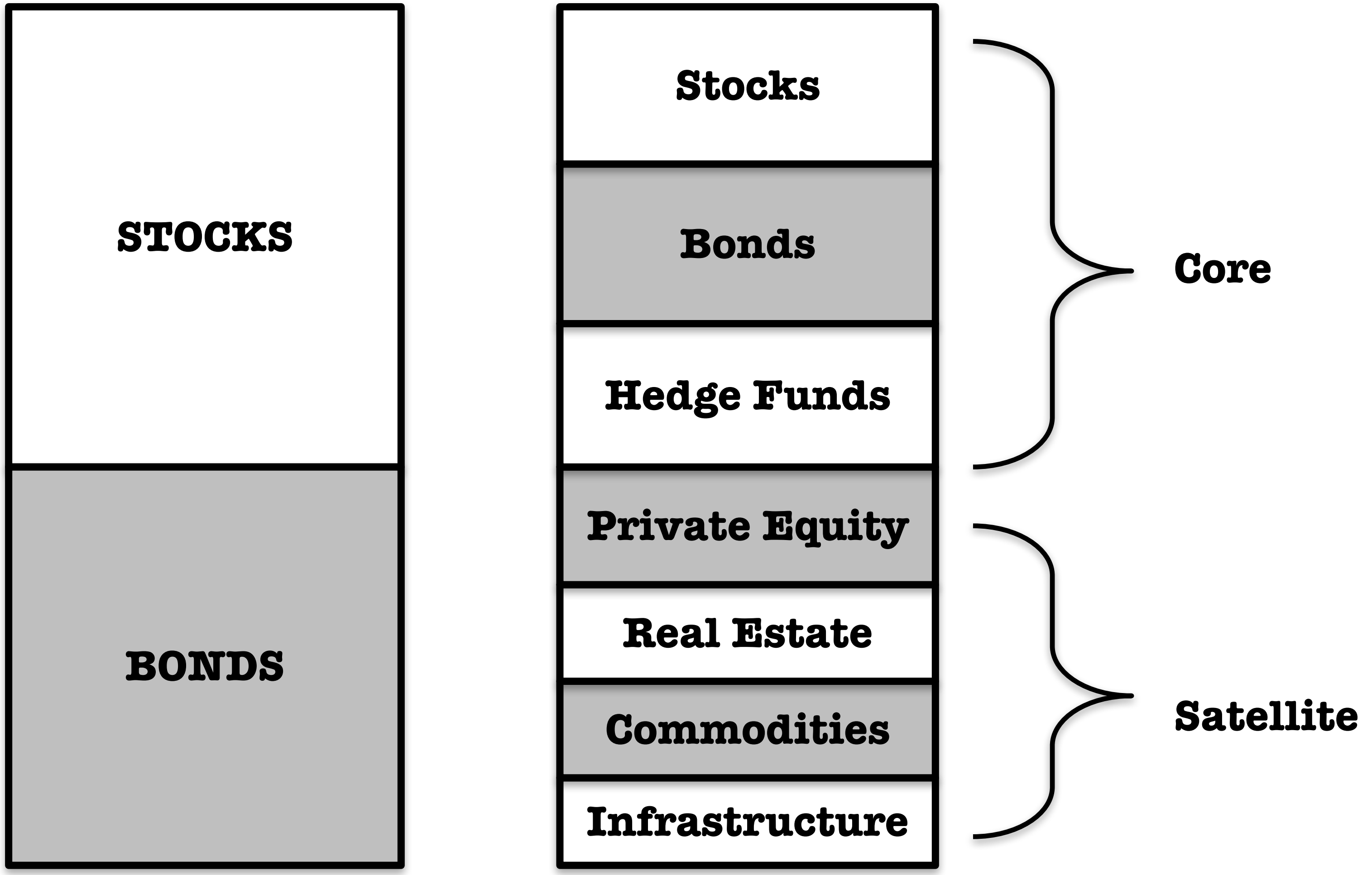
Review of Wyoming Treasurer Office Presentation “Historical Investment Returns,” August 24, 2020.

Jeff Hooke, August 28. 2020

Summary

- The Wyoming permanent funds are the victims of Modern Portfolio Theory (MPT), a portfolio management style that has been in vogue for the last 25 years.
- Under MPT, institutional managers, like the Treasurer, replace a portion of their low-fee traditional investments-- like public stocks and bonds -- with high- fee alternative investments-- like private equity and hedge funds. See Figure 1.
- The idea is that the high-fee products enhance profits over the traditional model, although several independent studies the last couple years have totally refuted this idea. In fact, MPT reduces profits versus the traditional model.

Figure 1
Traditional Portfolio vs.
Modern Institutional Portfolio



Why Do Institutional Money Managers use MPT if it Doesn’t Work?

- Many do not read studies that contradict MPT, since the studies mostly appear in obscure academic journals, only sometimes reaching the newspapers.
- Some refuse to believe the studies, even if a study has been reviewed by two Noble Laureates.
- Some think they can beat the averages of their peers and simple passive indexes, by using the pricey alternatives, even when Warren Buffett says most should index.
- Some think indexing will hurt their careers, since you seem smarter if you buy many complex investments.

Page 1 of Treasurer Presentation

- Wyoming goals and objectives are like other institutional investors, not particularly unique as suggested by the Treasurer.
- The state guidelines do not make the portfolio style for the permanent funds any different than most other endowments, state pension plans, sovereign wealth funds or foundations.
- The Wyofile story doesn't any special cherry picking.

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- The Wyoming funds have a equity to total asset ratio that is lower than its peers; this means lower returns compared to its peers when the stock market rises, and higher relative returns when the stock market falls.
- A better comparator in the article would have been a 50-50 index, rather than 60-40, but this does not truly change conclusions.
- The permanent mineral trust has an equity ratio of 65% today but this was around 50% in 2012.
- New Mexico and Alaska sovereign funds do not have equity ratios of 70% or more as suggested by the presentation.

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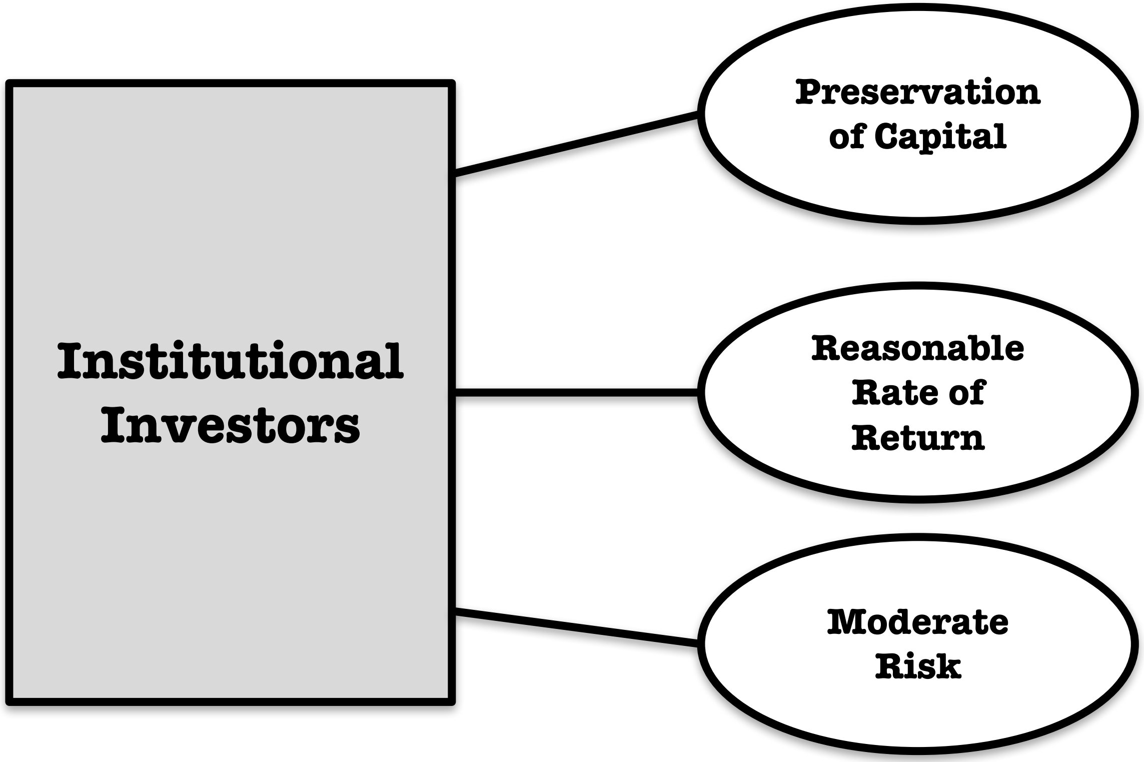
- Not sure why the Treasurer mentions 2009, which is 11 years ago.
- The SLIB policy is like most institutions. See Figures 2 and 3.
- The Wyofile story covers 10 years but the underperformance would also be evident for different time periods.
- Most consultants use 1, 3, 5 and 10 years.

Figure 2
Principal Institutional Investors

Pension Funds
Sovereign Wealth Funds
University Endowments
Foundations
Fund of Funds
Insurance Companies
Wealth Managers & Family Offices

Figure 3
Institutional Investors' Portfolio Objectives



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- If the Treasurer believes that the 60-40 will do lousy the next 10 years, he is predicting a bad stock market.

- He should therefore sell some of the funds’ stocks, MLPs real estate, PE, etc…

- Or, to save fees , just use a 40 stocks/60 bonds index…..more downside protection than a 60-40

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- Most consultants do not favor using a two-year yardstick. 1, 3, 5 and 10 years are common.
- The 60-40 is still the gold standard.
- Lately, institutions that have not “beaten” the 60-40 index want to use the MSCI ACW 60-40 index.
- The the poor performance on int’l stocks means the MSCI ACW is weak.
- The tactic is like “shifting the goalposts” to make it easier for institutions to win.

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- The chart is probably based on some self-made RVK benchmark that needs third party corroboration.
- RVK is getting paid by the State , so the state should check the RVK chart, given the amount of dollars involved.
- A better comparator is an objective, non-custom index , like a 50-50 index.

Page 9, Index it?

- All of the Funds' asset classes have index funds, such as US stocks, int'l stocks, bonds and real estate (REITs). The Treasurer does not seem to know this fact.
- Private equity is similar to public stocks in many ways.
- Hedge funds are usually a combination of public stocks and bonds. A 60-40 index has outperformed hedge funds easily the last few years.
- Internal management will cut costs, but indexing will cut costs even more, without sacrificing returns.

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- There is a long list of independent research that shows that active managers cannot beat an index after management expenses. That being said, people keep trying.
- This goes for bonds and stocks.
- The comparison does not show the salaries and other costs of in-house management in the yields.

Page 11

- Page 11 is a popular page with institutions.
- With its consultant, the institution creates a “custom index,” which the institution then always beats.
- This is like a child “grading his own homework.”
- It can’t stand up to independent scrutiny.

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- International stocks are cheaper for a reason.
- Many professionals consider them to be riskier than US stocks.

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- True, the US stock market is very tech dependent.

- The top five biggest stocks now account for 20% of the S&P 500 index by total value.

Page 15 , concept confusion

- Today’s 64% equity commitment by the PMTF is greater than that of New Mexico and Alaska.

- However, this equity exposure is consistent with many state retirement plans and university endowments.

Page 16, Fees

- Wyoming fees are understated.
- If you look at the State of New Jersey pension plan, which discloses both fixed fees and carried interest, New Jersey's hedge fund and PE fees are about 2.5% of such assets.
- For Wyoming, such fees should thus total $50 million alone. Adding 50 basis points for the other active asset classes, places the fee total much higher than $47 million indicated.
- Like most institutions, the Wyoming funds ignore carried interest fees because accounting rules provide the option to do so.

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