



September 2017

# INVESTMENT MANAGEMENT

Key Practices Could  
Provide More Options  
for Federal Entities  
and Opportunities for  
Minority- and Women-  
Owned Asset  
Managers

## Why GAO Did This Study

Asset management firms registered in the United States manage more than \$70 trillion. MWO firms manage less than 1 percent of those assets. The federal government has an interest in increasing opportunities for MWO businesses. Questions have been raised about how often federal entities use MWO asset managers and the transparency of their selection processes. GAO was asked to examine, among other things, (1) competitive challenges MWO firms face and how institutional investors address them, (2) selected federal entities' use of MWO firms, and (3) the entities' asset manager selection processes, including their use of key practices. GAO reviewed investment policies and financial statements of 8 entities that manage or sponsor federal retirement plans, an endowment, and an insurance program. GAO also interviewed 14 state, local, and private retirement plans and foundations and 10 MWO asset managers (selected based on size and other factors).

## What GAO Recommends

GAO makes four recommendations to increase opportunities for MWO firms, in keeping with federal interests. Four federal entities should use key practices, as appropriate. The Army and Air Force Exchange Service, Navy Exchange Service Command, and Tennessee Valley Authority Retirement System agreed. The Federal Retirement Thrift Investment Board disagreed. GAO maintains that key practices should be used, as discussed in the report.

View [GAO-17-726](#). For more information, contact Michael Clements at (202) 512-8678 or [clementsm@gao.gov](mailto:clementsm@gao.gov), or Charles Jeszeck at (202) 512-7215 or [jeszeckc@gao.gov](mailto:jeszeckc@gao.gov).

## INVESTMENT MANAGEMENT

### Key Practices Could Provide More Options for Federal Entities and Opportunities for Minority- and Women-Owned Asset Managers

## What GAO Found

According to asset managers and industry associations with which GAO spoke, minority- and women-owned (MWO) asset managers face challenges when competing for investment management opportunities with institutional investors, such as retirement plans and foundations. For example, institutional investors and their consultants often prefer to contract with large asset managers with brand recognition and with whom they are familiar. Also, small firms, including MWO firms, are often unable to meet minimum requirements set by institutional investors, such as size (assets under management) and past experience (length of track record). State, local, and private retirement plans and foundations GAO interviewed addressed these challenges in a variety of ways, such as asking their consultants to include MWO firms in their searches. Many plans also lowered their minimum threshold requirements so that the requirements were proportional to the size of the firms while maintaining the same performance requirements for all asset managers in their selection processes.

Federal retirement plans, the endowment, and the insurance program GAO reviewed invest in asset classes in which MWO asset managers have a market presence, but overall use of MWO firms varied. For example, some retirement plans either did not use any MWO firms or did not track this information. The endowment and insurance program reported using some MWO asset managers.

GAO identified four key practices institutional investors can use to increase opportunities for MWO asset managers. These practices are consistent with federal interests in increasing opportunities for MWO businesses.

- **Top leadership commitment.** Demonstrate commitment to increasing opportunities for MWO asset managers.
- **Remove potential barriers.** Review investment policies and practices to remove barriers that limit the participation of smaller, newer firms.
- **Outreach.** Conduct outreach to inform MWO asset managers about investment opportunities and selection processes.
- **Communicate priorities and expectations.** Explicitly communicate priorities and expectations about inclusive practices to investment staff and consultants and ensure those expectations are met.

Some federal entities we reviewed, such as the Federal Reserve System, have used all the practices, but others made partial, limited, or no use of the practices.

- The Federal Retirement Thrift Investment Board does not intend to use the practices in its planned mutual fund window platform.
- The Navy Exchange Service Command and Tennessee Valley Authority Retirement System used one practice, but have not used the others.
- The Army and Air Force Exchange Service has used two practices, and partially used two practices.

By using the key practices, the entities GAO reviewed could widen the pool of candidates in their asset manager searches and help ensure that they find the most qualified firms. In keeping with federal interests, the practices could also help address barriers MWO firms face and increase opportunities for them.

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## Abbreviations

BlackRock	BlackRock Institutional Trust Company
DOL	Department of Labor
ERISA	Employee Retirement Income Security Act of 1974
FAR	Federal Acquisition Regulation
FERSA	Federal Employees' Retirement System Act of 1986
FRTIB	Federal Retirement Thrift Investment Board
MWO	minority- or women-owned
OEB	Office of Employee Benefits
PBGC	Pension Benefit Guaranty Corporation
REIT	Real Estate Investment Trust
Trust	National Railroad Retirement Investment Trust
TSP	Thrift Savings Plan

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September 13, 2017

The Honorable Maxine Waters  
Ranking Member  
Committee on Financial Services  
House of Representatives

The Honorable Cory Booker  
United States Senate

The Honorable Gregory W. Meeks  
House of Representatives

Asset management firms registered in the United States managed more than \$70 trillion as of May 2017, but asset management firms owned by minorities or women (MWO asset managers or firms) manage less than 1 percent of these assets.<sup>1</sup> Despite this small percentage, some industry reports indicate that an increasing number of state, local, and private pension plans and other institutional investors have started using MWO asset managers.<sup>2</sup> According to other industry reports, using these managers could provide investors with potential benefits, such as generating a broader range of investment ideas.<sup>3</sup> Yet, in recent years, the

<sup>1</sup>We use the term “asset manager” to refer to an individual or firm that manages a portfolio of securities for defined benefit plans and other institutional investors or offers investment options, such as mutual funds, to participants in a defined contribution retirement plan. We base estimates of the asset management industry on regulatory assets under management reported to the Securities and Exchange Commission as of May 2017. We base our estimates of assets managed by MWO firms on our March to June review of their filings with the Securities and Exchange Commission.

<sup>2</sup>Ownership requirements that asset management firms must meet to be considered minority- or women-owned vary across different institutional investors and locations. For example, state retirement plans in Illinois and New York require at least 51 percent of a firm to be owned by a racial or ethnic minority or a woman to be considered a minority- or woman-owned business. In contrast, a city retirement plan in Dallas requires a minimum of 30 percent ownership by a minority or woman. In this report, we rely on self-reporting or identification by a third party of an asset management firm as being minority- or women-owned.

<sup>3</sup>See Thurman V. White, Jr. and the ABFE, *Who Manages the Money? How Foundations Should Help “Democratize Capital”: A Case Study of the W.K. Kellogg Foundation* (September 2014); National Association of Investment Companies, *The Financial Returns of NAIC Firms: Minority and Diverse Private Equity Managers and Funds Focused on the U.S. Emerging Domestic Market* (September 2012); and Barclays Capital, *Affirmative Investing: Women and Minority-Owned Hedge Funds* (June 2011).

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asset management industry also has become more concentrated, with the bulk of institutional assets managed by the largest investment firms. Specifically, the 100 largest asset managers account for more than 50 percent of total reported assets.

The federal government has an interest in increasing opportunities for minority- and women-owned businesses and helping address barriers they face. For example, the federal government has established a number of programs that assist small businesses, including those that are minority- and women-owned, when they seek to contract with federal agencies.<sup>4</sup> Officials that administer these programs have identified challenges these businesses may face in contracting with the federal government and have taken actions, such as conducting outreach, to help address them. Additionally, the Minority Business Development Agency in the Department of Commerce was created to foster the growth of minority-owned businesses of all sizes, and does this through, among other things, programs and services that increase access to capital, contracts, and markets. The agency has also identified challenges faced by minority-owned businesses and taken steps to help address them. More recently, the Dodd-Frank Wall Street Reform and Consumer Protection Act includes a provision requiring certain agencies to develop procedures to ensure the fair inclusion of women and minorities in contracting, among other things.<sup>5</sup>

In July 2015, members of Congress hosted a summit with representatives of several federal retirement plans and an insurance program to discuss barriers and other constraints to engaging MWO asset managers. At the summit, the congressional members announced the formation of a

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<sup>4</sup>This includes programs administered by the Small Business Administration (such as the women-owned small business program that increases contracting opportunities for the businesses). See GAO, *Women-Owned Small Business Program: Certifier Oversight and Additional Eligibility Controls Are Needed*, [GAO-15-54](#) (Washington, D.C.: Oct. 8, 2014); and *Government Contracting: Federal Efforts to Assist Small Minority Owned Businesses*, [GAO-12-873](#) (Washington, D.C.: Sept. 28, 2012).

<sup>5</sup>Pub. L. No. 111-203, § 342(c), 124 Stat. 1376, 1542 (2010) (codified at 12 U.S.C. § 5452(c)). Section 342 applies to all contracts of certain financial agencies for services of any kind, including the services of financial institutions, investment-banking firms, mortgage banking entities, underwriters, accountants, investment consultants, and providers of legal services. It also includes all contracts for all business and activities of the designated agencies, at all levels, including contracts for the issuance or guarantee of any debt, equity, or security; the sale of assets; the management of assets of the agency; the making of equity investments by the agency; and the implementation of programs to address economic recovery. § 342(d), 124 Stat. at 1542.

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working group to develop strategies for addressing the structural barriers that have prevented meaningful inclusion of MWO asset managers and committed to more robust congressional oversight of federal retirement plans and endowments moving forward. Policymakers have continued to raise questions about the transparency of the asset manager selection processes the federal entities used and the lack of diversity in federal asset management overall. You asked us to review the challenges MWO firms may face when competing for opportunities to provide asset management services and the use of these firms by selected federal entities. In this report, we examine (1) the challenges MWO asset managers may face when competing for investment opportunities, and practices used by selected state, local, and private entities that administer or oversee retirement plans and foundations to increase opportunities for MWO firms; (2) the major asset classes in which selected federal entities invest, their use of MWO firms, and the market presence of MWO firms in these asset classes; and (3) the policies and processes selected federal entities use to identify and select asset management firms, and their use of key practices to increase opportunities for MWO asset managers.

We reviewed federal retirement plans, an endowment, and an insurance program administered or overseen by eight federal entities (collectively referred to as federal entities): Army and Air Force Exchange Service, Federal Reserve System, Federal Retirement Thrift Investment Board, Railroad Retirement Board, Smithsonian Institution, Pension Benefit Guaranty Corporation, Navy Exchange Service Command, and



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Tennessee Valley Authority.<sup>6</sup> We selected federal entities and the National Railroad Retirement Investment Trust that had assets exceeding \$1 billion in 2015 and used passive or active strategies (or both) to manage investments.<sup>7</sup>

To identify challenges MWO asset managers face, we analyzed reports by industry stakeholders, such as trade associations, institutional investors, and investment managers. We interviewed 10 MWO asset managers and 4 MWO brokerage firms—selected based on size (assets under management or revenue), literature reviews, and recommendations from industry stakeholders.<sup>8</sup> To identify how entities that administer or oversee state, local, and private retirement plans and foundations (nonfederal plans and foundations) increase opportunities for MWO firms, we interviewed 14 entities—selected based on size (assets), use of an MWO program or other initiative to increase opportunities for MWO asset

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<sup>6</sup>A separate, nonfederal entity, the National Railroad Retirement Investment Trust, manages the retirement assets for the Railroad Retirement Board. We therefore refer to the National Railroad Retirement Investment Trust when describing the Railroad Retirement Board's externally managed retirement assets in this report. However, the National Railroad Retirement Investment Trust is not a department, agency, or instrumentality of the federal government, and it is not subject to title 31 of the U.S. Code, which governs the financial operations of the federal government and establishes the powers and duties of the U.S. Government Accountability Office. See 45 U.S.C. § 231n(j)(2). The inclusion of the National Railroad Retirement Investment Trust in our review is limited to describing its asset allocations, use of MWO firms, and asset manager selection process. In addition, a separate federal entity, the Tennessee Valley Authority Retirement System, manages retirement assets for the Tennessee Valley Authority. In this report, we refer to the Tennessee Valley Authority Retirement System when describing the Tennessee Valley Authority's externally managed retirement assets. Finally, the Smithsonian Institution was established by Congress in 1846 and is considered a trust instrumentality of the United States. The Smithsonian Institution has the authority to accept gifts. According to Smithsonian Institution representatives, the Smithsonian Institution's endowment does not have federal funds and is instead composed entirely of trust funds (private donations and money raised through revenue-generating activities), which are managed as a pool.

<sup>7</sup>We used the most recent available data (2015) to determine the size (assets) and asset allocations for the federal entities we reviewed and the National Railroad Retirement Investment Trust. We excluded federal entities that solely invested in Treasury securities that are not traded (and thus do not use external asset managers), such as the Civil Service Retirement System and the Federal Employees Retirement System. These two retirement systems provide the primary defined benefits for the vast majority of federal employees.

<sup>8</sup>Information from these interviews cannot be generalized to all MWO asset managers or MWO brokerage firms. Three asset managers we interviewed also had a division or department that offered brokerage services. Those brokers are included in the total number of brokers we listed.

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management, a literature review, and recommendations by industry stakeholders.<sup>9</sup> We also analyzed reports by industry stakeholders on key practices for MWO programs or similar initiatives.

To determine the major asset classes in which selected federal entities and the National Railroad Retirement Investment Trust invested, we obtained data from the entities and reviewed their annual reports and audited financial statements. To determine the presence of MWO firms in the same asset classes invested in by the federal entities and the National Railroad Retirement Investment Trust, we reviewed publicly available directories and databases of MWO asset managers. We then reviewed the firms' Form ADV filings in a publicly available Securities and Exchange Commission database to identify the asset classes in which they operate and the assets they reported managing.<sup>10</sup> We then compared the total assets reported by MWO firms we identified to total regulatory assets under management reported by all investment advisers in the database as of May 2017. To the extent available, we reviewed data on the percentage of each federal entity's and the National Railroad Retirement Investment Trust's asset managers that are minority- or women-owned, percentage of assets the firms managed, and asset classes in which firms invested. To assess the reliability of data in the Securities and Exchange Commission database, we identified and removed duplicate entries, checked data from the database against a selection of firms' original filings, and compared total regulatory assets under management for all firms in the database to an industry estimate of the global asset management industry. To assess the reliability of data for

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<sup>9</sup>Views expressed by these entities cannot be generalized to all state, local, and private retirement plans and foundations. We use certain qualifiers when collectively describing responses from nonfederal plans and foundations, asset managers, and industry associations, such as "some," "many," and "most." We define some as four; many as at least five, but less than most; and most as more than half relative to the total number possible.

<sup>10</sup>Investment advisers use Form ADV to register with both the Securities and Exchange Commission and state securities authorities. The Investment Advisers Act of 1940 requires certain investment advisers to register and report their regulatory assets under management, a measure of the securities portfolios for which a firm provides continuous and regular supervisory or management services. Advisers to certain privately offered investment funds may be exempt from the registration requirements, but may still be required to report the value of private funds they manage, such as hedge funds, private equity funds, or real estate funds. See 15 U.S.C. 80b-3(b). As a result, the proportion of assets reported by MWO firms may be overstated. This is because our estimate for all firms in the database includes only regulatory assets under management and may exclude assets reported by firms that manage private funds but are not required to register with the Securities and Exchange Commission.

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selected federal entities and the National Railroad Retirement Investment Trust, we interviewed representatives of the plans and Trust with knowledge of the systems and methods used to produce these data. We determined the data we used were sufficiently reliable for the purposes of our reporting objectives.

To determine how federal entities and the National Railroad Retirement Investment Trust identified and selected asset managers and their efforts to include MWO firms, we analyzed investment policies; documentation on selection processes and criteria; and documentation on programs, policies, or initiatives related to MWO asset managers. We also interviewed representatives from the entities we reviewed to learn more about selection processes and efforts related to MWO asset managers. We assessed the extent to which the federal entities used key practices to increase opportunities for MWO firms. We identified key practices by examining the practices used by selected nonfederal plans and foundations and by reviewing industry reports. We then validated the practices by obtaining input from 10 industry stakeholders and experts, selected based on factors such as depth of experience working with MWO firms and published research. We discuss our scope and methodology in greater detail in appendix I.

We conducted this performance audit from April 2016 to September 2017 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

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## Background

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### Federal Institutional Investors

Institutional investors include public and private entities that pool funds on behalf of others and invest the funds in securities and other investment assets. Examples of institutional investors include federal, state, and local government, and private retirement plans, endowments, and foundations.

In 2015, the eight entities we reviewed held close to \$388 billion in externally managed investment assets used to support their investment objectives, including funding retirement benefits for federal employees (see table 1). They administered or oversaw defined benefit retirement

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plans, defined contribution retirement plans, an endowment, and an insurance program, each with distinct investment objectives.

- Three of the eight entities we reviewed manage **defined benefit plans** that provide participants a retirement benefit amount using a formula based on factors such as years of employment, age at retirement, and salary level.<sup>11</sup> Typically, benefits are paid from a fund made up of assets from annual contributions by employers, employees, or a combination of the two and investment earnings from those contributions. Defined benefit plans typically have investment policies and guidance that outline goals for how the funds are to be invested.
- One of the eight entities we reviewed sponsors a **defined contribution plan** in which employees and employers contribute to an account directed by the employee into investment options offered by the plan. Policy objectives for defined contribution plans typically focus on offering a range of prudent investments suitable for participants to direct contributions in ways that meet their personal investment objectives.<sup>12</sup>
- Two of the eight entities we reviewed both manage **defined benefit plans** and sponsor **defined contribution plans**.
- Two of the eight entities we reviewed hold other types of investments. The Smithsonian Institution manages an **endowment**, which is comprised of trust funds, the majority of which have been permanently restricted by donors for a particular use, such as acquisition of artwork, funding curator positions, or public programs, according to agency officials. The Pension Benefit Guaranty Corporation operates an **insurance program** designed to partially insure defined benefit pensions sponsored by private employers. While the Pension Benefit Guaranty Corporation insures the pension benefits of nearly 40 million workers and retirees, as a federal guarantor of these plans it takes over the assets of underfunded terminated plans and is responsible for paying benefits to participants who are entitled to receive them.

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<sup>11</sup>The National Railroad Retirement Investment Trust is responsible for investing assets that fund railroad retirement tier 2 benefits, which are similar to a private sector defined benefit plan.

<sup>12</sup>While managers of defined benefit plans generally make investment decisions on behalf of participants, sponsors of defined contribution plans generally provide a menu of investment options from which participants may choose.

**Table 1: Overview of Seven Selected Federal Entities and the National Railroad Retirement Investment Trust, as of 2015**

Entity	Externally managed assets (dollars in billions)	Description	Investment objective
Federal Retirement Thrift Investment Board	\$251.3 <sup>a</sup>	Administers the Thrift Savings Plan, a defined contribution plan for federal employees and members of the uniformed services, including the Ready Reserves.	Provide prudent investments for accumulating funds for retirement income and low administrative costs while acting solely in the interest of participants and for the exclusive purpose of providing benefits to participants and beneficiaries.
Pension Benefit Guaranty Corporation	77.8	Manages an insurance program to protect pension benefits in private sector defined benefit plans.	Provide for timely and uninterrupted payment of pension benefits to plan participants and beneficiaries.
National Railroad Retirement Investment Trust <sup>b</sup>	23.8	Responsible for investing assets that fund railroad retirement benefits, some of which are similar to a private sector defined benefit plan.	Manage and invest industry-funded railroad retirement assets solely in the interest of the Railroad Retirement Board, an agency of the federal government, and by extension the participants and beneficiaries of the programs funded under the Railroad Retirement Act of 1974.
Federal Reserve System	12.5	Administers a defined benefit plan for eligible employees of the Federal Reserve Banks, the Board of Governors and Office of Employee Benefits of the Federal Reserve System, and the Consumer Financial Protection Bureau.	Make timely payment of benefits to current and future participants, requiring a balance between certainty of returns for payment of vested benefits and asset growth to cover nonvested benefits, which are expected to increase over time.
	7.2	Administers a defined contribution plan for employees of the Federal Reserve System	Offer participants an array of low-cost investment options to construct portfolios based on their varying risk-to-return profile.
Tennessee Valley Authority Retirement System	6.8 <sup>c</sup>	Administers a defined benefit plan covering most full-time and part-time annual employees of the Tennessee Valley Authority.	Long-term returns, in addition to contributions, should satisfy any current funding obligations and once fully funded, should keep pace with the growth of liabilities using a commensurate level of risk.
	2.0	Administers a defined contribution plan for members of the Tennessee Valley Authority Retirement System.	Provide a wide range of investment opportunities in various asset classes to allow for diversification and cover a wide risk-to-return spectrum; provide reasonable returns within prudent levels of risk; provide returns comparable to similar investment options; and control administrative and management costs to the 401(k) plan and participants.

Entity	Externally managed assets (dollars in billions)	Description	Investment objective
Army and Air Force Exchange Service	3.7	Administers a defined benefit plan covering regular full-time civilian employees who are citizens or residents of the United States.	Provide retirement benefit to participants and their beneficiaries by seeking the highest return on investment consistent with sufficient liquidity and investment risks that are prudent and reasonable given prevailing capital market conditions.
Navy Exchange Service Command	1.4	Administer a multiemployer defined benefit pension plan covering substantially all civilian employees of the Navy Exchange Service Command and the U.S. Coast Guard Community Services Command.	Obtain reasonable long-term total return within prudent levels of risk, while emphasizing preservation of capital in order to provide adequate retirement and death benefits to plan beneficiaries.
Smithsonian Institution	1.3 <sup>d</sup>	Manages an endowment consisting of approximately 600 individual funds established for a variety of reasons.	Generate sufficient returns over the long term to provide stable and growing payouts for current expenditures and protect the purchasing power of the endowment against inflation, with an acceptable level of risk.

Source: GAO analysis of information from eight entities. | GAO-17-726

<sup>a</sup>Excludes \$206.9 billion of participant investments in the Government Securities Investment Fund, which are internally managed. This fund invests exclusively in a nonmarketable short-term Treasury security that is specially issued to the Thrift Savings Plan.

<sup>b</sup>The National Railroad Retirement Investment Trust is independent from the federal government.

<sup>c</sup>The plan was closed to new employees beginning in July 2014. Only the Tennessee Valley Authority 401(k) plan is available to new employees as of July 2014.

<sup>d</sup>For the Smithsonian Institution, the term “externally managed assets” refers to assets overseen by the endowment’s Office of Investments, invested primarily in funds managed by external asset management firms.

## Investment Decisions and Stakeholders in the Investment Process

For the defined benefit plans, endowment, and insurance program we reviewed, the entities generally make investment decisions within a framework spelled out in investment policy statements approved by boards of directors, trustees, or regents. Their investment policy statements generally define an asset allocation, or mix of asset classes in proportions designed to meet the entity’s overarching investment objectives. For defined contribution plans, participants make investment decisions by deciding how to allocate the contributions they and their employer make among investment options offered through the plan. Entities that administer these plans may outline these options in plans’ investment policy statements. For three entities in our review, legislative

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mandates also specify certain investment decisions, such as asset diversification and investment options.<sup>13</sup>

The federal entities we reviewed and the National Railroad Retirement Investment Trust are fiduciaries that have responsibilities that are typically similar to those of private sector retirement plans in that they are required to act solely in the interest of participants and beneficiaries in the retirement plans. These responsibilities may include acting with the exclusive purpose of providing benefits to the participants and beneficiaries and defraying reasonable expenses of plan administration; carrying out their duties prudently; following the plan documents; and diversifying plan investments.<sup>14</sup>

A number of stakeholders are typically involved in the investment process. Generally, investment boards of directors or trustees, investment committees, investment officials and staff, investment consultants, asset

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<sup>13</sup>Specifically, the Employee Retirement Income Security Act of 1974 (ERISA), as amended by the Multiemployer Pension Reform Act of 2014, directs the Pension Benefit Guaranty Corporation to invest certain assets in a noninterest bearing account. 29 U.S.C. § 1305(b)(3)(A)-(B). The Railroad Retirement Act of 1974, as amended by the Railroad Retirement and Survivors' Improvement Act of 2001, directs the Board of the National Railroad Retirement Investment Trust to diversify investments to minimize the risk of large losses and avoid disproportionate influence over particular industries or firms, unless clearly prudent not to do so under the circumstances. 45 U.S.C. § 231n(j)(5)(A)(iii). The Federal Employees' Retirement System Act of 1986 (FERSA), as amended, requires the Federal Retirement Thrift Investment Board (Board) to establish five fund options for the Thrift Savings Plan, and directs the Board to implement investment policies that provide for prudent investments suitable for accumulating funds for retirement income and with low administrative costs. 5 U.S.C. §§ 8438(b)(1) and 8475.

<sup>14</sup>Some of the entities we reviewed have specific rules governing their responsibilities and obligations as fiduciaries. For example, the Federal Retirement Thrift Investment Board's fiduciary duties are similar to those of private sector plan fiduciaries. Both FERSA and ERISA require fiduciaries to act prudently and solely in the interest of plan participants and beneficiaries. See 5 U.S.C. § 8477(b) and 29 U.S.C. § 1104(a). However, one difference that relates to fiduciary responsibility is that under ERISA the Department of Labor (DOL) can generally take civil action against fiduciaries of private plans and Thrift Savings Plan (TSP) fiduciaries for breaches of their fiduciary duty, but FERSA does not allow DOL to bring civil actions against Board members or the Executive Director for the breaches of their fiduciary duty. Similarly, when acting like a trustee, the Pension Benefit Guaranty Corporation (PBGC) is not always held to the same fiduciary standards applicable to other trustees; PBGC is statutorily exempted from those standards to the extent they are inconsistent with its functions as guarantor of benefits for participants in covered pension plans. See 29 U.S.C. §§ 1104(a)(1) and 1342(d)(3).

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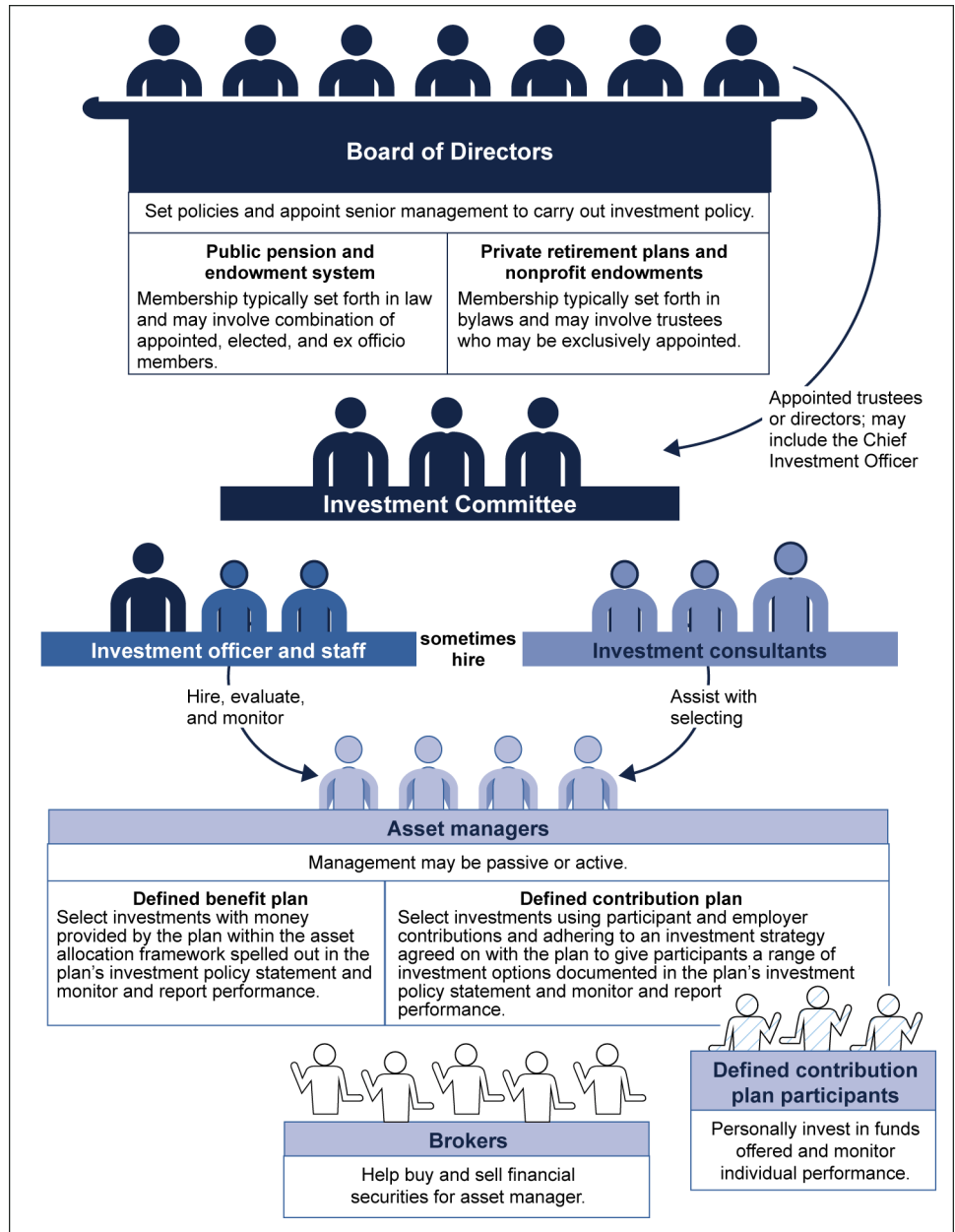
managers, and brokers work together to invest clients' funds in securities that match clients' financial objectives (see fig. 1).<sup>15</sup>

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<sup>15</sup>As discussed later in the report, the National Railroad Retirement Investment Trust does not use consultants in its investment process.



**Figure 1: General Roles and Responsibilities in the Investment Process**



Source: GAO analysis of information from selected entities. | GAO-17-726

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The defined benefit plans, endowment, and insurance program we reviewed generally retained external asset managers to select individual investments in accordance with the asset allocation frameworks in their investment policy statements. The defined contribution plans generally retained external asset managers to provide plan participants with investment options. Asset management firms typically select investments on behalf of the investors that hired them and regularly report on investment performance. Many earn income by charging service fees based on a percentage of assets they manage. These fees generally include the costs of trading charged by brokerage firms.<sup>16</sup>

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## Asset Classes and Portfolio Management

Asset management firms registered in the United States manage more than \$70 trillion.<sup>17</sup> Although thousands are registered to operate in the United States, the 100 largest asset managers account for more than 50 percent of total reported assets under management. Institutional investors we reviewed work with asset managers to typically invest in or offer participants investments in four broad asset classes: equity, fixed income, alternative assets, and cash and cash equivalents.

- **Equity** indicates ownership in a business in the form of common stock or preferred stock. The equity asset class includes mutual funds, collective investment trusts, and exchange-traded funds that invest in equity securities.
- **Fixed income** refers to any type of investment under which the borrower or issuer is obligated to make payments of a fixed amount on a fixed schedule. The fixed-income asset class includes mutual funds, collective investment trusts, and exchange-traded funds that invest in fixed-income securities.

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<sup>16</sup>For more information on costs paid by plan sponsors and participants for services, see GAO, *401(K) Plans: Increased Educational Outreach and Broader Oversight May Help Reduce Plan Fees*, [GAO-12-325](#) (Washington, D.C.: April 24, 2012). The federal entities we reviewed and the National Railroad Retirement Investment Trust do not directly hire brokerage firms. Instead, they delegate the responsibility to hire brokerage firms to their asset managers.

<sup>17</sup>Based on filings as of May 2017 with the Securities and Exchange Commission by registered investment advisers with at least \$100 million in regulatory assets under management, a measure of securities portfolios for which they provide continuous and regular supervisory or management services. See 17 C.F.R. § 275.203-1(a).

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- **Alternative assets** can include hedge funds, private equity, real estate, and commodities.<sup>18</sup> Plans may make such investments in an attempt to diversify their portfolios, achieve higher returns, or for other reasons. In recent years, two of the most common alternative assets that institutional investors held were hedge funds and private equity.<sup>19</sup>
  - **Cash and cash equivalents** are the company's assets that are cash or can be converted into cash in a very short period of time. They include bank accounts, marketable securities, commercial paper, Treasury securities, short-term government bonds (with maturities of 3 months or less), short-term certificates of deposit, and money-market funds.

Institutional investors generally use (or offer to participants) passive or active portfolio management strategies, or a mix of both. Passive management involves buying or creating an investment portfolio that closely tracks the performance of a broad class of assets usually defined by an index, such as the S&P 500. Passive managers attempt to match the performance of an index, typically with lower fees than active managers. Active managers attempt to exceed the performance of an index using their judgment about which individual investments in that asset class will do better than average. In defined contribution plans, the portfolio management is directed by the participants based on the range of options provided by the plan.

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## Federal Regulatory Requirements

The Federal Acquisition Regulation (FAR) establishes uniform policies and procedures for the acquisition of goods and services by executive

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<sup>18</sup>Real estate investments can include direct purchase of properties, interests in nonpublicly traded entities such as partnerships that invest in real estate, or investments in a Real Estate Investment Trust (REIT). A REIT is generally a company that owns income-producing real estate or real estate-related assets. REITs allow individual investors to earn a share of the income produced by commercial real estate without having to buy commercial real estate. Many REITs are registered with the Securities and Exchange Commission and are publicly traded. Commodities are goods and articles such as agricultural products, metals, oil, and financial products, including stock indexes and foreign currency.

<sup>19</sup>Although there is no universally accepted definition of hedge funds, the term is commonly used to describe pooled investment vehicles that are privately organized and administered by professional managers who often engage in active trading of various types of securities, commodity futures, options contracts, and other investment vehicles. Likewise, there is no commonly accepted definition of private equity funds, but such funds are generally privately managed pools of capital that invest in companies, many of which are not listed on a stock exchange.

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agencies. Among other things, the FAR includes requirements agencies must meet, such as full and open competition through competitive procedures.<sup>20</sup> With the exception of the Pension Benefit Guaranty Corporation, the FAR does not apply to the asset manager selection processes used by the federal entities or the National Railroad Retirement Investment Trust, according to representatives we interviewed.

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## Minority- and Women-Owned Asset Managers Face Challenges, but Found Opportunities at Some Nonfederal Retirement Plans and Foundations

According to many asset managers and industry associations with which we spoke, MWO asset managers face various challenges when competing for investment management opportunities with institutional investors, including retirement plans and foundations.<sup>21</sup> However, nonfederal plans and foundations with which we spoke used various approaches to help address many of these challenges.<sup>22</sup> These plans and foundations cited several factors that led them to take steps to increase opportunities for MWO firms.<sup>23</sup> For example, some noted organizational interest in diversity as the driving force behind more inclusive selection practices for asset managers. Others cited potential benefits of using MWO firms, such as helping to diversify risk in their portfolios.

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<sup>20</sup>The federal entities we included in our scope are independent agencies and thus generally may not be subject to executive branch regulations and executive orders. For contractors and subcontractors of executive branch agencies, certain federal equal opportunity and affirmative action requirements apply, and such contractors may be subject to review by the Department of Labor's Office of Federal Contract Compliance Programs (OFCCP). For additional information about OFCCP and anti-discrimination laws, regulations, and executive orders enforced by OFCCP, see GAO, *Equal Employment Opportunity: Strengthening Oversight Could Improve Federal Contractor Nondiscrimination Compliance*, [GAO-16-750](#) (Washington, D.C.: Sept. 22, 2016).

<sup>21</sup>The sample of asset managers with which we spoke was selected based on size (assets under management), asset classes, investment strategies, and other factors. For more information on our sample of asset managers, see appendix I.

<sup>22</sup>MWO brokerage firms face challenges similar to those that MWO asset management firms face when competing for opportunities. For more information on challenges faced by MWO brokerage firms and approaches taken by nonfederal plans and foundations to help address these challenges, see appendix III.

<sup>23</sup>The sample of nonfederal plans and foundations with which we spoke was selected based on size (assets), use of programs or initiatives aimed at increasing opportunities for MWO asset managers, and other factors. The nonfederal plans were primarily defined benefit plans, with 3 of the 14 administering both defined benefit and defined contribution plans. For more information on our sample of nonfederal plans and foundations, see appendix I.

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- **Investor and consultant brand bias.** According to most asset managers and industry associations we interviewed, institutional investors and their consultants often prefer to contract with larger asset managers with brand recognition or with whom they are familiar. Furthermore, according to some asset managers and industry associations, unless clients directly ask for MWO firms to be included in asset manager searches, consultants generally will not include them.<sup>24</sup> For example, one industry association noted that consultants generally exclude MWO asset managers due to an implicit bias that their clients' investment portfolio performance could potentially suffer if they use a MWO firm despite no information to indicate this would in fact be the case.

Having recognized brand bias as a challenge for MWO firms, some nonfederal plans and foundations have asked their investment consultants to maintain an inclusive process for sourcing, evaluating, and recommending investment managers across race, ethnicity, and gender. One of these plans and a local plan in Illinois told us that they asked their investment staff or consultants to ensure that at least one qualified MWO asset manager was invited to present to the institutional investor's decision-making body. In addition, one foundation ensured that its consultant was held accountable to more inclusive processes by requiring its investment consultant to annually report the number of diverse managers evaluated, recommended, and hired across the consultant's client base.

- **Perception of weaker performance.** According to most MWO asset managers and industry associations with whom we spoke, MWO firms may face challenges because institutional investors generally have a perception that MWO asset managers do not perform as well as non-MWO firms. However, a May 2017 study on diversity in the asset management industry by an academic institution and a research group found no differences in the performance of funds managed by

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<sup>24</sup>Two consultants with whom we spoke stated that they include MWO asset managers in their asset manager databases and have included MWO asset managers in the searches they conduct for clients.

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MWO firms and the performance of those managed by non-MWO firms, among the firms they analyzed.<sup>25</sup>

Furthermore, all nonfederal plans and foundations we interviewed told us that all firms managing assets in their respective portfolios, including MWO asset managers, were selected based on track record of performance and evaluated against the same performance standards as other asset managers in their portfolios. In addition, some nonfederal plans noted that these asset management firms may provide certain benefits in generating profit for their clients. For example, one plan noted that MWO firms offer more differentiated investment strategies than larger firms.

- **Size and infrastructure.** The size and limited infrastructure of smaller, newer MWO firms also may pose challenges. For example, according to most asset managers and industry associations with which we spoke, small MWO asset managers are frequently not able to meet threshold requirements set by institutional investors, such as minimum limits established for assets under management, liability insurance, and length of track record. Moreover, an asset manager and some nonfederal plans and foundations noted that back office functions and operational costs, such as for accounting and compliance, are high and make investments in these areas difficult for smaller, newer firms (including many MWO firms).

In light of these minimum threshold challenges for MWO firms and smaller firms in general, many nonfederal plans adjusted requirements to allow these firms to compete, while noting that they maintained the same performance requirements for all asset managers in their selection processes. Specifically, most nonfederal plans and two foundations either lowered their minimum requirements for assets under management, length of track record, or amount of liability insurance to help ensure the requirements were proportional to the size of the firms, or did not set any minimum or maximum assets under management threshold levels. As we will discuss later,

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<sup>25</sup>See Josh Lerner, Ann Leamon, Megan Madden, and Jake Ledbetter, *Diverse Asset Management Project Firm Assessment* (Salem, Mass.: May 2017). The study was conducted per request from a private grant-making foundation. It examined diversity in firm ownership across four asset classes: mutual funds, hedge funds, private equity, and real estate and found no differences in the performance of MWO firms after controlling for firm and fund-level characteristics. It relied on several sources of data, including publicly available and commercially available data sources, to identify MWO firms. We did not assess the extent to which the data used in the study are representative of all MWO firms.

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the Federal Reserve System and Pension Benefit Guaranty Corporation have made similar adjustments to increase opportunities for MWO asset management firms. Representatives from most nonfederal plans, foundations, the Federal Reserve System, and Pension Benefit Guaranty Corporation stated that they have not sacrificed performance or fallen short of their fiduciary responsibility in increasing opportunities for MWO firms.

- **Industry trends.** In May 2016, we reported that defined contribution plans have replaced defined benefit plans and become the dominant form of retirement plan for U.S. workers over the past three decades.<sup>26</sup> According to some asset management firms and industry associations, MWO firms face challenges due to this industry shift from defined benefit plans toward defined contribution plans where business opportunities for MWO firms may be too costly.<sup>27</sup> The marketplace shift from defined benefit to defined contribution plans also will likely drive up costs for asset managers and branding will be more important for defined contribution plans because asset managers will need to interact more directly with participants, according to an industry association we interviewed.

The industry shift from active management to passive management may also be a challenge. According to some asset managers, industry associations, and nonfederal plans we interviewed, MWO firms are less able to compete at defined contribution plans with passive management investment strategies because MWO firms lack the size and resources that larger firms have to keep asset management fees low for clients.<sup>28</sup> Furthermore, because asset management fees for passive management strategies are low, an asset management firm must have a volume of business large enough to be profitable.

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<sup>26</sup>GAO, *Retirement Security: Low Defined Contribution Savings May Pose Challenges*, [GAO-16-408](#) (Washington, D.C.: May 5, 2016).

<sup>27</sup>In addition, one nonfederal plan noted that in recent years existing defined benefit plans have been trying to reduce their number of asset managers as a cost management effort, which may further limit the opportunities available to MWO firms.

<sup>28</sup>The challenges faced by MWO firms in relation to passive management are not limited to defined contribution plans. As investors in defined benefit and defined contribution plans move from active to passive management strategies, MWO firms face the challenge of not being large enough or having sufficient resources for the scale needed to keep client fees low enough to be competitive with the larger firms who can do so because they do not have size and resource constraints. According to one asset manager we interviewed, passive management is dominated by large, well-established asset management firms, which makes it difficult for new firms to break in.

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In addition to adjusting minimum size and length of track record requirements, the nonfederal plans and foundations with which we spoke developed other strategies to help increase opportunities for MWO asset management firms.

- Some nonfederal plans and one foundation allocated a target amount of their investment portfolio to MWO asset managers. For example, to help increase opportunities for MWO asset management firms, a local plan in Texas developed a program that sets aside 10 percent of its total assets across all asset classes to be managed by asset management firms with \$50 million or less in assets under management and at least 30 percent ownership by minorities or women.<sup>29</sup> In addition, some nonfederal plans said they have developed emerging manager programs. For example, a state retirement plan in California has an emerging manager program—generally defined as a program geared towards newer, smaller asset managers—wherein each of the plan’s asset classes has emerging manager definitions based on assets under management, length of track record, or both.<sup>30</sup> In the plan’s private equity class, emerging managers do not have to meet a minimum track record requirement and must have \$1 billion or less in assets under management.

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<sup>29</sup>Other states have developed similar MWO programs as a result of state legislative mandates. For example, according to one New York retirement plan, New York has a mandate to promote and increase state contracting and subcontracting opportunities for minority- and women-owned business enterprises (including MWO asset management firms) pursuing opportunities with state businesses. In response, the New York plan said that it allocated about \$9 billion in fund assets to be managed by MWO firms as of March 31, 2016. In addition, Illinois currently requires a state agency or institution of higher education subject to the state Pension Code to set aspirational goals of at least 20 percent of the plan’s assets to be managed by MWO asset managers and asset managers owned by persons with disabilities. To meet this goal, in 2016 the Illinois plan said that it committed a total of \$725 million of its assets to MWO and emerging managers—13 percent to minority-owned firms, 6 percent to women-owned firms, and 1 percent to persons with a disability. According to the Illinois plan, in accord with the state mandate, the plan also reports annually on its use of MWO asset managers.

<sup>30</sup>According to a California plan’s 2015–2016 annual report on its emerging manager program, California law prohibits state agencies from discriminating against or granting preferential treatment to any individual or group on the basis of race, sex, color, ethnicity, or national origin in the operation of public contracting, and therefore, the retirement plan may not grant preferential treatment to asset managers based on these characteristics. However, data show women and minority managers make up a higher proportion of emerging managers than established managers; therefore, emerging manager strategies can result in greater ethnic and gender diversity among external asset managers. See CalPERS, *Emerging Manager Five-Year Plan: Pathway to the Future, Year Four Annual Report, Fiscal Year 2015-16* (Mar. 1, 2017).



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- Most of the nonfederal plans with whom we spoke used a fund-of-funds structure, in which a larger fund works as an intermediary for multiple, smaller managers. Three of these nonfederal plans noted that working with one firm to recruit, select, and manage underlying firms was an efficient and effective means of working with smaller, newer managers, including MWO firms. For example, a local government retirement plan in Illinois noted that the fund-of-funds manager they hired was able to hire MWO firms much more quickly than they would have been able to directly. Similarly, a foundation that sought to increase diversity told us that it specifically hired a fund-of-funds manager to help find MWO firms for its foundation. In addition, three nonfederal plans noted that another benefit to hiring a fund-of-funds manager was that the firm could serve as a mentor (providing guidance and coaching to the smaller asset management firms and MWO firms), which can help build institutional relationships over the long-term.
  - Nonfederal plans and foundations also helped increase opportunities for MWO firms by using outreach strategies to identify MWO managers that could meet their investment needs. For example, many nonfederal plans regularly participated in networking events, such as conferences, with MWO asset managers or networked with asset management trade associations that represent MWO firms.<sup>31</sup> Many of these nonfederal plans facilitated one-on-one interactions with MWO firms so prospective asset managers could better understand their selection processes.

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<sup>31</sup>Examples of asset management trade associations include the Association of Asian American Investment Managers, National Association of Investment Companies, National Association of Securities Professionals, and New America Alliance.

## Federal Entities We Reviewed Invest in Asset Classes in Which Minority- and Women-Owned Asset Managers Have a Presence, but Use of these Firms Varied

The federal entities we reviewed and the National Railroad Retirement Investment Trust invested primarily in equity and fixed income, while some also invested in alternative assets or maintained some level of cash and cash equivalents. The 2015 allocations of the defined contribution plans we reviewed, shown in table 2, reflect both the investment options plans offered to participants and participants' decisions about how to invest among them.<sup>32</sup>

**Table 2: Asset Classes of Three Selected Federal Defined Contribution Plans, as of 2015**

Entity	Asset class	Dollars (in millions)	Percent of total assets
Thrift Savings Plan	Equity	\$226,553.6	90
	Fixed income <sup>a</sup>	24,788.9	10
	<b>Total</b>	<b>251,342.6</b>	<b>—</b>
Federal Reserve System Thrift Plan <sup>b</sup>	Equity	3,506.9	49
	Fixed income	3,449.0	48
	Alternative assets <sup>c</sup>	249.6	3
	<b>Total</b>	<b>7,205.4</b>	<b>—</b>
Tennessee Valley Authority Retirement System Savings and Deferral Retirement Plan	Equity	748.9	37
	Fixed income	299.0	15
	Alternative assets <sup>d</sup>	48.7	2

<sup>32</sup>The Federal Employees' Retirement System Act of 1986, as amended, requires the Federal Retirement Thrift Investment Board (FRTIB) to offer participants in the Thrift Savings Plan five passively managed funds that invest solely in equity or fixed-income securities. See Pub. L. No. 99-335 § 101, 100 Stat. 514, 552 (codified as amended at 5 U.S.C. § 8438(b)). FRTIB internally manages one of these funds, the Government Securities Investment Fund, which invests in a nonmarketable short-term government security specially issued to the Thrift Savings Plan. Per regulations promulgated by the Department of Labor, the Executive Director of the FRTIB may allocate authority and responsibility for the investment and management of four of these funds to one or more of certain investment managers. See 29 C.F.R. § 2584.8477(e)-2(c). Similarly, the Executive Director of the FRTIB may allocate authority and responsibility for the investment and management of the Fixed Income Investment Fund to one or more qualified professional asset managers, as defined by FERSA to include certain investment advisers that have at least \$50 million in total client assets under management and that meet certain other requirements. See 29 C.F.R. § 2584.8477(e)-2(b); 5 U.S.C. § 8438(a)(8)(D), (b)(1)(B).

Entity	Asset class	Dollars (in millions)	Percent of total assets
	Cash and cash equivalents	59.0	3
	Other <sup>e</sup>	856.6	43
	<b>Total</b>	<b>2,012.2</b>	<b>—</b>

Legend: — = not applicable.

Source: GAO analysis of information from Federal Retirement Thrift Investment Board, Federal Reserve System, and Tennessee Valley Authority Retirement System. | GAO-17-726

Note: Represents externally managed assets, which may differ from an entity's reported net assets. Net assets reflect in part an entity's internal assets and liabilities. Totals may not add due to rounding. Allocations reported as of December 31, 2015.

<sup>a</sup>The Federal Retirement Thrift Investment Board also internally managed \$206.9 billion of participant investments in a Government Securities Investment Fund, which invests exclusively in a nonmarketable short-term Treasury security specially issued to the Thrift Savings Plan.

<sup>b</sup>Although not offered to participants as an investment option, the plan's trustee held approximately \$18.8 million in cash equivalents as of December 31, 2015.

<sup>c</sup>Reflects participant investment in a passively managed fund composed of shares in approximately 100 publicly traded Real Estate Investment Trusts.

<sup>d</sup>Reflects the portion of participant investment in a balanced fund that is in turn invested in real estate and commodities.

<sup>e</sup>Consists primarily of participant investment in target date funds that invest predominantly in equity and fixed income and a brokerage window option through which participants can invest in stocks, bonds, mutual funds, and other securities not offered by the plan.

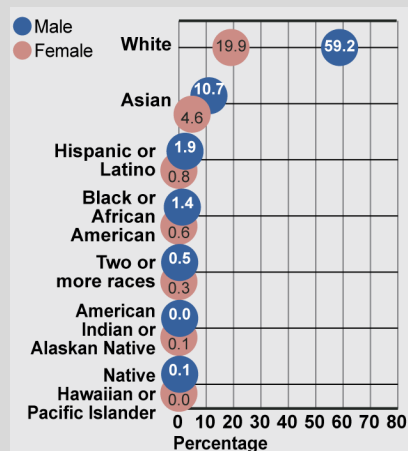
The defined contribution plans we reviewed used large asset managers not identified as minority- or women-owned to offer participants mostly passively managed investment options.<sup>33</sup> For example, the Thrift Savings Plan offers participants four passively managed funds, as required by statute, that attempt to replicate the performance of various equity and fixed-income indexes. Each of these funds is currently managed by BlackRock Institutional Trust Company (BlackRock).<sup>34</sup> The Tennessee

<sup>33</sup>All but two of the asset managers were listed among or were owned by one of the 50 largest asset managers in the world, according to an industry ranking. Willis Towers Watson, *The World's 500 Largest Asset Managers* (October 2016). According to industry research, these asset managers did not have at least 50 percent ownership by women or minorities. Pensions & Investments Research Center, *Pensions & Investments 2016 Money Managers*, accessed April 26, 2017, <http://researchcenter.pionline.com/rankings/all/overview>.

<sup>34</sup>The Federal Retirement Thrift Investment Board (FRTIB) selects managers for each fund separately by issuing periodic requests for proposals to manage an individual fund. As required by statute, the Thrift Savings Plan offers a fifth fund that invests exclusively in a nonmarketable Treasury security. See 5 U.S.C. § 8438(b)(1)(A). Additionally FRTIB officials told us they plan to offer Thrift Savings Plan participants a mutual fund window platform in 2020.

### Representation of Women and Minorities Among Managers at a Publicly Traded Asset Management Firm Serving Federal Entities

A number of entities we reviewed retain publicly traded asset management firms. For example, BlackRock Institutional Trust Company, National Association, a wholly-owned subsidiary of the publicly traded BlackRock, Inc. (BlackRock) oversees investment for substantial portions of the three federal defined contribution plans we reviewed, including all of the Thrift Savings Plan's externally managed assets in 2015. Measuring the diversity of a publicly traded corporation's ownership can be difficult. For example, more than 1,000 institutional investors, such as mutual funds, held nearly 140 million shares in BlackRock in March 2017. However, as required by Congress, BlackRock reported the composition of its managers as of August 2016 to the Federal Retirement Thrift Investment Board:



Source: GAO analysis of 2016 data prepared for the Federal Retirement Thrift Investment Board. | GAO-17-726

Valley Authority Savings and Deferral Retirement Plan also used BlackRock to offer passively managed funds in which participants invested over 60 percent of total 2016 plan assets (see sidebar). Similarly, the Federal Reserve Thrift Plan contracted with six large asset managers to offer the plan's 12 funds. Eight of these, accounting for nearly three-quarters of participant investments, were passively managed. The defined contribution plans' use of passively managed funds may limit opportunities for MWO firms. As discussed earlier, the shift toward defined contribution plans and passive management poses a challenge for MWO firms. In particular, some asset managers and industry associations with whom we spoke said MWO firms lack the size and resources to compete with the low fees larger firms can offer through passive management.

The federal defined benefit plans we reviewed and the Smithsonian Institution endowment generally invested more extensively in alternative assets in addition to equity and fixed income. As shown in table 3, in 2015 the Smithsonian Institution invested more than half the endowment's assets in alternative assets. Fiduciaries of four of the five defined benefit plans in our review also invested substantially in alternative assets, ranging from about one-quarter to about one-third of plan assets. The Pension Benefit Guaranty Corporation generally does not invest in alternative assets, but does hold a limited amount of these assets in line with its investment policy.<sup>35</sup>

<sup>35</sup>The Pension Benefit Guaranty Corporation's investment policy directs managers to invest assets over which they have discretion primarily in equity and fixed income. The investment policy's definition of equity includes publicly traded U.S. REITs, which in the report we refer to as alternative assets. Additionally, the investment policy recognizes the Pension Benefit Guaranty Corporation will in some instances inherit alternative assets from terminated defined benefit plans.

**Table 3: Asset Classes of Four Selected Defined Benefit Plans and Other Investment Entities, as of 2015**

Entity	Asset class	Dollars (in millions)	Percent of total assets
Pension Benefit Guaranty Corporation	Equity	\$22,466.0	29
	Fixed income	51,527.0	66
	Alternative assets	3,750.0	5
	Other	10.0	0
	<b>Total</b>	<b>77,753.0</b>	<b>—</b>
National Railroad Retirement Investment Trust	Equity	11,583.8	49
	Fixed income	4,820.7	20
	Alternative assets	7,407.8	31
	<b>Total</b>	<b>23,812.3</b>	<b>—</b>
Federal Reserve System Retirement Plan	Equity	5,972.6	48
	Fixed income	5,981.1	48
	Alternative assets	385.1	3
	Cash and cash equivalents	152.1	1
	<b>Total</b>	<b>12,490.9</b>	<b>—</b>
Tennessee Valley Authority Retirement System	Equity	2,968.6	44
	Fixed income	2,184.3	32
	Alternative assets	1,525.7	22
	Cash and cash equivalents	117.9	2
	<b>Total</b>	<b>6,796.5</b>	<b>—</b>
Army and Air Force Exchange Service Retirement Annuity Plan	Equity	1,257.7	34
	Fixed income	1,220.7	33
	Alternative assets	1,220.7	33
	<b>Total</b>	<b>3,699.0</b>	<b>—</b>
Navy Exchange Service Command Retirement Plan	Equity	549.3	41
	Fixed income	438.5	32
	Alternative assets	348.5	26
	Cash and cash equivalents	17.2	1
	<b>Total</b>	<b>1,353.6</b>	<b>—</b>
Smithsonian Institution Endowment	Equity	461.1	36
	Fixed income	77.9	6
	Alternative assets	714.2	56
	Cash and cash equivalents	25.9	2
	<b>Total</b>	<b>1,279.1</b>	<b>—</b>

Legend: — = not applicable.

Source: GAO analysis of information from the Pension Benefit Guaranty Corporation, the National Railroad Retirement Investment Trust, selected defined benefit plans, and the Smithsonian Institution endowment. | GAO-17-726

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Note: Represents externally managed assets, which may differ from an entity's reported net assets. Net assets reflect in part an entity's internal assets and liabilities. For the Smithsonian Institution, the term externally managed assets refers to assets overseen by the endowment's Office of Investments, primarily invested in funds managed by external asset management firms. Totals may not add due to rounding. The Army and Air Force Exchange Service Retirement Annuity Plan allocation reported as of January 30, 2016. The Federal Reserve System Retirement Plan, Tennessee Valley Authority Retirement System, and Navy Exchange Service Command Retirement Plan allocations reported as of December 31, 2015. Other allocations reported as of September 30, 2015.

We determined that MWO asset managers operate in the asset classes in which federal entities and the National Railroad Retirement Investment Trust invest. To do so, we identified more than 180 asset management firms designated through publicly available sources as having some level of minority- or women-owned ownership. These MWO asset managers operate in all four asset classes in which the entities in our review invested or offered investment options to participants. MWO asset managers we identified reported managing assets totaling more than \$529 billion.<sup>36</sup> As shown in table 4, most operate in the equity, fixed income, or alternative asset classes.<sup>37</sup> The market presence of these firms equaled less than 1 percent of all regulatory assets under management.<sup>38</sup> Two of the firms, with combined regulatory assets under

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<sup>36</sup>Based on our March to June 2017 review of asset manager filings with the Securities and Exchange Commission. Certain asset managers (also known as investment advisers) must disclose their regulatory assets under management to the Securities and Exchange Commission. See 17 C.F.R. § 279.1. According to two industry sources, this measurement may be higher than the assets under management firms generally report to clients. For example, asset managers may not deduct debt held by their fund in calculating regulatory assets under management. Additionally, regulatory assets under management include funds an investor has committed to provide an asset manager in the future. Despite these differences, according to one industry association, regulatory assets under management can indicate the size and importance of a group of asset managers. In addition to regulatory assets under management, we document assets reported by firms that manage private funds, such as venture capital funds, that are exempt from registering with the Securities and Exchange Commission.

<sup>37</sup>We also identified 21 firms—sometimes referred to as fund-of-funds managers—that package funds offered by other asset managers for investors. These fund-of-funds managers had regulatory assets under management totaling approximately \$203.3 billion. However, we do not include fund-of-funds managers or the assets they reported to the Securities and Exchange Commission in our analysis to avoid double counting in cases in which a fund-of-funds manager contracts with one of the asset managers we identified.

<sup>38</sup>This finding is broadly in line with a 2017 study published by a group of industry and academic researchers with access to a number of proprietary and confidential sources of data on MWO asset managers. The authors of the study identified a larger number of MWO asset managers than we did from publicly available sources. However, in total these firms represented slightly more than 1 percent of the asset management industry, which they valued at \$71.4 trillion. See Lerner, Leamon, Madden, and Ledbetter, *Diverse Asset Management Project Firm Assessment*.

management of about \$42 billion, identified themselves as specializing in passive management investment strategies.

**Table 4: Asset Management Firms Identified as Minority- or Women-Owned, by Asset Class**

Number of asset managers	Equity	Fixed income	Alternative assets	Cash and cash equivalents	Assets reported to Securities and Exchange Commission (Dollars in millions) (range)
41	✓	—	—	—	94,939.8 (3.0 – 19,514.7)
8	—	✓	—	—	26,072.4 (2.2 – 9,192.3)
96	—	—	✓	—	159,444.7 (367.7 – 46,993.6)
1	—	—	—	✓	88.0 (N/A)
27	✓	✓	—	—	215,914.6 (6.5 – 105,990.0)
3	✓	—	✓	—	3,409.0 (779.2 – 1,688.9)
2	—	✓	✓	—	10,118.1 (1,282.9 – 8,835.2)
6	✓	✓	✓	—	7,682.8 (48.3 – 6,421.4)
1	—	✓	✓	✓	11,821.8 (N/A)
1	✓	✓	✓	✓	202.1 (N/A)
186	—	—	—	—	529,693.2 (2.2 – 105,990.6)

Legend: ✓ = firm manages this asset class, — = firm does not manage this asset class.

Source: GAO analysis of state government and industry materials. | GAO-17-726

Note: Asset managers identified as minority- or women-owned by stakeholders to state and municipal pension programs and industry. Ownership by women and minorities varies and in some cases is not known. Although we did not independently verify ownership, in certain cases we removed an asset manager from consideration based on a review of its filings with the Securities and Exchange Commission and the asset manager's website.

Although we identified MWO asset managers operating in each of the four major asset classes, use of MWO asset managers in 2015 and 2016 by the federal entities we reviewed and the National Railroad Retirement Investment Trust varied (see table 5). For example, in 2015, none of the three defined contribution plans we reviewed used MWO asset managers. Four of the five defined benefit plans we reviewed reported using at least some MWO asset managers, but one of these plans did not track this information and was unable to provide us with specific data on its use.<sup>39</sup> Finally, the Pension Benefit Guaranty Corporation did not use MWO asset managers in 2015, but did retain four MWO asset managers in 2016.<sup>40</sup>

**Table 5: Use of Minority- or Women-Owned Asset Managers by Seven Selected Federal Entities and the National Railroad Retirement Investment Trust, 2015 and 2016**

		Used minority or women-owned asset managers
Defined contribution plans	Thrift Savings Plan	X
	Federal Reserve System Thrift Plan	X
	Tennessee Valley Authority Retirement Authority Savings and Deferral Retirement Plan	X
Defined benefit plans	National Railroad Retirement Investment Trust	✓
	Federal Reserve System Retirement Plan	✓
	Tennessee Valley Authority Retirement System	✓
	Army and Air Force Exchange Service Retirement System	✓
	Navy Exchange Service Command Retirement Plan	X
Other	Pension Benefit Guaranty Corporation	✓
	Smithsonian Institution Endowment	✓

Legend: ✓ = used at least one minority- or women-owned (MWO) asset management firm, X = did not use any MWO firms.  
 Source: GAO analysis of documentation from and interviews with selected federal entities and the National Railroad Retirement Investment Trust. | GAO-17-726

<sup>39</sup> Additionally, representatives from the Tennessee Valley Authority Retirement System told us they retained a MWO firm from 1997 to 2013 to manage approximately 5 percent of the defined benefit plan’s allocation to fixed income. Similarly, representatives from the Navy Exchange Service Command Retirement Plan told us they retained a MWO firm that subsequently ceased to be minority- or women-owned when the firm’s founding members sold their ownership stake.

<sup>40</sup> The fixed income assets to be managed by these four firms would equate to less than 1 percent of the Pension Benefit Guaranty Corporation’s externally managed assets as of the end of fiscal year 2015.



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The Federal Reserve System's, National Railroad Retirement Investment Trust's, and Smithsonian Institution's use of MWO asset managers for their defined benefit plans and endowment was proportionately higher than the market presence of such firms. In 2015, 5 of the Federal Reserve System Retirement Plan's 32 asset management firms (16 percent) were MWO firms. These firms managed 2 percent of the plan's total assets, totaling \$253 million. Four of these asset managers were private equity firms. The fifth handled a portion of the plan's fixed income portfolio with two other asset managers handling much larger portions of plan assets under a similar investment strategy. The MWO asset manager achieved investment performance for the plan in 2015 comparable to that achieved by the two larger asset managers. In 2016, 10 of the National Railroad Retirement Investment Trust's approximately 140 asset management firms (about 7 percent) were majority owned by women and minorities. Collectively, these 10 firms managed about 5 percent of total plan assets. Additionally, another 46 of the plan's asset management firms had some level of ownership by minorities and women. Representatives of the Smithsonian Institution estimated 14 percent of their asset management firms—equal to about 13 of the more than 90 firms the endowment retained as of the end of 2016—were owned by women or minorities.<sup>41</sup>

In comparison, we identified a number of nonfederal entities that use MWO asset managers. These include retirement plans in five states, one of which set a goal of having 20 percent of its plan's assets managed by MWO asset managers. We also identified three foundations that increased opportunities for MWO asset managers, for example by amending their investment policy or establishing a program to hire MWO asset managers. Finally, we interviewed officials from two corporations, one of which retains MWO firms for both its defined contribution and defined benefit plans. Representatives of the other corporation told us they retain almost 30 MWO firms to manage nearly \$600 million, or about 4 percent, of the corporation's defined benefit plans and foundation. Despite not having an explicit program in place to hire these firms, the

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<sup>41</sup>Representatives of the endowment reported that these firms had ownership by minorities or women of 51 percent or higher. The percentage of such firms increased from 9 percent in 2015. These firms managed about 11.4 percent of the endowment's assets as of May 2017. Representatives of the endowment told us this proportion was likely to increase because multiple MWO firms in the alternative asset class have yet to draw down all the funds the endowment has committed to provide them. Additionally, about 17 percent of the endowment's asset management firms had at least some level of ownership by minorities or women.

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corporation cited two key actions that create opportunities for MWO firms to compete. The first is conducting outreach so MWO asset managers understand how to do business with the corporation. The second is communicating to the plan consultant that the corporation expects to see a diverse array of firms when selecting asset managers.

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## Some Federal Entities Made Limited Use of Key Practices When Selecting Asset Managers

Asset manager selection processes varied by federal entity, but generally included conducting research to identify potential asset managers and conducting an evaluation of potential asset managers before making final selections. We identified four key practices that institutional investors can use to increase opportunities for MWO asset managers: establishing and maintaining top leadership commitment, removing potential barriers, conducting outreach to MWO firms, and communicating priorities and expectations about inclusive practices to investment staff and consultants. Some of the federal entities we reviewed implemented all these key practices, but others made partial, limited, or no use of the practices.

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## Asset Manager Selection Processes Varied by Federal Entity and Some Entities Relied More on Consultants Than Others

All the federal entities we reviewed had internal policies related to their selection processes for asset managers. The processes generally included conducting research to identify potential asset managers and evaluating candidates before making final selections, but varied in some respects as the examples below show. We did not evaluate the National Railroad Retirement Investment Trust's asset manager selection processes because it is not a department, agency, or instrumentality of the federal government, and it is not subject to the federal law that governs the financial operations of the federal government and establishes the powers and duties of the GAO.<sup>42</sup>

- **Selection criteria.** All the entities had performance requirements and most had minimum requirements related to size (assets under management) and length of track record, but the thresholds asset managers had to meet for these requirements varied.<sup>43</sup> For example, the minimum size requirements were \$1 billion in assets under

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<sup>42</sup>See 45 U.S.C. § 231n(j)(2). For information reported by the National Railroad Retirement Investment Trust on its asset manager selection processes, see appendix II.

<sup>43</sup>The entities typically assessed asset managers' performance by reviewing returns. The criteria were generally documented in investment policy statements, solicitations for asset management services, or were communicated to consultants for use in asset manager searches.

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management for two of the defined benefit plans we reviewed, and ranged from \$1 billion to \$60 billion in assets under management for the defined contributions plans. The minimum size requirement for the Pension Benefit Guaranty Corporation was \$250 million in assets under management for applicants in the smaller asset managers pilot program (discussed later in the report), and ranged from \$10 billion to \$50 billion for managers outside of the program.<sup>44</sup> Minimum length of track record requirements ranged from 3–5 years for two of the defined benefit plans we reviewed, and ranged from 3–15 years for the defined contribution plans. The minimum length of track record requirement for all managers used by the Pension Benefit Guaranty Corporation was 5 years. In addition to performance, size, and length of track record, the entities we reviewed used other criteria when selecting asset managers, such as investment strategies, diversification of portfolio, organization and resources, and best value.<sup>45</sup>

- **Use of public solicitation process.** The Pension Benefit Guaranty Corporation and the Federal Retirement Thrift Investment Board use full and open competition when selecting asset managers.<sup>46</sup> Full and open competition allows all prospective asset managers who meet certain requirements to submit bids or competitive proposals. The Pension Benefit Guaranty Corporation and Federal Retirement Thrift Investment Board seek competitive proposals from prospective asset managers by issuing requests for proposals, which are published publicly on the Federal Business Opportunities website.<sup>47</sup> Asset

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<sup>44</sup>Representatives from the Navy Exchange Service Command, Smithsonian Institution, and Tennessee Valley Authority Retirement System stated that they did not have minimum size or length of track record requirements.

<sup>45</sup>In general, the entities developed selection criteria that would identify asset managers that could help the entities meet their investment objectives.

<sup>46</sup>As stated earlier, the Federal Acquisition Regulation (FAR) establishes uniform policies and procedures for the acquisition of goods and services by executive agencies and includes requirements for full and open competition. But according to the federal entities we reviewed, with the exception of the Pension Benefit Guaranty Corporation, the FAR does not apply to the selection processes for asset managers. Federal Retirement Thrift Investment Board representatives told us that while not bound by the FAR, they have used a FAR-based model since 1986 for its contracts, including investment manager contracts.

<sup>47</sup>Requests for proposals are written solicitations requesting proposals from potential asset managers to supply goods or services upon specified terms and conditions. The requests allow the entities to collect information from potential asset managers that will help them determine if the services being offered meet their requirements and to compare quality and price across potential managers.

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management opportunities for the other entities are not published publicly. Instead, the entities use other avenues such as internal investment staff or consultants to identify potential asset managers, as discussed later in this report.

- **Frequency of asset manager searches.** The Federal Retirement Thrift Investment Board solicits asset management services for its four externally managed funds every 5 years.<sup>48</sup> The Federal Reserve System reviews its public markets asset manager arrangements at least every 5 years and, based on the results of the review, may search for new asset managers.<sup>49</sup> Pension Benefit Guaranty Corporation officials told us that their asset manager searches are ongoing, with generally from one to three searches occurring each year for varying asset classes. The rest of the entities we reviewed do not have a set schedule for conducting asset manager searches. Asset manager searches for these entities typically occur when an asset manager underperforms and needs to be replaced, there is a change in asset allocation that warrants a new asset manager, or when a new investment opportunity arises.

Almost all of the entities used consultants to some extent in their selection processes, but some entities relied on consultants more than others.

- Three entities (Army and Air Force Exchange Service, Navy Exchange Service Command, and Tennessee Valley Authority Retirement System) work closely with consultants. While these entities approve final asset manager selections, the consultants primarily drive the search and evaluation process. Specifically, the consultants identify potential asset managers from their proprietary databases based on the entities' selection criteria.<sup>50</sup> The consultants then produce evaluation reports on candidates for the entities to

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<sup>48</sup>As stated earlier, the Thrift Savings Plan Government Securities Investment Fund is internally managed.

<sup>49</sup>This does not preclude the Federal Reserve System from conducting asset manager searches outside of the review period as needed.

<sup>50</sup>The processes the consultants used to assess asset managers for inclusion in their databases vary, but generally involve assessing asset managers against criteria developed by the consultants and then developing a rating for each firm. Only firms that receive top ratings and meet the clients' selection criteria are recommended to clients. Army and Air Force Exchange Service representatives told us they can also direct their consultant to evaluate for consideration any asset manager which is not part of its consultant's database.

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review and provide recommendations about which asset managers to select.

- Three entities (Federal Retirement Thrift Investment Board, Pension Benefit Guaranty Corporation, and Smithsonian Institution) told us they use consultants to help identify potential asset managers or provide expertise on other areas, such as specific asset classes or asset manager fees. However, evaluations to select asset managers are conducted internally by the entities. As stated earlier, the Federal Retirement Thrift Investment Board and the Pension Benefit Guaranty Corporation issue requests for proposals, which allow prospective asset managers to submit proposals to be considered for asset management opportunities. The entities evaluate the submissions and then make final selections. The Smithsonian Institution's investment staff prepare a memorandum after reviewing and vetting asset managers. The memorandum is provided to the endowment's Investment Committee, which makes final selections.
- Federal Reserve System representatives told us they primarily rely on internal market searches to identify potential asset managers for both of its retirement plans, but use consultants in limited instances. Specifically, the Federal Reserve System uses a consultant for asset classes in which it may be difficult to find asset managers, such as real estate. After identifying potential asset managers, the Federal Reserve System issues a request for proposal to potential candidates. Candidate submissions are graded using a scoring matrix and the results are used to identify from three to five firms, which then are invited to interview. Final selections are made following the interviews.

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### Some of the Federal Entities We Reviewed Made Limited or No Use of Key Practices

We identified four key practices that can be used as part of investors' asset manager selection processes to help broaden the processes and ensure that qualified MWO firms are considered (see table 6). We identified the key practices based on a review of industry reports and interviews with a sample of state, local, and private retirement plans and foundations. We then validated the practices by obtaining feedback from experts and industry stakeholders.<sup>51</sup> The key practices are closely related, and improvements or shortfalls in one practice may contribute to improvements or shortfalls in another practice. The practices do not require investors to develop targets or allocations for MWO asset management firms or to change performance standards. In addition, we

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<sup>51</sup>For additional information on the process we used to identify and validate the key practices, see appendix I.

identified examples of how some institutional investors have implemented the key practices, which may provide insights to other investors as they undertake or attempt to strengthen or improve their own initiatives related to MWO firms. The examples are not exhaustive and each institutional investor may implement the identified practices in its own way.

**Table 6: Key Practices for Increasing Opportunities for Minority- and Women-Owned (MWO) Asset Managers**

Key practice	Definition/Description	Examples of how practice can be implemented
Top leadership commitment	Demonstrate commitment to increasing opportunities for MWO asset management firms	<ul style="list-style-type: none"> <li>Document commitment to asset management diversity in investment policies</li> </ul>
Remove potential barriers	Review investment policies and practices to remove barriers that limit the participation of smaller, newer, firms	<ul style="list-style-type: none"> <li>Adjust thresholds for assets under management, insurance, and length of track records to ensure that requirements are proportional to size of firm</li> <li>Develop emerging manager programs or similar initiatives that may increase opportunities for MWO firms</li> </ul>
Outreach	Conduct outreach to inform MWO asset managers about investment opportunities and the selection process	<ul style="list-style-type: none"> <li>Meet with industry associations and participate in networking events with MWO asset managers</li> <li>Invite MWO asset managers to make marketing presentations directly</li> <li>Publicize asset management opportunities through avenues, such as trade associations, databases, or a central website</li> </ul>
Communicate priorities and expectations	Explicitly communicate priorities and expectations about inclusive asset management practices to investment staff and consultants and ensure those expectations are met	<ul style="list-style-type: none"> <li>Communicate expectations to staff and consultants for including MWO asset managers in asset manager searches</li> <li>Ask investment consultant to develop an inclusive process for sourcing, evaluating, and recommending investment managers and ensure accountability by asking consultants to report on the number of diverse managers evaluated</li> <li>Require that at least one qualified MWO asset manager be invited to present to the investor's decision-making body</li> </ul>

Source: GAO analysis of information from selected state, local, and private retirement plans and foundations and industry reports. | GAO-17-726

As stated earlier, many nonfederal plans and foundations we interviewed have implemented these practices to increase opportunities for MWO firms and told us that using the practices does not conflict with their fiduciary responsibilities. According to these plans and foundations, MWO firms they used were selected based on track record of performance and

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may provide certain benefits in generating profit for their clients. Furthermore, according to plan representatives and other industry stakeholders with whom we spoke, diversifying plan investments to manage risk can be accomplished through the diversification of asset managers. Industry reports and industry stakeholders, including plan representatives with whom we spoke, also noted that implementing a more inclusive selection process for asset managers can widen the pool of candidates, which can help ensure that retirement plans and foundations are identifying the best asset managers.

Additionally, as stated earlier, the federal government has an interest in helping increase opportunities for minority- and women-owned businesses and addressing barriers they face. The key practices we identified, which can broaden an investor's pool of asset manager candidates to help ensure qualified MWO firms are considered for asset management opportunities and increase opportunities for these firms, are consistent with this interest.

We found that three of the federal entities we reviewed used all the practices, but the other four entities made partial, limited, or no use of them (see table 7).<sup>52</sup>

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<sup>52</sup>“Uses” indicates that the entity completed an action or actions to implement the practice; “partially uses” indicates that the entity has started an action or actions to implement the practice, but has not completed the action(s); and “does not use” indicates that the entity has not started or completed any action(s) to implement the practice.

**Table 7: Use of Key Practices to Increase Opportunities for Minority- and Women-Owned Asset Managers, for Seven Selected Federal Entities, as of 2017**

Entity	Key practices			
	Top leadership commitment	Remove potential barriers	Outreach	Communicate priorities and expectations
Army and Air Force Exchange Service	◐	◐	●	●
Federal Reserve System	●	●	●	●
Federal Retirement Thrift Investment Board	○	○	○	○
Navy Exchange Service Command	○	●	○	○
Pension Benefit Guaranty Corporation	●	●	●	●
Smithsonian Institution	●	●	●	●
Tennessee Valley Authority Retirement System	○	●	○	○

Legend: ● Uses ◐ Partially uses ○ Does not use

Source: GAO analysis of information from and interviews with selected federal entities. | GAO-17-726

Specifically, the Federal Reserve System and Smithsonian Institution have developed inclusive policies and taken other steps to increase opportunities for MWO asset managers, and the Pension Benefit Guaranty Corporation has developed a program to help increase opportunities for smaller asset management firms, including smaller MWO firms.

- Federal Reserve System.** The Federal Reserve System's Office of Employee Benefits (OEB) has documented top leadership commitment by developing policies that support the inclusion of MWO firms in its asset manager searches. For example, OEB's procurement guidelines, which describe the process that staff should follow when procuring goods and services, state that the office fully supports equal opportunity in procurement. The guidelines also state that prospective lists of vendors (including asset managers) to receive requests for proposals should take into account OEB's policy that qualified firms interested in doing business with the office, including minority- and women-owned businesses, should be included in the candidate pool as appropriate. Additionally, in 2014 the Federal Reserve System's Committee on Investment Performance established a policy requiring that each investment mandate for its two retirement plans be reviewed at least every 5 years on a rolling basis, which has



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provided additional opportunities to qualified MWO firms to compete for all of OEB's investment mandates on a regular basis.<sup>53</sup>

The Federal Reserve System removed a potential barrier to MWO firm participation by lowering its minimum requirement for assets under management. According to Federal Reserve System representatives, about 5 years ago OEB lowered the requirement from \$5 billion in assets under management to \$1 billion in assets under management for its defined benefit and defined contribution plans. To conduct outreach, the Federal Reserve System has participated in meetings and conferences organized by industry associations that represent MWO firms and met with MWO firms individually, according to Federal Reserve System representatives. Federal Reserve System representatives have communicated their priorities and expectations to investment staff by implementing policies that have opened opportunities for MWO firms, as discussed earlier. The entity has also tracked its use of MWO asset management firms and the proposals it received from prospective MWO asset managers.

Federal Reserve System officials told us that their efforts to increase opportunities for MWO asset managers were primarily driven by two factors. First, the decision was driven by a desire to find the best managers in the industry. Second, officials stated that they were aware of the issues surrounding the lack of inclusion in the asset management industry and made changes to help address these issues. Federal Reserve System officials noted that actively including MWO asset management firms in their searches was consistent with prudent investor requirements and fiduciary obligations. Officials also noted that some potential benefits could be gained by a more inclusive selection process, such as helping manage risk by diversifying the portfolio and mitigating manager concentration risk through new MWO managers.

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<sup>53</sup>For example, according to a report by the office, in 2015 (the first year this policy was in effect) OEB solicited and obtained six proposals from MWO firms to manage a fund with about \$2 billion in assets in its defined contribution plan. While none of the firms were selected, OEB officials reported that they have established an ongoing dialogue with the firms and will likely consider them in the future. In addition, officials reported that they identified and were considering an MWO firm for a passive management mandate. As stated earlier, the Federal Reserve System currently uses some MWO asset managers in its defined benefit plan. According to officials, the Federal Reserve System will continue using the same inclusive practices in future asset manager searches.

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- **Pension Benefit Guaranty Corporation.** The Pension Benefit Guaranty Corporation demonstrated top leadership commitment by launching a Smaller Asset Managers pilot program in 2016. According to the entity's 2016 annual report, the program was created to reduce barriers that smaller investment firms face when competing for the agency's business. As part of this program, the Pension Benefit Guaranty Corporation removed a potential barrier to entry faced by smaller firms by lowering its minimum requirement for assets under management. Specifically, its minimum, which representatives told us typically ranges from \$10 billion to \$50 billion, was lowered to \$250 million for program applicants. All other asset manager selection requirements, including performance, remained the same.<sup>54</sup>

The Pension Benefit Guaranty Corporation conducted outreach to smaller asset managers to promote its pilot program. For example, the Pension Benefit Guaranty Corporation held a pre-bidding conference designed to help applicants understand the selection process. The entity also listed the request for proposal for its program on the Federal Business Opportunities website and advertised the program in industry publications. In addition, the Pension Benefit Guaranty Corporation communicated its priorities and expectations regarding its program to its consultant by requesting the consultant help identify prospective MWO firms for the pilot program, according to officials.

After completing the selection process for its pilot program, the Pension Benefit Guaranty Corporation selected five firms to participate. Of the five firms, four were minority- or women-owned firms or both.<sup>55</sup> Pension Benefit Guaranty Corporation officials stated that, moving forward, they will evaluate the firms on their performance against the portfolio benchmark over a full market cycle.

- **Smithsonian Institution.** The Smithsonian Institution has demonstrated top leadership commitment by revising its investment guidelines and asset manager questionnaire to reflect its commitment to diversity. Specifically, in March 2017 the Smithsonian Institution

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<sup>54</sup>Specifically, program applicants were required to have a 5 year performance history and undergo the same competitive evaluation as all other PBGC asset managers.

<sup>55</sup>As reported in PBGC's 2016 annual report, each firm is responsible for investing \$175 million in fixed income. In the report, PBGC stated that it limited its allocations to each firm to no more than 20 percent of the firm's assets under management, which is in keeping with industry standards.

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revised its investment guidelines by adding “environmental, social, and corporate governance considerations in the investment process” as one of its selection criteria. According to Smithsonian Institution representatives, this change allows the Smithsonian Institution to incorporate diversity as additional criteria for asset manager selection. The Smithsonian Institution also included a statement in its annual asset manager questionnaire stating that its Office of Investments strives to promote diversity and inclusion among its manager hires. Furthermore, representatives stated that the Board of Regents and Investment Committee encourage them to look broadly at portfolio diversification not only in terms of asset classes and investment strategies, but also of the racial and gender diversity of asset managers. In addition, the Smithsonian Institution does not have minimum size or length of track record requirements, which has allowed smaller asset managers, including small MWO firms, to compete for asset management opportunities with the endowment.

The Smithsonian Institution has also conducted outreach to MWO firms. According to Smithsonian Institution representatives, investment staff meet with MWO asset managers on an ongoing basis. Staff have also participated in conferences focused on women-owned and emerging managers. Finally, the Smithsonian Institution has communicated its priorities and expectations about inclusive selection processes by asking its consultants for a list of diverse managers, according to Smithsonian Institution representatives. Representatives also told us that investment staff have been directed to proactively identify MWO asset managers to add to this list based on their capability and expertise.

Smithsonian Institution representatives told us they have often found investing with smaller asset managers (including smaller MWO firms) to be attractive to them. According to the Smithsonian Institution, small firms tend to be entrepreneurial and entrepreneurial firms are more successful when dealing with changing market dynamics, which can increase the chances of delivering superior investment returns. Representatives also noted that even though the endowment has a small staff and limited resources, they have not found it difficult to identify MWO asset managers for the endowment.

Three entities have used one or more of the practices, but have not fully implemented all of them.

- **Army and Air Force Exchange Service.** The Army and Air Force Exchange Service has used two of the key practices we identified

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(outreach and communicating priorities and expectations) and partially used (has started but has not completed actions related to) the other two practices (top leadership commitment and removing potential barriers). Specifically, the Army and Air Force Exchange Service has taken several steps to conduct outreach to MWO asset managers. For example, representatives told us that they have held face-to-face interviews with many MWO firms and gathered information on these firms for potential future investments. Army and Air Force Exchange Service representatives have also attended conferences and networking events with MWO asset managers, directed these firms to their consultant to learn more about the Army and Air Force Exchange Service's selection process, and accepted visitation requests from MWO asset managers, according to representatives. The Army and Air Force Exchange Service also has communicated its priorities and expectations for a more inclusive asset manager selection process. For example, the Army and Air Force Exchange Service has instructed its investment staff to meet with representatives from MWO trade groups. Additionally, the entity has requested that its consultant include MWO asset managers who meet its portfolio needs in asset manager searches.

However, the Army and Air Force Exchange Service has not completed actions related to top leadership commitment and removing potential barriers. According to representatives, plan trustees have had initial discussions about taking additional steps to increase opportunities for MWO firms at trustee meetings, but have not taken actions related to these initial discussions. In addition, representatives told us they use some fund-of-funds investments, which have allowed smaller firms, including some MWO firms, to compete for opportunities with the Army and Air Force Exchange Service and have started to review their policies and practices to include more participation of MWO firms in asset manager searches, but have not completed this review as of June 2017.<sup>56</sup>

Army and Air Force Exchange Service representatives told us they consider the Army and Air Force Exchange Service to have used all of the key practices we identified because they have taken at least some

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<sup>56</sup>As stated earlier, fund-of-funds investments are one investment strategy that investors have used to work with smaller asset management firms, including smaller MWO firms. The Army and Air Force Exchange Service does not track the ownership characteristics of its asset managers and therefore could not confirm the number of MWO asset managers with which it works or the amount of assets these firms manage.

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action related to each of the practices. However, they did not have an expected completion date for two of these actions.

- **Navy Exchange Service Command.** The Navy Exchange Service Command has used one key practice (removing potential barriers), but has not used the other three practices (top leadership commitment, outreach, and communicating priorities and expectations). Specifically, the Navy Exchange Service Command does not have minimum size or length of track record requirements for its asset managers. According to officials, the Navy Exchange Service Command does not use these two criteria to select asset managers in part to help ensure asset manager searches are conducted as widely as possible and include smaller asset managers, including smaller MWO firms. However, the Navy Exchange Service Command has not directly made efforts to reach out to MWO firms. Moreover, the entity has not taken any actions to demonstrate top leadership commitment and has not communicated its priorities and expectations to its consultant because it has not specifically requested that its consultant include qualified MWO asset managers in its searches for the Navy Exchange Service Command.

According to Navy Exchange Service Command representatives, they have not taken steps to implement all of the key practices because they rely on their consultant to take these actions. Navy Exchange Service Command representatives told us that their consultant is committed to conducting inclusive asset manager searches for all of its clients, performs outreach to MWO asset managers, and regularly reports to the Navy Exchange Service Command on its outreach efforts. Navy Exchange Service Command representatives also noted that it may not be practical for the Navy Exchange Service Command to directly conduct outreach to MWO firms because the entity is small and its consultant has the resources and practices in place for performing outreach to MWO firms. However, Navy Exchange Service Command representatives have not specifically directed their consultant to be more inclusive in their asset manager searches or to conduct outreach.

- **Tennessee Valley Authority Retirement System.** The Tennessee Valley Authority Retirement System has used one key practice (removing potential barriers). The entity does not have minimum size or length of track record requirements, which can help widen the pool of asset managers that the Tennessee Valley Authority Retirement System considers for selection. However, the Tennessee Valley Authority Retirement System has not used the other three practices

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(top leadership commitment, outreach, and communicating priorities and expectations).

According to Tennessee Valley Authority Retirement System representatives, it is their understanding that their consultants research and evaluate MWO asset managers and that to the extent such firms meet selection criteria and rank high in the evaluation of a particular investment mandate or strategy that the Tennessee Valley Authority Retirement System is pursuing, the firms would be considered for selection. Tennessee Valley Authority Retirement System representatives also told us that limited staff and resources make it difficult for them to conduct outreach to MWO firms. However, the entity has not communicated its priorities or expectations to its consultants because it has not directly requested or ensured that its consultants include qualified MWO asset managers in searches specifically conducted for the Tennessee Valley Authority Retirement System, nor has the entity directed its consultants to conduct outreach to MWO firms. Furthermore, the Tennessee Valley Authority Retirement System has not taken any actions to demonstrate top leadership commitment.

The Federal Retirement Thrift Investment Board has not used any of the key practices. The board described a variety of reasons that have prevented it from taking steps to increase opportunities for MWO asset managers.

- **Federal Retirement Thrift Investment Board.** According to Federal Retirement Thrift Investment Board representatives, the Federal Retirement Thrift Investment Board and Executive Director serve as fiduciaries to Thrift Savings Plan participants and as such administer the Thrift Savings Plan in the sole interest of participants and beneficiaries. According to Federal Retirement Thrift Investment Board representatives, the criteria used to select asset managers for the Thrift Savings Plan funds include providing a passive index strategy (as mandated by statute) and best value, which is a combination of technical ability and low price. Representatives stated that while qualified MWO firms are not restricted from responding to their requests for proposals, given the size of Thrift Savings Plan funds and the operational scale needed to manage a significant

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amount of assets at a low cost, only a relatively small number of firms respond.<sup>57</sup>

Further, Federal Retirement Thrift Investment Board representatives told us they plan to implement a mutual fund window platform for the Thrift Savings Plan in 2020, and acknowledged that the platform could provide an opportunity for MWO asset management firms. According to plan representatives, they are seeking a platform that will provide participants with a “broad array” of options, which they define as a platform that includes a large number of mutual funds covering a wide range of investment options. However, plan representatives told us they do not plan to incorporate key practices into their selection process when selecting a mutual fund platform.

According to Federal Retirement Thrift Investment Board representatives, they are fiduciaries required to act solely in the best interest of plan participants and beneficiaries and therefore cannot make a decision based on criteria that favor any vendor or potential vendor and cannot require that MWO firms be included in the platform. As stated earlier, the key practices we identified can help broaden the pool of qualified asset managers that investors can select from, and do not mandate the hiring of MWO firms or sacrificing performance standards. Moreover, other entities that have implemented the key practices, including two that administer defined contribution plans, have found that using inclusive selection practices do not conflict with fiduciary obligations.<sup>58</sup>

By fully implementing the key practices, the four entities could widen the pool of potential candidates in their asset manager searches and help ensure that they are finding the most qualified firms that meet their investment needs. In keeping with federal interests, the practices could

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<sup>57</sup>Each of the Thrift Savings Plan’s externally managed funds was individually competed, and the same asset manager was selected for each of them. Some of the key practices we identified in the report to widen the pool of fund management candidates could become relevant should the entity decide to use other managers in the future. Such a pool is expected to grow to the extent that MWO asset managers gain the capacity to meet the Federal Retirement Thrift Investment Board’s selection criteria.

<sup>58</sup>Federal Retirement Thrift Investment Board documentation also indicates that one of the primary drivers in offering a mutual fund window platform to Thrift Savings Plan participants is to satisfy participant desire for expanded investment options. By implementing a more inclusive selection process, the Federal Retirement Thrift Investment Board could bring in a broad array of asset managers with different investment strategies and products that can help provide participants with these options.

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also help address barriers MWO firms face and increase opportunities for these firms.

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## Conclusions

Some of the federal entities we reviewed have taken steps to implement more inclusive selection processes for asset managers, including developing a pilot program for smaller asset managers and establishing policies that support the inclusion of MWO firms in asset manager searches. However, opportunities exist for other entities we reviewed to take additional actions by implementing key practices. Specifically, the Army and Air Force Exchange Service, Navy Exchange Service Command, and Tennessee Valley Authority Retirement System have used one or more of the key practices to increase opportunities for MWO firms, but have not fully implemented all of them. The Federal Retirement Thrift Investment Board has not used any of the key practices. Implementing (or fully implementing) the key practices could widen the pool of potential candidates in their asset manager searches and help ensure that they are finding the most qualified firms that meet their or their plan participants' investment needs. Additionally, in keeping with federal interests, if implemented, the practices could eliminate or mitigate some of the barriers that MWO firms face and increase opportunities for MWO firms.

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## Recommendations for Executive Action

We are making a total of four recommendations to four agencies:

- The Chief Investment Officer of the Army and Air Force Exchange Service should fully implement key practices to increase opportunities for MWO asset managers as part of its selection processes. Specifically, the Chief Investment Officer should complete actions related to top leadership commitment and removing potential barriers. (Recommendation 1)
- The Chief Investment Officer of the Federal Retirement Thrift Investment Board should use key practices as appropriate to increase opportunities for MWO asset managers if and when implementing its mutual fund window platform. Specifically, the Chief Investment Officer should take actions to demonstrate top leadership commitment, remove potential barriers, conduct outreach to MWO firms, and communicate its priorities and expectations for an inclusive selection process to its staff and consultants if and when it begins to search for a mutual fund window platform. (Recommendation 2)



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- The Chief Investment Officer of the Navy Exchange Service Command should fully implement key practices to increase opportunities for MWO asset managers as part of its selection processes. Specifically, the Chief Investment Officer should take actions to demonstrate top leadership commitment, and to the extent that staff and resources are a constraint, should direct its consultant to conduct outreach to MWO firms and communicate its priorities and expectations for an inclusive selection process by requesting its consultant conduct more inclusive asset manager searches specifically for the Navy Exchange Service Command. (Recommendation 3)
  - The Chief Investment Officer of the Tennessee Valley Authority Retirement System should fully implement key practices to increase opportunities for MWO asset managers as part of its selection processes. Specifically, the Chief Investment Officer should take actions to demonstrate top leadership commitment, and to the extent that staff and resources are a constraint, should direct its consultant to conduct outreach to MWO firms and communicate its priorities and expectations for an inclusive selection process by requesting its consultant conduct more inclusive asset manager searches specifically for the Tennessee Valley Authority Retirement System. (Recommendation 4)

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## Agency Comments and Our Evaluation

We provided a draft of this report to the Army and Air Force Exchange Service, Federal Reserve System, Federal Retirement Thrift Investment Board, Railroad Retirement Board, Smithsonian Institution, Pension Benefit Guaranty Corporation, Navy Exchange Service Command, National Railroad Retirement Investment Trust, and Tennessee Valley Authority Retirement System for review and comment. We received written comments from the Army and Air Force Exchange Service, Federal Retirement Thrift Investment Board, Navy Exchange Service Command, and Tennessee Valley Authority Retirement System.

In their comments, reprinted in appendix IV, the Army and Air Force Exchange Service and Navy Exchange Service Command agreed with our recommendations. The Army and Air Force Exchange Service stated that it would continue to press forward in implementing the key practices to increase opportunities for MWO asset managers in a manner consistent with its investment goals and guidelines. The Navy Exchange Service Command stated that it will demonstrate top leadership commitment by formally directing its consultant in writing to conduct outreach to MWO firms on the entity's behalf and communicate

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expectations for an inclusive selection process for asset managers. The Navy Exchange Service Command also provided technical comments, which we incorporated as appropriate.

In its comments, reprinted in appendix V, the Federal Retirement Thrift Investment Board disagreed with our recommendation. The Federal Retirement Thrift Investment Board said that when developed, the request for proposal for the mutual fund window will cover topics such as information security and compatibility with the Thrift Savings Plan recordkeeping software, and breadth of fund choices offered. The Federal Retirement Thrift Investment Board stated that this will allow the Thrift Savings Plan to offer participants that wish to use the mutual fund window the greatest amount of choice in a secure, seamless, and efficient manner. The Board also noted that fiduciary rules make it difficult to make guarantees about any fund that might be offered in a future mutual fund window. However, as we discuss in our report, implementing a more inclusive selection process could bring in a broad array of asset managers with different investment strategies and products that can help the Federal Retirement Thrift Investment Board provide participants with more investment options. Further, our recommendation would not require the use of MWO asset managers in the mutual fund window, but instead would help broaden the Federal Retirement Thrift Investment Board's selection processes and help ensure that qualified MWO firms are considered. The Federal Retirement Thrift Investment Board also provided technical comments, which we incorporated as appropriate.

In its comments, reprinted in appendix VI, the Tennessee Valley Authority Retirement System agreed with our recommendation. The entity stated that it was committed to a process with its consultants and asset managers that provides equal opportunities for asset managers of all types of ownership, including MWO firms. The entity also outlined actions it would take to implement the key practices, such as documenting its commitment to equal opportunity for all asset managers, including MWO firms, in its investment policy statement and working with its consultant to set up a process for providing the Tennessee Valley Authority Retirement System information on potential MWO asset managers researched and evaluated by its consultant.

The Federal Reserve System, Pension Benefit Guaranty Corporation, and the Smithsonian Institution provided technical comments, which we incorporated as appropriate. The National Railroad Retirement Investment Trust and the Railroad Retirement Board informed us that they had no comments.

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As agreed with your offices, unless you publicly announce the contents of this report earlier, we plan no further distribution until 30 days from the report date. At that time, we will send copies to the agencies and other interested parties. In addition, the report will be available at no charge on the GAO website at <http://www.gao.gov>.

If you or your staff have any questions about this report, please contact (202) 512-8678 or [clementsm@gao.gov](mailto:clementsm@gao.gov), or (202) 512-7215 or [jeszeckc@gao.gov](mailto:jeszeckc@gao.gov). Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this report. GAO staff who made key contributions to this report are listed in appendix VII.



Michael E. Clements  
Director, Financial Markets and Community Investment



Charles A. Jeszeck  
Director, Education, Workforce, and Income Security

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# Appendix I: Objectives, Scope, and Methodology

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In this report we examined (1) the challenges minority- and women-owned (MWO) asset managers may face when competing for investment opportunities, and practices used by selected state, local, and private entities that administer or oversee retirement plans and foundations to increase opportunities for MWO firms; (2) the major asset classes in which selected federal entities invested, their use of MWO firms, and the market presence of MWO firms in these asset classes; and (3) the policies and processes selected federal entities use to identify and select asset management firms, and their use of key practices to increase opportunities for MWO firms.

We reviewed federal retirement plans, an endowment, and an insurance program administered or overseen by eight entities (collectively referred to as federal entities): Army and Air Force Exchange Service, Federal Reserve System, Federal Retirement Thrift Investment Board, Railroad Retirement Board, Smithsonian Institution, Pension Benefit Guaranty Corporation, Navy Exchange Service Command, and Tennessee Valley Authority.<sup>1</sup> We selected the federal entities and the National Railroad Retirement Investment Trust based on size (assets of more than \$1 billion in 2015) and investment strategies (passive or active management or both).<sup>2</sup> We excluded federal entities that solely invested in Treasury securities that are not traded (and thus do not use external asset

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<sup>1</sup>A separate, nonfederal entity, the National Railroad Retirement Investment Trust, manages the retirement assets for the Railroad Retirement Board. We therefore refer to the National Railroad Retirement Investment Trust when describing the Railroad Retirement Board's externally managed retirement assets in this report. However, the National Railroad Retirement Investment Trust is not a department, agency, or instrumentality of the federal government, and it is not subject to title 31 of the U.S. Code, which governs the financial operations of the federal government and establishes the powers and duties of the U.S. Government Accountability Office. See 45 U.S.C. § 231n(j)(2). The inclusion of the National Railroad Retirement Investment Trust in our review is limited to describing its asset allocations, use of MWO firms, and asset manager selection process. In addition, a separate federal entity, the Tennessee Valley Authority Retirement System, manages retirement assets for the Tennessee Valley Authority. In this report, we refer to the Tennessee Valley Authority Retirement System when describing the Tennessee Valley Authority's externally managed retirement assets. Finally, the Smithsonian Institution was established by Congress in 1846 and is considered a trust instrumentality of the United States. The Smithsonian Institution has the authority to accept gifts. According to Smithsonian Institution representatives, the Smithsonian Institution's endowment does not have federal funds and is instead composed entirely of trust funds (private donations and money raised through revenue-generating activities), which are managed as a pool.

<sup>2</sup>We used the most recent available data (2015) to determine the size (assets) and asset allocations for the federal entities we reviewed and the National Railroad Retirement Investment Trust.

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managers), such as the Civil Service Retirement System and the Federal Employees Retirement System. These two retirement systems fund the primary defined benefit pension benefits for the vast majority of federal employees.

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**Objective 1: Challenges  
Faced by MWO Asset  
Managers**

To identify challenges that MWO asset management firms face, we analyzed reports by industry stakeholders, such as asset management trade associations, institutional investors, and investment managers. We also conducted interviews with asset management trade associations (National Association of Investment Companies, National Association of Securities Professionals, Association of Black Foundation Executives, Association of Asian American Investment Managers, New America Alliance, Private Equity Women's Initiative, and Diverse Asset Managers Initiative), 10 MWO asset managers, and 4 MWO brokerage firms.<sup>3</sup> These firms were selected based on size of the firms (assets under management for asset managers and revenue for brokers), literature reviews, and recommendations from industry stakeholders. Information gathered from these interviews cannot be generalized to all MWO asset managers or MWO brokerage firms.

To identify how entities that administer or oversee state, local, and private retirement plans and foundations (nonfederal plans and foundations) increase opportunities for MWO asset management firms, we interviewed 14 entities: California Public Employees' Retirement System, California State Teachers' Retirement System, Employees' Retirement Fund of the City of Dallas, Exelon, Illinois Municipal Retirement Fund, Kellogg Foundation, Knight Foundation, Maryland State Retirement and Pension System, New York State Common Retirement Fund, Prudential's Strategic Investment Research Group, Silicon Valley Community Foundation, Teachers' Retirement System of Illinois, Teacher Retirement System of Texas, and Verizon Investment Management Corp.<sup>4</sup> Seven of these entities administered defined benefit plans; three administered defined benefit and defined contribution plans; three were foundations;

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<sup>3</sup>Three of the asset managers we interviewed also had a division or department that offered brokerage services. Those brokers are included in the total number of brokers we listed.

<sup>4</sup>We use certain qualifiers when collectively describing responses from nonfederal plans and foundations, asset managers, and industry associations, such as "some," "many," and "most." We define some as four; many as at least five, but less than most; and most as more than half relative to the total number possible.

and one was an investment group. These entities were selected based on size (assets), use of an MWO program or other initiative designed to increase opportunities for MWO asset management, a literature review, and recommendations by industry stakeholders. Information gathered from these interviews cannot be generalized to all nonfederal plans and foundations. We also analyzed reports by industry stakeholders on key practices for MWO programs or similar initiatives. When relevant, we also gathered information from these sources on the challenges faced by MWO brokerage firms and practices used to increase their business opportunities.

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**Objective 2: Asset Classes  
Invested in by Selected  
Federal Entities and Use  
of MWO Firms**

To determine the major asset classes invested in by selected federal entities and the National Railroad Retirement Investment Trust, we obtained data from the entities and reviewed their annual reports and audited financial statements for information on annual allocations made to each asset class. Allocation data from annual reports and audited financial statements reflect in some instances the investment objectives of funds managed by external asset management firms, which may not align precisely with the holdings of each fund. However, we concluded these data were sufficiently reliable to document the asset classes in which the federal entities we reviewed and the National Railroad Retirement Investment Trust, invest.

To determine the presence of MWO firms in the same asset classes in which the federal entities in our review and the National Railroad Retirement Investment Trust invested, we reviewed publicly available directories and databases of MWO asset managers compiled by industry stakeholders and state retirement plans.<sup>5</sup> We then reviewed the firms' Form ADV filings in the Investment Adviser Public Disclosure database of the Securities and Exchange Commission to identify the asset classes in

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<sup>5</sup>Our analysis understates the presence of MWO firms because of our reliance on publicly available sources to identify them. A 2017 study published by a group of industry and academic researchers with access to a number of proprietary and confidential sources of data on MWO asset managers identified a higher number of MWO firms. Our analysis may further understate the presence of MWO firms because we excluded MWO firms we identified that invested in real estate that do not register with the Securities and Exchange Commission.

which they operate and the assets they reported managing.<sup>6</sup> Finally, we compared the total assets reported by MWO firms we identified to total regulatory assets under management reported by all registered investment advisers in the database as of May 2017.<sup>7</sup> To assess the reliability of data in the Securities and Exchange Commission database, we identified and removed duplicate entries. We also checked data in the database against the Form ADV filings of a random selection of firms to ensure the database accurately reflects firms' filings. Finally, we compared total regulatory assets under management for all investment advisers in the database to a July 2016 industry estimate of the global asset management industry and found them to be similar. We also compared the proportion of assets reported by the MWO firms we identified to one calculated by researchers in May 2017 and also found them to be similar. Although we did not independently verify the accuracy of Form ADV filings, we concluded the data we obtained from them were sufficiently reliable to estimate the proportion of regulatory assets under management held by MWO asset managers.

To the extent available, we reviewed data on the percentage of each federal entity's and the National Railroad Retirement Investment Trust's asset managers that are minority- or women-owned, the percentage of assets managed by these MWO firms, and the asset classes in which the firms invested. To assess the reliability of these data, we interviewed representatives of three federal entities and the National Railroad Retirement Investment Trust with knowledge of the systems and methods used to produce these data. We determined that the data we used were sufficiently reliable for purposes of estimating federal entities' and the National Railroad Retirement Investment Trust's use of MWO asset managers in 2015 and 2016.

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<sup>6</sup>The Investment Advisers Act of 1940 requires certain investment advisers to register and report their regulatory assets under management, a measure of the securities portfolios for which a firm provides continuous and regular supervisory or management services. Advisers to certain privately offered funds may be exempt from the registration requirements, but may still be required to report the value of private funds they manage, such as hedge funds, private equity funds, or real estate funds. See 15 U.S.C. 80b-3(b).

<sup>7</sup>The Securities and Exchange Commission publishes monthly Registered Investment Adviser Information Reports summarizing some of the information registered asset management firms report in Form ADV filings, including their total regulatory assets under management. We used the May 2017 Registered Investment Advisers Information Report as the basis for our estimate of assets reported by all asset management firms. Because this report excludes assets reported by firms that manage private funds but are not required to register with the Securities and Exchange Commission, our analysis may overstate the proportion of assets reported by MWO firms we identified.

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Objective 3: Asset  
Manager Selection  
Processes and Use of Key  
Practices

To determine the policies and processes that selected federal entities and the National Railroad Retirement Investment Trust used to identify and select asset managers and efforts to include MWO firms, we analyzed investment policies; documentation on the processes and criteria used to select asset managers, including internal guidelines and examples of requests for proposals for investment management services; and available documentation on programs, policies, or initiatives related to MWO firms. In addition, we interviewed representatives from the entities we reviewed to learn more about their selection processes and efforts related to MWO asset managers.

We assessed the extent to which federal entities used key practices to increase opportunities for MWO firms. Specifically, we identified key practices by examining the practices used by nonfederal plans and foundations and by reviewing industry reports. We then validated the practices by obtaining input from 10 industry stakeholders and experts selected based on factors such as depth of experience working with MWO firms and published research. The stakeholders and experts generally agreed with the practices we identified, but one expressed a concern about implementing two of the practices.<sup>8</sup> We then assessed the extent to which the federal entities we reviewed used each key practice using three categories. “Uses” indicates that the entity completed an action or actions to implement the practice; “partially uses” indicates that the entity has started an action or actions to implement the practice, but has not completed the action(s); and “does not use,” which indicates that the entity has not started or completed any action(s) to implement the practice. One analyst reviewed the entities’ policies and practices and made the initial assessment. A second analyst then verified these steps to ensure consistent results.

We conducted this performance audit from April 2016 to September 2017 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that

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<sup>8</sup>According to the stakeholder, implementing top leadership commitment and removing potential barriers may be difficult to implement and may require additional tactics for successful implementation. The rest of the experts and stakeholders did not share this concern.



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the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

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# Appendix II: National Railroad Retirement Investment Trust

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Representatives from the National Railroad Retirement Investment Trust (Trust) stated that trustees and investment staff have a fiduciary obligation to invest the Trust's assets solely in the best interest of the Trust and its beneficiaries.<sup>1</sup> Representatives told us they do not believe their asset manager selection process, described below, has precluded the Trust from hiring smaller or minority- and women-owned (MWO) firms.

- **Selection criteria and process.** According to Trust representatives, the Trust does not have minimum size or length of track record requirements for its asset managers, but considers an asset manager's size, as well as the appropriate size of a possible allocation to the manager, when determining whether to hire the manager. They also stated that it was important to hire managers that have a demonstrable history of successfully investing and that generally, track records that cover longer time periods are more statistically significant than shorter-term track records because there are more data points to analyze. Trust representatives emphasized that considering these factors has not prevented the Trust from hiring smaller firms, and that about half of their asset managers are small to mid-size firms.

According to Trust representatives, the Federal Acquisition Regulation does not apply to the Trust's asset manager selection process. The Trust uses internal investment staff to identify potential asset managers. Trust representatives told us that searches for asset managers in the public markets (for example, publicly traded stocks and bonds) typically occur when an asset manager needs to be replaced (due to a variety of reasons, such as personnel changes), whereas searches for asset managers in private markets (for example, alternative assets such as private equity and real estate) occur on an ongoing basis.

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<sup>1</sup>A separate, nonfederal entity, the National Railroad Retirement Investment Trust, manages the retirement assets for the Railroad Retirement Board. We therefore refer to the National Railroad Retirement Investment Trust when describing the Railroad Retirement Board's externally managed retirement assets in this report. However, the National Railroad Retirement Investment Trust is not a department, agency, or instrumentality of the federal government, and it is not subject to title 31 of the U.S. Code, which governs the financial operations of the federal government and establishes the powers and duties of the U.S. Government Accountability Office. See 45 U.S.C. § 231n(j)(2). The inclusion of the National Railroad Retirement Investment Trust in our review is limited to describing its asset allocations, use of MWO firms, and asset manager selection process.

- **Use of Consultants.** Trust representatives told us that they do not use consultants; rather, in-house investment staff conduct the research and evaluation process. Generally, investment staff identify potential asset managers by researching commercial or internally developed databases and then conduct an internal review, which includes reviewing information on prospective firms' investment strategies and meeting with the firms. Investment staff subsequently develop a memorandum on the prospective asset managers and conduct a final internal analysis before recommending asset managers to trustees, who approve all final selections and the amount of the planned investment.
- **Key Practices.** According to Trust representatives, the Trust has taken steps to increase opportunities for MWO firms. Specifically, the Trust's board has discussed the Trust's selection practices as they relate to MWO firms on an ongoing basis during its quarterly meetings and has analyzed its use of MWO firms. In addition, Trust representatives told us they conducted outreach by meeting with trade associations representing MWO firms. Further, according to Trust representatives, the Trust does not have minimum size or length of track record requirements for its asset managers, which has removed potential barriers to smaller firms, including smaller MWO firms. Finally, according to Trust representatives, the Trust has tentatively approved revisions to its investment procedures manual that would incorporate statements about valuing diversity and having an inclusive asset manager selection process. Trust representatives told us that the Trust's board intends to formally approve the revisions at its upcoming board meeting.

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# Appendix III: Minority- and Women-Owned Brokerage Firms

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The federal entities we reviewed and the National Railroad Retirement Investment Trust do not directly hire brokerage firms. However, in conducting our work on nonfederal plans, we identified challenges minority- and women-owned (MWO) brokerage firms face that may limit them from fully competing for opportunities with institutional investors, including retirement plans and foundations, and the asset managers these entities use.<sup>1</sup>

- **Brand bias.** According to two MWO brokerage firms with which we spoke, MWO brokers may have difficulty competing with larger brokerage firms that are well known in the industry and have long-standing relationships with asset managers.
- **Size.** One brokerage firm with which we spoke noted that some institutional investors and asset managers may have the misconception that smaller broker dealers cannot execute trades as effectively as large brokerage firms, and that using MWO brokers will cost more.<sup>2</sup> Another brokerage firm told us that net capital thresholds were too high for newer, smaller MWO brokers to meet. As a result, MWO brokers may have greater difficulty competing for opportunities.
- **Track record.** Shorter track records are also a hindrance, according to brokerage firms we interviewed. For example, one brokerage firm noted that although most brokers may have worked with large corporations before starting their own companies, they may not get the credit for the experience they have because they are a new firm. As a result, they may be overlooked when investors search for brokerage firms.

Some state, local, and private plans have taken actions to address these challenges and increase opportunities for MWO brokerage firms.<sup>3</sup>

- **Communicate expectations.** Two nonfederal plans and one foundation we interviewed directed their asset managers to use more

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<sup>1</sup>We spoke with a sample of MWO brokerage firms. These four firms were selected based on size and other factors. Information from these interviews cannot be generalized to all MWO brokerage firms.

<sup>2</sup>We did not assess the performance of MWO brokers in comparison to non-MWO brokers.

<sup>3</sup>Some of the retirement plans we met with either had broker-dealers in house who executed trades, or delegated the responsibility of hiring broker-dealers to their asset managers.

inclusive practices for sourcing and hiring qualified MWO brokerage firms.

- **Conduct outreach.** A state plan also directly communicated with MWO brokerage firms at networking events, and directed its asset managers to do so as well.
- **Report usage of MWO brokers.** Some state and local retirement plans have legislative mandates to promote the use of MWO firms, including brokers, and require that their asset managers report on their use of MWO brokerage firms. For example, a local plan in Illinois sets MWO broker-dealer utilization percentage goals across asset classes for its asset managers, and requires that asset managers report monthly on MWO broker utilization.

# Appendix IV: Comments from Army and Air Force Exchange Service and Navy Exchange Service Command



MR. MICHAEL CLEMENTS  
DIRECTOR  
FINANCIAL MARKETS AND COMMUNITY INVESTMENTS  
U.S. GOVERNMENT ACCOUNTABILITY OFFICE  
441 G STREET, NW  
WASHINGTON, DC 20548

Dear Mr. Clements:

This is the Department of Defense (DoD) response to the Government Accountability Office (GAO) Draft Report, GAO-17-726 "INVESTMENT MANAGEMENT: Key Practices Could Provide More Options for Federal Entities and Opportunities for Minority Women-Owned Asset Managers," dated July 27, 2017 (GAO Code 100825). Detailed comments on the report recommendations are enclosed.

Sincerely,

A handwritten signature in black ink, appearing to read 'Kevin J. Iverson', is placed above the typed name.

KEVIN J. IVERSON, CIA, CFE, CGFM  
Senior Vice President, Audit & IG

Enclosure:  
As stated

**GAO DRAFT REPORT DATED 27 JULY 2017  
GAO-17-726 (GAO CODE 100825)**

**“INVESTMENT MANAGEMENT: KEY PRACTICES COULD PROVIDE MORE  
OPTIONS FOR FEDERAL ENTITIES AND OPPORTUNITIES FOR MINORITY AND  
WOMEN-OWNED ASSET MANAGERS”**

**DEPARTMENT OF DEFENSE COMMENTS TO THE GAO RECOMMENDATIONS**

**RECOMMENDATION 1:** The Chief Investment Officer of the Army and Air Force Exchange Service should fully implement key practices to increase opportunities for MWO asset managers as part of its selection processes. Specifically, the Chief Investment Officer should complete actions related to top leadership commitment and removing potential barriers.

**DoD RESPONSE:** Concur. The Army & Air Force Exchange Service will continue to press forward implementing the key practices to increase opportunities for MWO asset managers in a manner consistent with our investment goals and guidelines to maintain an acceptable risk tolerance level, to create a sufficient level of overall diversification, and to produce sustained net investment returns over the long term. Estimated Completion Date: 31 December 2017.

**RECOMMENDATION 3:** The Chief Investment Officer of the Navy Exchange Service Command should fully implement key practices to increase opportunities for MWO asset managers as part of its selection processes. Specifically, the Chief Investment Officer should take actions to demonstrate top leadership commitment, and to the extent that staff and resources are a constraint, should direct its consultants to conduct outreach to MWO firms and communicate its priorities and expectations for an exclusive selection process by requesting its consultant conduct more inclusive asset manager searches specifically for the Navy Exchange Service Command.

**DoD RESPONSE:** Concur. While being fiscally prudent, Navy Exchange Service Command (NEXCOM) Trust supports and endorses a fully inclusive search for asset managers, including MWO firms. NEXCOM's consultant, Wilshire, has an active outreach program in place for MWO firms and regularly reports to NEXCOM on their outreach efforts. The Chief Investment Officer for Navy Exchange Service Command Trust will further demonstrate top leadership commitment by formally directing its consultant in writing to conduct outreach to MWO firms on NEXCOM's behalf and communicate expectations for an inclusive selection process for asset managers. This will endorse the positive work its consultant already has been doing for MWO firms. Estimated Completion Date: 15 February 2018.

# Appendix V: Comments from Federal Retirement Thrift Investment Board



FEDERAL RETIREMENT THRIFT INVESTMENT BOARD  
77 K Street, NE Washington, DC 20002

August 24, 2017

Mr. Michael Clements  
Director, Financial Markets and Community Investment  
Government Accountability Office  
441 G Street, N.W.  
Washington, D.C. 20226

Dear Mr. Clements:

Thank you for the opportunity to review and comment on the draft report "Investment Management: Key Practices Could Provide More Options for Federal Entities and Opportunities for Minority and Women-Owned Asset Managers (GAO-17-726)".

I would like to take this opportunity to reiterate the primary rationale underlying the Federal Retirement Thrift Investment Board's (FRTIB) decision to implement a mutual fund window (MFW). We believe that a MFW will allow the TSP to enhance its offerings through a new investment platform for those TSP participants seeking specialized investment choices (which could include participants searching for funds managed by minority and women-owned firms), while preserving the simplicity and low costs of the core funds for the vast majority of participants who will not use the MFW.

When the FRTIB undertook market research regarding MFW platforms, we learned that the number of mutual funds offered by the respondents ranged from 6,000 to 23,000 funds. These mutual fund offerings come from over 670 mutual fund families. The market is in a constant state of flux. As you note, the FRTIB does not foresee implementing a MFW before 2020. I have enclosed an article from the August 14, 2017, print edition of the *Wall Street Journal* entitled "Fiduciary Rule Casualty: Brokers' Fund Offerings" which I believe demonstrates the difficulty in making guarantees about any fund that might be offered in a future MFW.

In response to GAO's recommendation to the FRTIB, I can assure you that when it is developed, the request for proposal for the MFW will cover such topics as information security and compatibility with the TSP recordkeeping software, as well as the breadth of the fund choices offered. This will allow the TSP to offer participants that wish to use the MFW the greatest amount of choice in a secure, seamless and efficient manner.



Thank you again for the opportunity to comment on the draft report. If you have any questions or would like to discuss these points further, please contact Kim Weaver, Director of External Affairs.

Sincerely,

A handwritten signature in cursive script, appearing to read "Ravindra Deo", followed by a small circular mark.

Ravindra Deo  
Executive Director

# Appendix VI: Comments from Tennessee Valley Authority Retirement System

## TVA RETIREMENT SYSTEM

400 West Summit Hill Drive, WT 8A  
Knoxville, Tennessee 37902-1401

August 25, 2017

Comptroller General Gene L. Dodaro  
U.S. Government Accountability Office  
441 G Street, NW  
Washington, D.C. 20548

GAO Report – Investment Management – Key Practices Could Provide More Options for Federal Entities and Opportunities for Minority and Women-Owned Asset Managers

Dear Mr. Dodaro:

The Tennessee Valley Authority Retirement System (TVARS or System) was established by the Tennessee Valley Authority (TVA) to provide retirement benefits for TVA employees, retirees and beneficiaries. In this role, TVARS has a statutory obligation to manage the assets of the System that are used to pay retirement benefits and the investment funds and options made available for participants in the TVA Savings and Deferral Retirement Plan (401(k) Plan).

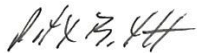
The TVARS Board and investment staff have partnered with top external investment consultants to help with the investment responsibilities of the System and 401(k) Plan. In fulfilling these responsibilities, TVARS is focused on a process and evaluation criteria in partnership with its investment consultants to engage asset managers that will meet the goals and strategies for the investment of System and 401(k) Plan assets. This process includes the research and evaluation of minority and women-owned (MWO) asset management firms by our consultants. Our search process contains no minimum requirements that would serve as a barrier to entry for any potential MWO asset managers, and to the extent any MWO asset manager meets the criteria and ranks high in the evaluation for a TVARS investment mandate or strategy, TVARS has and would consider the firm for interviews and selection. This process has resulted in the current and historical engagement by TVARS of MWO asset managers.

TVARS is committed to an engagement process with its consultants and asset managers that provides equal opportunities for managers of all types of ownership, including MWO firms. After review of GAO's recommendations and key practice suggestions for increasing opportunities for MWO asset managers, TVARS will do the following:

- Document in the System's investment policy statement this commitment to equal opportunity for all asset managers, including MWO firms

- Work with the System's consultant to set up a process for providing TVARS information on potential MWO asset managers researched and evaluated by the consultant
- When TVARS works with its consultant on identifying a short list of top, qualified firms for a particular investment strategy or mandate, request that at least one MWO asset manager be included in the list for further evaluation and consideration

Sincerely,



Patrick D. Brackett  
Executive Secretary

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# Appendix VII: GAO Contacts and Staff Acknowledgments

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## GAO Contacts

Michael E. Clements, (202) 512-8678 or [clementsm@gao.gov](mailto:clementsm@gao.gov) or Charles A. Jeszeck, (202) 512-7215 or [jeszeckc@gao.gov](mailto:jeszeckc@gao.gov)

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## Staff Acknowledgments

In addition to the contacts named above, Kay Kuhlman (Assistant Director), Kimberley Granger (Assistant Director), Erika Navarro (Analyst in Charge), Farah Angersola, Bethany Benitez, Raheem Hanifa, John Karikari, Risto Laboski, Jill Lacey, Marc Molino, Tom Moscovitch, Barbara Roesmann, Adam Wendel, and Amber Yancey-Carroll made key contributions to this report.

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## Strategic Planning and External Liaison

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