State Treasurer Andrew Sidamon-Eristoff

Treasury and Interdepartmental Testimony

Assembly Budget Committee

May 6, 2015

Chairman Schaer, Budget Officer O'Scanlon, and members of the Assembly Budget Committee. I am pleased to present the Governor's Fiscal 2016 budget for the Department of the Treasury and Interdepartmental Accounts.

I am joined today by Thomas Neff, Deputy Treasurer for Budget, Charlene Holzbaur, Director of the Office of Management and Budget, and David Ridolfino, Associate Deputy Treasurer. Also here are many Treasury Division Directors and the chief executive officers of some of Treasury's "in-but-not-of" agencies.

Please allow me to address an important preliminary matter. As he has repeatedly said, Governor Christie is committed to making as large a pension payment as possible while we pursue reforms to fix the pension system once and for all. Accordingly, even though I am scheduled to return later this month with an update on revenues, I thought you might be interested to know that it appears that total revenue for Fiscal 2015 may well exceed projections, perhaps by as much as $200 million. While the ultimate impact on this year's ending fund balance is still dependent on spending and other factors, the Governor believes any unexpected addition to fund balance for Fiscal 2015 should be added to the State's pension contribution when that payment is made in June. At the appropriate time, we will request a supplemental appropriation from the Legislature to that effect.

That said, I understand that today's focus is not on the $33.8 billion State budget in its entirety — but rather on the $6.276 billion budgeted for Treasury and the State's Interdepartmental accounts.

Treasury's functions are broad in scope, diverse, and often extremely complex. In addition to managing the State's budget process, Treasury divisions are responsible for collecting revenue, asset management, public finance, and delivering an array of critical statewide services such as procurement, capital construction, risk management, and benefits administration.

The Governor's Fiscal 2016 budget allocates $2.09 billion to Treasury. As you know, this top-level number doesn't distinguish between the majority of Treasury spending that passes through the department's accounts and the $483.8 million Direct State Services appropriation that supports Treasury's normal operations. The Direct State Services appropriation, in turn, includes funding for the "in-but-not-of" agencies that are housed under Treasury, but are not under the direct control of the State Treasurer. These include the Board of Public Utilities, the Office of Information Technology, the Office of the State Comptroller, the Public Defender, the Casino Control Commission, the Division of the Rate Counsel, and the Office of Administrative Law.

Setting aside appropriations for these agencies, the Governor's budget recommends a $198.6 million General Fund appropriation to support Treasury's core missions and operating divisions, down more than $1.7 million from our adjusted appropriation for Fiscal 2015. This does not include programs supported by revolving fund and internal services fund resources, such as Central Motor Pool, Distribution Center, Print Shop, Capital Post Office, Unclaimed Property Administration and the fee-supported portion of the Division of Property Management and Construction related to statewide construction activity. In addition, the budget appropriates $46.5 million to the Division of Pensions and Benefits and $16.9 million to the Division of Investment from the Pensions and Health Benefits Trust Funds.

Currently, Treasury's work force includes approximately 3,092 full-time employees. Most — about 2,298 — are supported through the General Fund, while the rest are supported by fee-based or revolving funds. This represents a reduction of 206 positions, or 6.2 percent, from our staffing level of 3,298 when this administration took office.

To convey the breadth of Treasury's day-to-day activities, I would take a moment to provide a brief sampling of some of our divisions' recent operational activities and accomplishments since we met in this forum last year:

- As part of the implementation of a new contract with the State of New Jersey Deferred Compensation Plan Administrator, the **Division of Investments** reopened its internally-managed Large and Small Cap Equity fund to new contributions, providing participants with new low-cost, actively-managed equity investment options.
- Along with the New York Lottery, the New Jersey **Division of the Lottery** in June 2014 launched CASH4LIFE, a new game that guarantees top prize winners $1,000 a day for life. The new game has been extremely well-received and is now expanding to include Pennsylvania and Virginia. The Lottery is planning to launch a new instant online draw game this coming August.
- Working with the Department of Transportation and the State Police, the **Division of Administration** recently completed the first phase of replacing the State's antiquated fuel dispensing system for State vehicles to one that uses radio frequency technology to verify mileage and fueling eligibility.
- The **Office of Management and Budget** successfully implemented a new law that required direct deposit for all State employee compensation as of July 2014, eliminating the need to print, pressure seal, and deliver over 12,000 checks a month. OMB is also moving forward with a vendor to implement a modern budget management and planning system.
- With the help of the Office of Information Technology, the **Division of Pensions and Benefits** implemented three new on-line service applications for employers and member employees. The Division also successfully managed the complex transition to financial reporting under GASB 67.
- As of April 28, 2015, the **Division of Property Management and Construction** had procured the demolition of 203 Sandy-damaged homes in South River, Sayreville and Woodbridge as part of the Department of Environmental Protection's "Blue Acres" program, with many more in the pipeline. DPMC is also engaged in the first Energy Savings Improvement Project (ESIP) at the campus of the State Police in West Trenton.
- In addition to managing major issuances in support of local schools, higher education, transportation, and various environmental programs, the **Office of Public Finance** remarketed variable rate TTFA bonds with a fixed rate to reduce risk, thereby eliminating the need for letter of credit support, and managed an innovative refunding that generated total cash flow savings of $125 million for the State and New Jersey Transit in Fiscal Years 2015 and 2016 combined.
- The **Division of Purchase and Property** will soon complete the rollout of NJSTART, the State's new, state-of-the-art eProcurement solution. NJSTART launched a registration initiative for its Vendor Portal in May 2014, and nearly 5,300 vendors have already signed up.
- The **Division of Revenue and Enterprise Services** implemented a series of new services, including a new, enterprise-class, front-end processing platform; an automated online system for New Jersey's business entity filing program; "CorpWatch," a new online service to help corporations and LLCs monitor legal filings; e-filing for fiduciary tax returns; and a new online notary public commissioning process.

- The **Division of Taxation** designed and executed a special collections outreach program that generated $75 million. Taxation also achieved a 77% overall e-file rate for tax year 2013 resident income tax returns.
- The **Division of Unclaimed Property** implemented a new online holder reporting application and returned property worth a record-breaking $125 million to rightful owners.

I am extremely proud of everything Treasury staff members have accomplished, and continue to accomplish.

Before turning to your questions, I would like to take a few minutes to address several budget-related topics of apparent interest to members of the committee. Let me begin by gently refuting some unfortunate misconceptions regarding the State pension funds' alternative investments, performance, management fees, and related reporting.

The first misconception is that the New Jersey funds' investment in alternative asset classes is unusual. The truth is that New Jersey's diversified investment portfolio lies squarely within industry norms. Like most large public pension funds and other institutional investors, the New Jersey Division of Investment, under the policy oversight of the State Investment Council, maintains a diversified investment portfolio that includes allocations to "alternative" asset classes such as private equity, hedge funds, and real estate. The objective has been, and remains, to achieve greater diversification and a better risk/return profile. Although the move to alternative asset classes has its origins in recommendations of independent consultants in 2002 and 2004, the Division and the Investment Council significantly increased allocations to alternatives during the previous administration. Indeed, the amount of new commitments to private equity and real estate funds has declined substantially during this administration, even as New Jersey has slowly increased its target allocation for alternatives generally to 29.5%. The actual allocation at the end of 2014 was 28.2%. For comparison, the average target allocation to alternatives across a peer group of 11 large public pension funds is now 32%.

A second misconception is that the New Jersey funds' investment in alternative asset classes has come at the expense of investments in publicly traded securities, e.g. domestic equities, such that New Jersey has somehow "missed" the recent bull market in equities. The truth is that New Jersey's investments in alternatives have represented a shift from traditional investment grade fixed income securities, <u>not</u> publicly traded securities, and this shift has generated extra value. The funds' exposure to public equities has actually increased since the end of Fiscal 2010 from 42% to 46% as of December 31, 2014. Since the beginning of Fiscal 2010, the Division has reduced the overall allocation to investment grade fixed income by 17.4% while increasing the overall allocation to alternatives by 14.1%. Over that same period, the alternatives portfolio has outperformed fixed income by more than 2.3% annualized, generating over $2.8 billion in added value over the past five years.

A third misconception is that New Jersey's alternative investment portfolio has underperformed net of all fees. The truth is that, over the past five years, the alternative investment portfolio has outperformed both the total pension fund and a traditional 70% stock / 30% bond portfolio. Indeed, it may be said simply that the alternative portfolio is meeting its intended objectives: it is providing superior risk-adjusted returns as part of a prudently diversified overall investment portfolio.

Speaking of overall performance, I am pleased to report that New Jersey's overall investment returns have been in line with, or superior to, that of its peers for most periods:

- For Fiscal 2014, New Jersey's return was 16.87%, beating the benchmark return by 108 basis points and more than double the assumed rate of return. The Fund has exceeded the assumed rate of return in four of the last five fiscal years;

- For calendar 2014, New Jersey's return of 7.27% was better than the median return of large public pension plans of 7.25%;

- For the three years ending June 30, 2014, New Jersey's return of 10.2% was exactly in line with the median return for large public pension plans;

- For the seven-year period ending June 30, 2014 --- in essence the period since the onset of the global financial crisis in 2007 --- New Jersey's return of 5.7% was in the 21st percentile of large public pension plans; and

- On a Sharpe Ratio basis --- which measures risk-adjusted performance --- New Jersey ranks in the 19th percentile for three years, the 23rd percentile for four years, and the 19th percentile for five and six years.

A fourth misconception is that New Jersey is abnormally opaque with respect to investment management fees and other compensation paid to outside mangers and consultants. The truth is that, due to legitimate differences in accounting methodologies, there is no standard or consistent methodology in how public pension funds report fees and compensation. However, by any comparison, New Jersey's reporting is more transparent and inclusive than that of the vast majority of its peers. In the spirit of transparency, New Jersey discloses carried interest retained by, as well as management fees paid to, outside general partners for all alternative investments. A review of Fiscal 2013 and 2014 CAFRs and annual reports revealed that, of the 17 largest public pension funds in the United States, only two plans besides New Jersey disclosed carried interest retained by general partners for all alternative investments. Four other plans disclosed some, but not all, carried interest retained. Any fair comparison of fees and compensation across plans must take into account the variability in reporting.

A fifth and final misconception is that New Jersey is paying too much in fees. The truth is that New Jersey's management fees and expenses are below the average for peer large public pension funds, and that recent awards of incentive compensation including carried interest are a consequence of managers' demonstrated success in delivering strong returns for the pension funds. The Division of Investment has aggressively negotiated preferential terms and governance rights across all alternative investments that incentivize strong performance, ensure the alignment of interests, and have generated significant cost savings. In Fiscal 2014, New Jersey's expense ratio for external management fees was 0.33%, below the average of 0.41% for large public pension funds that disclosed the amount of fees they paid to external investment advisors. Further, New Jersey's alternative portfolio, including global diversified credit, returned 15.16% and generated approximately $3.7 billion of gross profit in Fiscal 2014. In total, New Jersey paid $237 million in management fees and General Partners of these funds retained $335 million in carried interest as a result of strong returns for these investments. Therefore, these portfolios generated $3.1 billion of net profits in Fiscal 2014.

With your permission, I would like now to offer a few observations regarding the Division of the Lottery's contract with Northstar NJ for sales and marketing services.

Let me dispel whatever suspense there may be: Less than two years into a complex 15-year contracting relationship, the Division is satisfied with Northstar's performance. Northstar has followed through on its contractual commitments with respect to investments in staffing, retailer recruitment and support, marketing and promotions, and modern technology. Although net revenue to the State has not met expectations, we believe that Northstar's investment and activities to date have in fact shielded New Jersey from the worst of what is clearly a national scale, industry-wide decline in lottery sales and net revenues. In other words, we believe that New Jersey would be worse off but for the Northstar contract.

Some additional detail:

First, Northstar has made significant investments that are generating increased sales and higher profits for the Lottery's retail partners. Specifically, Northstar has created 130 private sector jobs, including 31 former State employees, and has increased the sales and marketing staff from 64 under State management to 115. No State employees were laid off. Northstar has increased the retail network by 11% since October 1, 2013, including new deployments at Wawa and Rite Aid. This expansion has generated at least $165 million in new sales revenue while earning lottery retailers, mostly small businesses, an extra $9 million in commissions. Retailer organizations that once opposed the Northstar contract have offered praise for the extra support that their members are now receiving.

In terms of technology, Northstar has introduced automated "claims and payment" systems to streamline all aspects of claims payment. In addition, Northstar provided the Lottery with the technology and equipment to improve the closeout of instant game returns, which helps retailers manage their inventory more effectively. Northstar has expanded the instant ticket vending machine network and introduced state-of-the art full-service machines. Overall, Northstar has invested, to date, almost $30 million in technology and other improvements. Given the nature of public budgeting and procurement processes, it is highly unlikely that the Lottery would have been able to make and sustain this level of commitment in a similar timeframe.

Second, Northstar is demonstrating success in growing revenues with respect to that portion of the Lottery's portfolio of games that is most clearly amenable to its management and control. The Lottery's portfolio includes three broad categories: "lotto" jackpot games, dominated by the two major multistate jackpot games, Mega Millions and Powerball; traditional daily machine or "numbers" games; and instant ticket ("scratch off") games. Sales of lotto games are increasingly dependent on the frequency and size of multistate jackpots. There is little, if anything, that any single lottery, or contractor, can do to impact the frequency and size of multistate jackpots. However, effective sales and marketing can, and should, impact sales of daily machine and instant ticket games. In that context, I am pleased to report that Northstar's and the Lottery's efforts have generated strong growth in these sales. Sales of instant tickets were up 3.9% in Fiscal 2014 (Northstar started work in October) and are up 10.5% in Fiscal 2015.

Third, Megamillions and Powerball --- the two large multi-state games --- are in decline across the country and New Jersey's lottery revenues have suffered as a result. The decline is reflective of a market shift not related to any one state's performance.

It is a simple fact that consumer demand for these games is waning, most notably among casual players with respect to large jackpots. To some extent, this is a function of fewer significant jackpots. For example, in Fiscal 2014, there were 11 multistate drawings with jackpots above $300 million; in Fiscal 2015, there have been only four such drawings so far with less than two months to go and little time for a large jackpot to build in the near future.

More important, we and other lotteries are experiencing the growing impact of "jackpot fatigue" --- the fact that it is taking larger and larger jackpots to draw casual players into the market. Essentially, the excitement of large jackpots declines over time. For example, a September 2013 (FY 2014) Powerball jackpot of $317 million drew approximately $6.4 million in sales (approximately 4-5 times a typical sale of lottery tickets.) However, a February 2015 Powerball jackpot of an identical amount drew approximately $4.8 million in sales, a 25% decline. Moreover, due to the reduction in player interest, it is taking more "rolls" to generate large jackpots, resulting in a self-fulfilling cycle of underperformance. These trends are hitting all participating lotteries; here in New Jersey, year to date Mega Millions and Powerball sales through April are down almost 30%. The story is the same elsewhere and no one state's efforts can correct it.

Fourth, the growth in instant ticket sales noted above --- while delivering a lower margin to the bottom line --- is providing welcome mitigation against the decline in multistate game sales. While half of 44 reporting lotteries experienced decreased net revenues in Fiscal 2014 compared to Fiscal 2013, the New Jersey Lottery maintained its contribution to the State budget. While 36% of reporting lotteries experienced a decline in sales, New Jersey generated a small increase to a record $2.9 billion. Overall sales for this fiscal year through April are up 2.9%.

Finally, I want to reassure the committee that the State is committed to managing its relationship with Northstar with continuing vigor and diligence. The contract contains important performance standards and financial guarantees. We will not hesitate to exercise the State's contractual rights as appropriate to protect the long-term interests of our taxpayers and residents.

Before turning to your questions, I would be remiss if I didn't acknowledge that the State Supreme Court is today hearing argument in a case that could have a direct impact on both the Fiscal 2015 and 2016 budgets. Although I cannot offer legal analysis, I would affirm that it is our duty to monitor and plan for budget contingencies, large and small, throughout the fiscal year. No matter the scope or timing, we are ready to identify for the Governor's consideration---and through him the Legislature's consideration---options for dealing with any reasonably foreseeable contingency. We appreciate that, by constitutional design, there would be a need to work collaboratively with the Legislature in dealing with any major contingency. To that end, as I noted during my previous appearance before this committee, we have offered our technical assistance to the Legislature and the Office of Legislative Services in reviewing information concerning uncommitted balances, line item appropriations, and actual expenditures contained in the State's Comprehensive Financial System (CFS).

Thank you for your patience. I hope that my extended comments have anticipated some of your questions and concerns.