National Association of Investment Companies

Initiative to Diversify Federal Fund Manager Pool Gains Momentum

By Alan Hughes of the National Association of Investment Companies

The federal government began its first supplier diversity program back in the 1950s with the establishment of the Small Business Administration to oversee the federal contracting process and level the playing field for small businesses. The concept was expanded with the 8(a) Business Development Program, which assists diverse-owned businesses. Over the years, the federal government's efforts toward diversity and inclusion—while not perfect—have improved, and many diverse enterprises have succeeded as a result by demonstrating their ability to compete when roadblocks are removed.

However, those same efforts of inclusion have yet to fully reach the world of finance, where the federal government invests little of its $800 billion in pension assets under management with diverse-led investment firms. How bad is it? Approximately 34 percent of the federal workforce currently self-identifies as a member of a minority group, yet if one looks at the Federal Retirement Thrift Investment Board, one would see virtually all of its $375 billion in pension assets (other than allocations for fixed income government bonds) managed by one mega-firm—BlackRock.

While diversity is alive and well among the rank-and-file of the U.S. armed forces, the same cannot be said for those who manage their retirement benefits. The Army & Air Force Exchange Service, which has over $5.5 billion in retirement assets, is invested by 29 managers, none of whom are diverse. The same holds true for the $14.1 billion U.S. Army NAF Retirement Plan Trust and $1.5 billion Navy Exchange Service Command.

Senator Cory Booker (D-NJ) is one of several legislators who are looking to change this abysmal trend. Booker, along with Elizabeth Warren (D-MA), Congresswoman Maxine Waters (D-CA), Ranking Member of the Financial Services Committee, and senior committee member Congressman Gregory Meeks (D-NY), hosted a Congressional Diverse & Emerging Manager Federal CIO Briefing in July that brought together state, local, and private-sector chief investment officers (CIOs) and legislators to determine what steps can be taken to ensure diverse- and women-owned financial services firms are able to meaningfully participate in the management of federal retirement assets.

"During my first year in the Senate, I urged the Commerce, Labor, and Treasury departments to address the underrepresentation of minorities and women among asset managers used by the federal government. It's important to continue the discussion to find ways we can expand access and opportunity for women- and minority-owned asset management firms," Senator Booker said. "These asset managers are experienced professionals who often outperform larger firms, and we can't afford to ignore their talents. The federal government should have professionals managing their pension plans who reflect the diverse makeup of the hardworking employees who faithfully contribute their hard-earned money into the federal retirement system."

The legislators extolled progress made during the discussion. “I am thankful to the stakeholders who provided their perspective on the steps that federal retirement plans and endowments need to take to ensure that firms that manage federal retirement and endowment assets reflect the growing diversity of the federal workforce and the nation,” Congresswoman Waters stated. “This event created space for critical dialogue to help establish a plan of action to finally address barriers to inclusion within federal retirement plans and endowments. I will continue to work with Senator Booker, Representative Meeks, and other members of Congress to lay the foundation for removing long-standing obstacles to meaningful inclusion in federal asset management.”

However, not all CIOs appear to embrace these efforts. The National Railroad Retirement Investment Trust, which lists one non-diverse master custodian for its $26 billion in assets, has declined invitations to attend these briefings. Attempts to contact trust CIO and CEO Catherine A. Lynch for comment were unsuccessful.

The CIO briefing was part of ongoing efforts to ensure that diverse managed firms—particularly those who rank among the top industry performers—are given equal consideration with regard to managing retirement funds for federal employees. The White House convened a symposium in September on this same topic, which brought in some 80 industry professionals and legislators that included three Cabinet Secretaries, several members of Congress, and the President’s Senior Advisor, Valerie Jarrett.

“The argument is simply that you have people of color who have the capacity to manage billions of dollars on behalf of fiduciaries like CalPERS, CalSTRS, New York Common, so we want to have the same right with the federal pension funds as well,” says Tom Soto, Vice Chair of Programs for New America Alliance (NAA), an organization dedicated to advancing the economic development of the American Latino community. Soto, on behalf of the NAA, has worked with the National Association of Investment Companies (NAIC) and National Association of Securities Professionals (NASP) to advocate that the federal government diversify their pension plan investment managers.

Since the main U.S. anti-trust laws—the Sherman Act of 1890, Clayton Act of 1914, and Federal Trade Commission Act of 1914—do not extend to the management of the federal thrift, a handful of large firms are able to dominate in this space in spite of the fact that some smaller firms are delivering superior returns. “For far too long, highly qualified minority- and women-owned asset management and brokerage firms have been left behind when it comes to the management and administration of federal retirement plans and endowments,” says Congresswoman Waters. “If we are to make meaningful progress toward closing the racial wealth gap, high-performing minority- and women-owned firms must have fair access to federal contracting opportunities like asset management and brokerage services to help expand their businesses and create jobs.”

There are several reasons to explain how a nation that began small business diversity efforts decades ago could be so behind the times when it comes to the management of its own funds. One is that federal CIOs are fairly insulated from diverse managers. They are overseen by 11 different boards of trustees, and most have high thresholds on how much capital a firm must have under management to do business with them. This creates not only a lack of access for the smaller diverse firms, but also a situation where despite performance they are simply not on the federal government’s screen.

Another issue is a lack of transparency, according to Jason Lamin, co-founder of Lenox Park LLC, a New York City-based due diligence advisory firm. “When you go to a pension system and say, ‘how many firms do have you have in your stable of asset managers with 51% or more diverse ownership? How much in the way of assets under management does that represent? What percentage of your entire trust does that represent?’ Those are questions that really should be able to be answered,” he says. “I can't figure out why it's so difficult. It always comes with a lot of caveats, and people don't ever specifically get down to that number. When forced, on the odd occasion that somebody really has pinpointed to come down to the number, it's generally not very good.”

Lamin claims some of the absence of data can be attributed to the anecdotal nature of much of what is known about the lack of diversity in federal fund management. “We don't know many managers that are of color or small or disabled or veteran that are managing assets on behalf of the federal pension system,” he attests. “We know certain examples with the Federal Retirement Thrift Investment Board where really there's one asset manager managing the entirety of those assets. We don't think very many people have been asking the questions, and I think generally the system has gotten very good at diluting the answer, so that there's no real way to pinpoint. The suspicion is that [the number of diverse firms managing federal funds] is not very good at all.”

Soto describes the lackluster diversity efforts as a disconnect between the pension fund community of the federal government and the population changes that have occurred in the U.S. “This is the population they represent—workers, many of whom are diverse and of color,” he says. “Other [state and municipal] pensions have developed programs to provide capital to diverse managers, who by the way in many cases are outperforming the larger, more established. The federal systems have failed to recognize this change. Our objective is to ensure that they now get the message.”

For now, a strategy is being mapped out by way of several meetings between legislators, asset managers, and CIOs. It also serves as a means for CIOs to familiarize themselves with outperforming portfolio managers who may be under their radars. Activity within the last 12 months has resulted in increased discussion, and one federal plan, the $85 billion Pension Benefit Guarantee Corporation, is conducting an emerging manager pilot program.

Success will require a multi-pronged approach, explains Robert L. Greene, CEO of the National Association of Investment Companies. The first is a plan to educate and engage in informing the various CIOs about opportunities and benefits associated with investing with diverse managers. “Along that path, we have engaged existing public pension plan limited partners that have been longstanding investors and done well in the space and used them as exemplars of how to successfully invest with diverse managers and create outstanding returns.”

The second approach is to work with interested members of Congress to create a legal environment through policy changes and through the enactment of specific laws to ensure that diversity is a component of judiciary responsibility and not seen as antithetical to judiciary responsibility. “The last piece for us is to work with the White House in getting people appointed to the boards of trustees who are experienced in investing and understand the broad landscape of the investment manager marketplace,” Greene says. ‘Not singularly familiar with mega firms or brand-name firms, but also have a very good acumen and understanding of the value that emerging managers and diverse managers bring to an investment strategy.”

Another possible solution to this would be a push for greater diversity within the ranks of pension plan trustees, creating an environment in which diverse managers would be more likely to be considered. “There's been a lot of research that shows that diverse organizations typically outperform organizations that are not diverse because you bring different perspectives to the table when you're discussing some of the best outcomes and solutions,” says Michael Kennedy, Senior Client Partner at Korn Ferry, a global executive recruitment and management firm. “So I think that's the first thing—looking at the leadership of those and also the composition of those two organizations.” Kennedy, who was also appointed chairman of the Federal Retirement Thrift Investment Board by President Barack Obama, also points out that a more diverse organization is more likely to cast a broader net and look for asset management firms that may not necessarily be recommended by consultants who often suggest big-name firms.

While it may happen slowly, a plan is being formulated. “We're asking them, ‘Can you talk to your peers and maybe facilitate an opportunity on your turf with your peers so that some of us can come in?’” says Haslip. “I think the takeaways are that we're making slow progress. The challenge is still to get all those pension fund officials for all of the relevant pension funds in the same room. The challenge is because of the structure—even the federal government has varying degrees of influence over the host appointment.”

Much of the progress that has been made is on the state and municipal levels. New York, California, Illinois, and Texas have emerging manager programs that have not only embraced inclusion, but also delivered positive returns to employee retirement plans. “The first thing you have to do is get the plan sponsor sensitive to the fact that there is a value here and that this makes sense from an analysis standpoint as well as a diversity standpoint,” explains Joseph Haslip, former Assistant Comptroller for Pensions in New York City, one of the cities with a robust emerging manager program.

Once the decision-makers began looking at these firms’ track records, performance, and managers’ backgrounds, they became amenable to casting a wider net, according to Haslip. Managers were classified as emerging, developing, or developed, based on assets under management. Depending on size and infrastructure, funds would receive either a direct investment or indirect capital by way of a fund-of-funds.

But the results were unquestionable. New York City was investing approximately $1 billion with small and emerging managers in 2001, and by 2009, roughly $7.5 billion of the city’s $90 billion in assets were managed by small or diverse firms. There were snags along the way. “There was a natural wrestling match with the consultants, but over time they realized that we were serious about this,” Haslip says. “We spent the time to challenge them to supplement their database.”

A program such as what New York City’s done on a federal scale will—if enacted—take five to 10 years to put into place, Kennedy estimates. But on the positive side, diverse firms will continue to grow in size, leading to more that are able to manage the large pools of capital within federal pension plans by the time any such program exists. “I'm optimistic about their future and knowing who some of these firms are and the quality of the products that they have and the caliber of the management teams and the caliber of some of the investment professionals on staff,” says Kennedy. “If you look at the composition of some of these firms, there are some very impressive groups. Most of the managers are Ivy League educated, many of whom have worked at large, reputable asset management organizations. That, coupled with their investment track record, I think really positions them to move beyond sort of that label of just being a ‘minority firm.’”

The argument for diversifying managers boils down to providing the best returns by having the best managers, for which a wide net must be cast. However, until investment managers, legislators, and other advocates can successfully push to enact measures to promote or ensure inclusion, it seems the only diversity within federal pension plans will be the asset allocations within their respective portfolios.