay base benefits and COLAs

1. See Appendix for expected rate of return analysis and capital market assumptions
2. Per Cambridge Associates (FPPA's Investment Consultant) using the same capital markets assumptions
3. Per GRS (FPPA's Actuary) and disclosed within FPPA's 2022 Annual Report

# Fees

**Fees Matter – It is critical that FPPA ensures we get what we pay for when paying any fee**

- Fees are considered in our investment approach and investment decisions (among many factors) are based on a ***net of fees basis*** *(what is expected in risk/return after paying the fees)*
- Some asset classes cannot be done passively *(private equity & hedge funds)*
- All assumptions and historical performance are reported on a ***net of fees basis***
  - Net of management fees, incentive fees, carried interest, partnership expenses, consulting fees, due diligence travel, legal costs, investment staff salaries and benefits
  - For 2022, all fees totaled 1.58% of total average assets

# Summary

- As fiduciaries, one of our primary responsibilities is to manage risks
- As fiduciaries, FPPA utilizes a thorough process and deploys significant resources in the development and implementation of its investment approach, including the continuous assessment on the appropriateness of using passive investment options
- As fiduciaries, FPPA's investment process and results are on a net of fees basis
- A shift to an entirely passive investment approach *(historically and prospectively)* would have a significant negative impact on FPPA's ability to pay base benefits and COLAs
- Every pension fund is *unique* and needs to be implemented to its own liabilities, contributions, funded status, liquidity and *resources*
  - FPPA is unique as a smaller fund, being fully funded and with a liquidity profile to support our current investment approach

# Appendix A

## Capital Market Assumptions

2021 & 2022 December Assumptions

| | 2021 CA Intermediate Term | | 2022 CA Intermediate Term | | 2021 CA Long Term | | 2022 CA Long Term | |
|---|---|---|---|---|---|---|---|---|
| **Asset Class** | **Compound Return** | **Risk** | **Compound Return** | **Risk** | **Compound Return** | **Risk** | **Compound Return** | **Risk** |
| Global Equities | 6.6% | 17.5% | 7.2% | 17.5% | 5.8% | 17.5% | 7.4% | 17.5% |
| Absolute return | 5.5% | 4.0% | 6.4% | 9.9% | 5.5% | 4.5% | 6.0% | 9.9% |
| Long/short | 6.0% | 13.2% | 5.8% | 13.2% | 6.0% | 13.2% | 6.6% | 13.2% |
| Private Markets | 8.0% | 19.0% | 8.4% | 19.0% | 7.6% | 19.0% | 8.5% | 19.0% |
| Fixed Income - Rates | 2.4% | 7.0% | 4.7% | 7.0% | 3.7% | 7.0% | 5.2% | 7.0% |
| Fixed Income - Credit | 2.9% | 7.6% | 6.2% | 8.9% | 4.2% | 7.6% | 6.5% | 8.9% |
| Cash | 0.1% | 2.0% | 4.4% | 2.0% | 2.1% | 2.0% | 3.9% | 2.0% |
| Inflation | 2.4% US, 2.3% Global | | 3.0% US, 2.8% Global | | 2.5% | | 2.7% | |

Note(s): Intermediate return assumptions reflect Cambridge Associates' Steady State Return Projections. FPPA portfolio-specific assumptions for Absolute Return and Long Short in 2021 . Private markets utilize the intermediate US inflation assumption while Global equities utilize the intermediate global inflation assumption. Compound returns represent geometric AACRs.

# Appendix B

**FPPA Strategic Asset Classes** | 2022 December Assumptions

| | Long-Term Pool (LTP)<br>Interim Target | Glide Path Pool (GPP) | Short-Term Pool (STP) |
|---|---|---|---|
| **Intermediate-Term** | | | |
| **Compound Return** | **7.45%** | **6.91%** | **5.25%** |
| Standard Deviation | 13.32% | 10.12% | 6.22% |
| Probability of Achieving 7% | 54.20% | 48.90% | |
| **Long-Term** | | | |
| **Compound Return** | **7.63%** | **7.13%** | |
| Standard Deviation | 13.32% | 10.12% | |
| Probability of Achieving 7% | 59.40% | 52.50% | |
| **Asset Allocation** | | | |
| Global Equities | 38% | 17% | 10% |
| Absolute return | 9% | 6% | |
| Long/short | 6% | 6% | |
| Private Markets | 31% | 30% | |
| Fixed Income - Rates | 10% | 30% | 70% |
| Fixed Income - Credit | 5% | 6% | 10% |
| Cash | 1% | 5% | 10% |

Note(s): Compound returns represent geometric AACRs

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