



Michael Corleone Was Right All Along

The other evening, I had the TV on and Godfather Part 2 was playing in the background. As always, I was drawn to the incredible acting and brilliance of Al Pacino and the nuanced references to life and death throughout this classic movie.

There is one scene in particular that I think represents some of the best acting I have ever watched – the scene in Nevada where Senator Pat Geary meets privately with Michael Corleone, Tom Hagen, and Michael's bodyguards. During this scene, Senator Geary asks for a cut of the revenue from the Corleone casinos and then casts aspersions on Michael Corleone's Italian heritage and his family, and imputes his ethnicity with the Corleone criminal empire. Michael then pauses and calmly replies to the Senator, "Senator, we are both part of the same hypocrisy."

What may we conclude from this brilliant reply?

In his reply, Michael Corleone illustrated the equivalence between organized crime and political crime. One is "unofficial" (organized crime) and the other one is "official" and far deeper rooted and powerful since every decision has upon it the imprimatur of the State. Senator Geary realized that Michael Corleone was correct in his assessment and only offered a snicker.

This plot reminds me of a Latin proverb – *Corruptio optimi est pessima*

"The corruption of the best is the worst."

In the movie, Michael Corleone was correct in his assessment – political crime is equivalent to organized crime.

You may be wondering why a cybersecurity professional is writing about this topic. Cybersecurity isn't just about the bits and bytes. To understand the motivations of adversaries, we have to understand the value propositions and "bounty" offered by the crime.

If the bounty is high and the effort is relatively low, then adversaries may find the opportunity to be attractive.

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Recently, an old friend emailed to me a statement that is sent to all the state employees of one particular state. A couple items caught my eye. See below for details.

Fiduciary net position			
	FY 2016		FY 2015
Assets			
Cash	\$ 300,328,830	\$ 170,646,589	
Receivables	86,542,095	128,747,086	
Investments (fair value)	14,741,054,632	14,967,254,053	
Securities lending collateral (state treasurer)	64,256,000	64,779,000	
Capital assets, net	6,938,949	5,272,553	
Total assets	\$ 15,199,120,506	\$ 15,336,699,281	
Total liabilities	\$ 160,592,356	\$ 77,832,709	
Net position	\$ 15,038,528,150	\$ 15,258,866,572	
 Changes in fiduciary net position			
	FY 2016		FY 2015
Revenues			
1 Contributions			
Member	\$ 256,198,172	\$ 266,139,156	
Employer	1,882,243,268	1,804,319,356	
Total contributions	2,138,441,440	2,070,458,512	
2 Investment income, net	(125,442,932)	681,377,052	
Total revenues	\$ 2,012,998,508	\$ 2,751,835,564	
Expenses			
Benefits	\$ 2,190,501,203	\$ 2,034,858,435	
Refunds	26,708,730	23,128,975	
Administrative	16,126,997	16,547,823	
Total expenses	\$ 2,233,336,930	\$ 2,074,535,233	
Net increase/(decrease)	(220,338,422)	677,300,331	
Net position – restricted for pension benefits (beginning of year)	15,258,886,572	14,581,566,241	
Net position – restricted for pension benefits (end of year)	\$ 15,038,548,150	\$ 15,258,886,572	

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- The “Employer” in this case is the state taxpayers (you and I). For every dollar the member or state employee contributes, we the taxpayers are contributing (\$1,882,243,268 divided by 256,198,172), which works out to the taxpayer contributing **\$7.35 for every dollar** contributed by the state employee! That is one hell of a retirement matching plan. When can we sign up? I have never seen a corporate 401K plan that was this generous.
- So these generous contributions by the taxpayers mean that the pensions must be in sound condition, no? Answer: The pension is only 34.4% funded. See excerpt below directly from the statement:

previous fiscal year. This resulted in a reduction in the funded ratio from 36.2% at June 30, 2015 to 34.4% at June 30, 2016.

2

- This item raises more questions. This line item refers to a net investment income loss in FY16 of \$125 million. A loss in a record stock market year. The average percent return of the S&P 500 index in 2016 was:

What did the S&P 500 return in 2016?

The 2016 S&P 500 Return

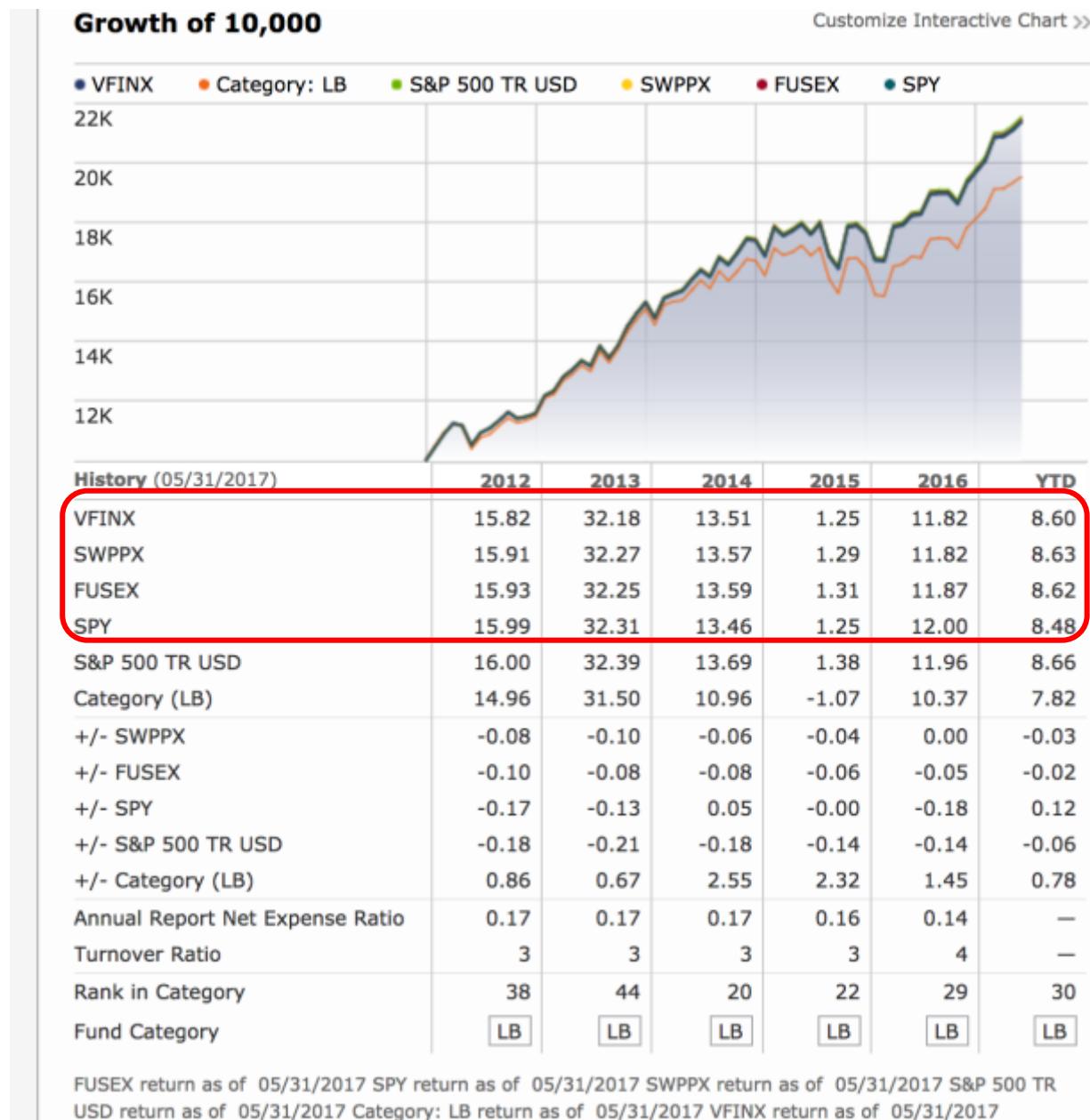
01/04/2016 Open	12/31/2016 Close	
S&P 500 Total Return	3811.74	12.25%
S&P 500 Index	2038.20	9.84%

Let's play Devil's Advocate and say that maybe the funds didn't index properly, maybe the expense ratio for the Index funds was too high, maybe they made some really horrible stock picks, etc. etc.

See below for the % returns of four very popular S&P 500 Index Funds. You will realize that the investment loss of \$125 million raises more questions.

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FY16 returns for some well-known S&P 500 Index funds (from Morningstar):



Does anything on this chart indicate that a loss seems probable? Where did the \$125 million get invested? How may one justify a loss of \$125 million in a record stock market year? The official statement from the state government. See excerpt below directly from the statement:

contributed by Active SERS members. The System experienced a loss in investment income for Fiscal Year 2016 reflecting the overall market conditions at the time. The increase in benefits paid during FY 2016, reflects the overall increase in the number of retirees and in those choosing to retire.

"The System experienced a loss in investment income for Fiscal Year 2016 **reflecting the overall market conditions at the time.**"

One more thing – the Board of Trustees for the pension fund indicated that they would reduce the investment return assumption to 7% from 7.25%. After a loss of \$125 million wouldn't it seem prudent to adjust the assumed return to 0.00%?

Most people are too busy to really pay attention to these minutiae. Who really even reads their statements? After we get ready in the morning, shave, brush our teeth, catch the train or fight traffic, work like dogs, feed our families, etc. who really has time to oversee what our elected officials do with our tax dollars? After a long week would we rather spend time unwinding and relaxing or analyzing financial statements?

After all, it's not a prohibitive amount of money that we contribute to the state coffers. We all wish taxes were lower, but what's an increase of a few hundred dollars in the whole scheme of things? In the aggregate, tax increases actually mean a lot.

Every few years we take out our anger as voters and we then upturn the old system and bureaucrats and then we place our hope in "fresh" new faces who haven't been corrupted by the system. We elect the "best" people possible. Then we find out in the third and fourth terms that the fresh new faces just resemble the same old stale bureaucrats...regardless of party affiliation.

Based on the brief analysis presented above, we cannot and should not accuse any party or administration of any malfeasance. However, as citizens, it is our duty and obligation to demand transparency of our democratically elected representatives.

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Based on this expectation, and in the spirit of encouraging transparency, we would like to offer the following questions:

1. Which investment firm manages the investments and savings of these government employees?
2. What funds were specifically traded that would generate a loss? What are the details of this loss? This should be public information.
3. Does the investment firm that manages state funds have any ties to any elected official(s)?
4. Has this investment firm had any regulatory issues or sanctions (FINRA/SEC)?
5. Has FINRA performed an audit or examination of this investment firm? If so, when was the examination performed and what were the results? Who was this information reported to in the State government chain of command? Was there any fallout due to such a huge loss?

These questions and requests for information represent an attempt to increase the transparency between elected officials and the citizens whom they serve.