From: Kevin L. Bryant
To: 'Jim Kappler' <centristview@yahoo.com>
BCC: 'Kevin Bryant' <kevin@kevinbryant.com>
Date: 2/4/2015 2:00:53 PM
Subject: RE: Public Pension Returns Inflated By Bogus Private Equity Returns: Study

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Dear Jim, I read your email, and then I asked some questions of the Investment Commission about the valuation of private equity, which is a sizeable component of the portfolio there, and the specific article that you sent to me. I have copied below their reply to me. I will share this email with my colleagues on the subcommittee.

The results of both an Inspector General's investigation and a statutorily required fiduciary audit performed by an outside firm hired by the IG have shown no wrongdoing or questionable practices at the Commission. I am comfortable that their accounting and public representations are legitimate, but I always appreciate receiving information that allows me to ask new questions.

Thanks for your diligence,

Kevin

Dear Senator Bryant,

Thanks for giving RSIC the opportunity to share with you our basic standards and practices regarding private equity valuation. We believe that we are leaders in the public fund universe, and our standards and practices reflect our commitment to avoiding some of the pitfalls described in the article. I've noted below some of the elements of our regular due diligence process that is performed with every potential new private equity manager. I hope that this allows you to respond fully to your constituent, but please never hesitate to call upon us for more information.

- The values of private equity, real estate, and private debt investments are determined by the investment managers based upon documented valuation policies.
- Each fund is audited annually by a reputable external audit firm and the valuation of the private equity investments are a subject of review during those audits.
- Staff at both RSIC and PEBA review the external audits and ensure they have clean audit opinions and are conducted by reputable firms.
- As part of receiving a clean external audit, managers must value the assets at fair value according to the Financial Accounting Standards Board (FASB) accounting guidance.
- Additionally, some managers have their assets valued by independent third party valuation agents or appraisers on a regular basis.
- A joint valuation team including staff members of both RSIC and PEBA meet at least quarterly to review valuation topics.
- Our process for valuation has been reviewed by the Inspector General, the external auditor for PEBA and Funston—the fiduciary auditor.
- The external auditor always has provided a "clean" audit opinion regarding the financial

statements of PEBA and the fiduciary auditor

Listed below are the questions straight from our Operational Due Diligence Questionnaire.

1. Please submit your current Valuation Policy.
2. Who is on the Valuation Committee and can you outline the full process on how valuations are created, reviewed and submitted to the Valuation Committee for final approval?
3. Describe your Limited Partner Advisory Committee ("LPAC") & Independent Board of Directors (major roles and meeting schedule)
   • How often does the LPAC meet and do they review or approve company valuations?
   • Do you share minutes or in-camera sessions with the other LP's for these LPAC meetings?
4. Describe portfolio companies reporting obligations to the firm, including types of information required and frequency.
   • Are annual audits required for each portfolio company and is a "Big 4" or nationally recognized accounting firm required?
   • Describe any qualified opinions received by the Firm's portfolio investments during the Firm's period of ownership.
   • Describe any situation in which a portfolio company or property has filed for bankruptcy or failed to make payments under any secured or unsecured indebtedness during the Firm's period of ownership.
5. Do you use a third party valuation agent (i.e. Duff & Phelps) for non-public assets?
   • Please describe their review (do they analyze all fund holdings, sampling only or a review of the valuation methodology against the stated policy).
   • Does this process occur quarterly or annually (projected frequency)?
6. Explain the methodology for the IRR calculation; include the system/software used and please describe the internal controls over this process.

From: Jim Kappler [mailto:centristview@yahoo.com]
Sent: Monday, January 12, 2015 9:11 PM
To: Kevin L. Bryant
Cc: Anne Thayer
Subject: Public Pension Returns Inflated By Bogus Private Equity Returns: Study

Senator Kevin,

Since you are co-chairing a subcommittee to look at pension funds, you probably will find this of interest. I while back, I was exchanging emails (below) with Jeffrey Hooke, who has studied pensions. I used his data for a posting in my occasional blog (below) comparing pension fund returns.

You might contact Mr. Hooke about his study mentioned in the following article. If his study shows inflated returns for SC pension funds, consider inviting him to address your subcommittee.

Thanks.

Jim Kappler

Public Pension Returns Inflated By Bogus Private Equity Returns: Study
http://www.ibtimes.com/public-pension-returns-inflated-bogus-private-equity-returns-study-1780130

[Excerpt]
Across the United States, similarly robust returns have proven key elements in the Wall Street sales pitch that has persuaded state and city pension overseers to entrust vast sums of money to private equity managers. The private equity industry has successfully portrayed itself as no less than a savior for underfunded pension systems, at once an alternative to the volatility of the stock market and a source of outsized gains. By one estimate, $260 billion of public money is now under the management of these firms.

But as Congress this week considers reducing regulatory scrutiny of private equity firms, one problem complicates the narrative: A lot of the gains the private equity industry purports to have achieved are of the on-paper-only variety. Far from cash in the bank, they are instead estimates of the value of assets that have yet to be sold -- assets that pension systems are relying on to ultimately finance benefits for millions of current and future retirees.

Those estimates are largely self-reported by the private equity firms. Soon-to-be-released research obtained by International Business Times suggests that the firms have effectively embellished their returns to make them look more attractive to pension managers.

"Private equity managers constantly insist that their investments are less volatile and more safe than the broad stock market, but that may be a matter of perception rather than reality," said investment banker Jeffrey Hooke, who co-authored the upcoming study on private equity valuations with researchers from George Washington University. "The investments in private companies may only appear safer because the private equity managers are in control of how the investments look on paper, not because the actual value of the assets are more stable or better performing."

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----- Forwarded Message -----
From: Jeffrey Hooke <hookej@aol.com>
To: centristview@yahoo.com
Sent: Monday, January 12, 2015 3:25 PM
Subject: buyout article

just published...schedule got moved up...

http://m.ibtimes.com/public-pension-returns-inflated-bogus-private-equity-returns-study-1780130

Sent from my iPad

Jeffrey Hooke
hookej@aol.com

-----Original Message-----
From: Jim Kappler <centristview@yahoo.com>
To: Jeffrey Hooke <hookej@aol.com>
Sent: Sat, Jul 13, 2013 2:10 pm
Subject: Re: Ex C apples to apples

Jeff,

Graphs highlighting for 35 states with ending year on 6/30 attached, with SC & MD highlighted.
Jim Kappler

From: Jeffrey Hooke <hookej@aol.com>
To: centristview@yahoo.com
Sent: Wednesday, July 10, 2013 9:59 AM
Subject: Re: Ex C apples to apples

Jim, you mix apples and oranges, because you have a few states with different year ends.

I attach the Excel spreadsheet with only the 35 states with June 30 year ends.

These are the ones we did medians for, and it is included as Ex C in the website.

I'd like to see a new graph for these 35, if you have time to do it.

Jeff
Jeffrey Hooke
hookej@aol.com
-----Original Message-----
From: Jim Kappler <centristview@yahoo.com>
To: Jeffrey Hooke <hookej@aol.com>
Sent: Tue, Jul 9, 2013 11:54 am
Subject: Re: Graphs pulled from Wall Street Fees and Returns report data

Jeff,

My spreadsheets with graphs are attached. Let me know if you get any interesting responses.

If you want to get people motivated enough to actually act, you are going to have to make enough people spitting mad. (Take a look at what is happening with the govt. in Egypt. The military staged a coup and tossed out the President because enough people got spitting mad.)

The people you would make the angriest are probably the govt. employees and retirees/pensioners whose pension money is being eaten away by investment fees. Consider sending this dismal performance data to those groups, especially the retirees who have time to get involved.

Since your organization is in Maryland, I created a set of graphs with Maryland highlighted red. (Maryland does not appear to be ranking so high, either.) Consider doing this customization for the different states you send this to. State specific data will make the data relevant and hit home to those different audiences, and some will get angrier than others.

In this case, the median is the best statistic to use for comparisons. It describes the relationship of one half of the states to the other (e.g., higher or lower, better or worse) Is your state's pension fund performance better or worse that most of the states in the country? Is your state's pension fund paying higher or lower fees than most of the states in the country?

When people come up with their own answers to the above questions (e.g., My state has worse performance AND pays higher fees.) they will be more likely to to act. (It prompted me to make graphs.)

This suggests that you focus initially on the scatter plot quadrant with the worst performing states that are paying higher (>0.4%) fees AND having lower (<1.6%) returns than the median national values.

On a graph, especially where you compare things, it is the pattern of dots, bars, lines, or pieces of pie that grab the audience's attention. I find that numbers sometimes get in the way when you try to make comparisons. I created a second set of Maryland graphs with the numbers on the X & Y axes hidden (font color = white). You can therefore focus better on the patterns of bar and dots.

When you speak to an audience, you might in include the numberless graphs in your presentation. First, show the numberless graphs and ask the audience, "What is going on here?" With out the numbers, they will focus on whether their state is simply better or worse that most others. Then, show the graphs with number on the X-Y axis scales.

Regards.

Jim Kappler

From: Jeffrey Hooke <hookej@aol.com>
To: centristview@yahoo.com
Sent: Tuesday, July 9, 2013 9:32 AM
Subject: Re: Graphs pulled from Wall Street Fees and Returns report data

thx, jim, like to have a version I can send out.

great graphs...
Jeffrey Hooke
hookej@aol.com
-----Original Message-----
From: Jim Kappler <centristview@yahoo.com>
To: info <info@marylandtaxeducation.org>; jwalters <jwalters@mdpolicy.org>
Cc: csummers <csummers@mdpolicy.org>
Sent: Wed, Jul 3, 2013 9:53 pm
Subject: Graphs pulled from Wall Street Fees and Returns report data

Mr. Walters & Mr. Hooke,

I read your report on on Wall Street Fees and Returns.
http://www.mdpolicy.org/research/detail/wall-street-fees-investment-returns-maryland-and-49-other-state-pension-funds

I wrote of it in my occasional blog and added some graphs. (A picture is worth 1000 words. And, given the choice, most people prefer a simple picture over 1000 words.)

http://paycheckeconomics.wordpress.com/2013/07/04/comparison-of-return-rates-investment-expenses-of-state-pension-funds/

Included is a scatter plot of Returns vs. Fees. A couple in interesting outliers show up: Alabama's high returns and South Carolina's high fees.

I am not sure of the validity, but an interesting data set would be the $fees/employee enrolled in each state's pension program.

Thank you for your time and consideration.

Jim Kappler
Anderson, SC