

T H E T E X P E R S



# PENSION OBSERVER

THE OFFICIAL PUBLICATION OF THE TEXAS ASSOCIATION OF PUBLIC EMPLOYEE RETIREMENT SYSTEMS

*Fall 2003*

## **Constitutional Amendment to Protect Texas Public Employees Adopted**

By *TEXPERS*

Approximately three years ago, when the TEXPERS campaign to protect public employee pension funds from possible political predation or decimation began in earnest, we knew we faced an uphill battle of serious magnitude and uncertain outcome. We also knew that the financial future of Texas' present and future retired public employees was certainly endangered if we did not undertake and win this battle swiftly.

Now that the battle has been won and the Constitutional Amendment to Protect Public Employees' Pension Benefits has become law by a resounding 72% majority of the votes, we are reflecting on how it was accomplished, the deep gratitude we owe to so many who helped make it happen and what we have learned from the process.

First, a little history. Initially, we were alarmed to find that Depression-era case law still on the books in Texas allowed the governing body of a public pension plan in the state to modify, reduce or eliminate pension benefits that a worker had earned. This fact was brought to our attention a few years ago by attorney Robert Klausner in his presentation during a TEXPERS Annual Conference. It was groundbreaking information that provoked immediate TEXPERS efforts to remedy the situation by promoting passage of an amendment to the Texas constitution— first lead by Dwight Walker, then by Randy Stalnaker.

*We are relieved that Texas has joined the 47 other states that protect public employee pension*

## **Enhanced Equity Indexing**

By *Richard E. Fee*

Why enhanced indexing? Periods of underperformance from an actively managed portfolio can be painful to endure, leading some investors to seek the relative certainty of a passive investment approach. In exchange for that certainty, the index investor forfeits the opportunity to add value above the benchmark return.

Rather than completely foregoing the potential to outperform the benchmark, investors are increasingly turning to enhanced index funds to capture some of the added-value potential of active management, while maintaining an index-like level of risk. Consider these advantages of enhanced indexing:

- To add value above the benchmark, enhanced index managers can capitalize on inefficiencies within the equity market, while controlling relative risk factors versus a chosen benchmark.
- With tracking error (the annualized standard deviation of relative returns versus the underlying benchmark) of 2% or less, enhanced index approaches are less likely to experience protracted periods of significant underperformance versus the index.
- Fees for enhanced index approaches

The TEXPERS Board of Directors about gathering data and support a separate entity, the Committee legally dedicated to spearhead the amendment campaign. The Committee in turn employed a lobbyist team and created a special purpose PAC fund. Once that was in place, the fight to pass the amendment began in earnest. We conducted fund raising campaigns statewide, garnering funds from employee groups, unions, individuals, TEXPERS and investment managers who provide services to public employee retirement systems. Most fund raising was accomplished by direct mail, email, receptions and telephone solicitation.

*systems from  
Depression-era  
case law.*

A laborious period was spent meeting with public employee pension fund representatives from across the state in order to write language which most would find agreeable. As we worked to remove any opposition to the amendment, we found that statewide retirement systems did not want to be a part of the amendment so we drafted language to exclude them. After we drafted language acceptable to the Texas Municipal League, it withdrew its opposition and we were ready to proceed. The rewrite effort went on into the legislative process but eventually enough people agreed to the language that we were able to introduce it and press on with gaining necessary legislative support.

We needed to rally a two-thirds vote of the Texas House and Texas Senate in order for the amendment to be placed on the ballot for voters to approve. Working in conjunction with our lobbyists, along with both Democrat and Republican members, we convinced the leadership of both houses of the merits of the amendment. For over 100 years the Texas House and Senate had been under the leadership of the Democratic Party. This legislative session marked the first time that both the Senate and the House were under control of the Republicans. We found that even though both houses were under Republican leadership, that new leadership was very fair and open-minded to our amendment.

We then selected our authors in each house of the Texas legislature. The Constitutional Amendment to Protect Public Employees' Pension Benefits was filed in the Senate by Senator Kim Brimer of Fort Worth and in the House by Representative Phil King of Weatherford.

At appropriate times, we conducted letter writing, email and fax campaigns to members of the committees where

are typically lower than fees on more aggressive strategies.

- Enhanced index approaches generally have lower turnover than active approaches. Less trading means lower trading costs, which in turn allows more of the potential alpha to be captured.

Enhanced index strategies seek to maximize the information ratio, or the ratio of excess return versus the underlying benchmark to tracking error. While enhanced index portfolios will likely produce only modest excess return, tracking error should likewise be low in comparison to actively managed portfolios.

While the added value from an enhanced index approach may be comparatively modest, it is important to remember that small increments in return can have large dollar consequences. Consider this: \$10 million invested in an S&P 500 index fund on June 30, 1993 would have grown to \$26.0 million over the next ten years; the same investment in an enhanced index fund that outperformed the index by just 1.0 percentage point annually would have grown to \$28.5 million — a startling difference of \$2.5 million.

Summary enhanced indexing can provide institutional investors with the dual advantages of low tracking error and modest added value versus a specified benchmark. Enhanced index portfolios can be useful for institutional funds in several ways:

- Those who find the arguments against active management compelling could choose to invest all of their equity allocation in an enhanced index fund. This alternative offers the relative safety of low tracking error, but without completely foregoing the potential for added value.
- Some studies suggest that “core-and-

the resolution was in each house. When it was ready to be voted on by both houses in their entirety, we activated the letter writing, email and fax campaign to all members of the legislature for that particular house. TEXPERS members visited the members of the Texas legislature at the state capitol to discuss their concerns about the need for the amendment.

Finally, due to excellent work by many people across the state and our very effective lobbyists, the amendment passed in the waning hours of the 78th session of the Texas Legislature even though many people had predicted it could not be passed. A short celebration preceded our next chore in the pursuit of successful passage of this amendment.

In an imminent election scheduled for September 13, 2003, the amendment was now on the ballot with 21 other amendments to be voted upon. This didn't allow much time to get our logistics together. We hired HillCo Direct, a firm specializing in direct mail campaigns and public relations.

Essential to successful passage of the amendment was the education of public employees across the state of Texas. We accomplished this with direct mail, a video presentation distributed statewide to retirement systems and employee groups and by holding two workshops. The first workshop was for TEXPERS members at the 2002 TEXPERS Annual Conference in Fort Worth. The second workshop held in Austin was attended by people statewide. Invitees were employee groups, retirement systems, state employees and local government employees.

We accelerated our fundraising efforts to send out direct mail to those people we anticipated would vote in the election. More fundraising was necessary to mount the direct mail campaign and support local get-the-vote-out programs in cities such as Houston and Fort Worth while seeking favorable newspaper editorials across the state. It was a whole hearted effort that produced exactly the results we hoped it would.

Much to everyone's surprise, the amendment passed with an astonishing 72% of the vote. Mission accomplished!

Our success in this rewarding endeavor taught us some important lessons we all would do well to remember:

satellite" strategies could benefit from using an enhanced index fund as part of their multi-manager team. By replacing or re-allocating some of the assets in the traditional index fund, the portfolio's mean-variance efficiency could be improved.

Carefully controlled, risk-managed portfolios allow enhanced indexers to control benchmark volatility, while capitalizing on the potential to deliver added value in a consistent fashion. Institutional investors increasingly find this combination of low relative risk and modest added value attractive.

*Richard E. Fee is Regional Sales Director of OFI Institutional Asset Management in Mesa, AZ.*

#### MARK YOUR CALENDARS!

### TEXPERS FIFTEENTH ANNUAL CONFERENCE

Sunday – Wednesday  
**March 28 – 31, 2004**  
 The Hilton Americas – Houston  
 1600 Lamar Street  
 Houston, Texas 77010  
 800-236-2905  
 Fax 713-739-8007

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 \$127 Single or Double  
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- Don't tolerate a losers attitude.
- Believe you will be successful.
- Think smart.
- Have friends on both sides of the aisle in the Texas legislature— both Republicans and Democrats.
- Organize grass roots support, including retirement systems, employee groups, unions and retiree associations. All politics are local. Your most active supporters and hardest workers see issues from a personal as well as broad perspective.
- Recruit and motivate volunteers: we found retirees are an excellent group of people who play a very important role in getting things done on a volunteer basis.
- You'll need money and lots of it. If you ask, people are willing to give.
- Employ the best lobbyists money can buy— like Neal T. “Buddy” Jones and Clint Smith of HillCo Partners. HillCo is the premier full-service independent lobbyist firm ranked by the Texas Monthly Best Client List as one of Texas' most important in the field. Jones leads the government relations team of experienced, knowledgeable professionals that have an in-depth understanding of the political process and public policy decisions in Texas.
- Support a strong leader—like Randy Stalnaker—who can overcome obstacles and is smart and timely in making political decisions during the legislative process.

Has this process provided a blueprint for future TEXPERS endeavors? Well, perhaps not precisely a blueprint, but certainly it has been instructive and an inspiration to act forcefully when we see the need and can anticipate the support of Texas voters who have proven they care about the well being of public retirees.

For the present, we are relieved that Texas has joined the other 47 states that protect public employee pension systems from the vagaries of a Depression-era law that could have caused the impoverishment of loyal public employees and retirees.

We are proud that TEXPERS and the Committee For Secure Retirement have been the driving force that brought together the many disparate parties who helped push this amendment to passage— from retirees who donated a portion of their modest pensions for the

effort, to state legislators, to devoted employees, to corporate supporters and surely to the voters who made it finally happen on election day. It makes us proud to be TEXPERS members and ever more determined to remain vigilant in our duties.

And, finally, we are profoundly grateful for your assistance in this campaign. Every vote, every dollar, every supportive appearance before a group, every phone call or letter to a representative counted! This amendment wouldn't have happened without your full, active support of TEXPERS. Many thousands of Texas public retirees can now be confident of a financially safer retirement thanks to your efforts.

In the months and years to come there will no doubt be many other issues and challenges we will need to overcome in our mission to protect public employee pension systems. Now that we can approach 2004 with our pension funds brought into the safe harbor of this new amendment, let us look forward to doing even more to keep TEXPERS a strong, proactive, educational force for the future benefit of all the retirees who look to us for guidance and protection. It's not only our mission, it's our duty—one we are proud to shoulder with you as partner.

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### **Washington Outlook**

*By Matt Aukofer*

#### **Risky Future of PBGC Comes Under Congressional Microscope**

The Pension Benefit Guaranty Corp. (PBGC) has accumulated a record deficit of \$5.7 billion and members of Congress are worried that the agency's troubles could result in a

### **Portable Alpha—A Viable Solution**

*By John F. Brown and Ed Kung*

The challenges faced today by plan sponsors have been well documented: decreasing asset returns combined with growing liability streams have created an environment where all investment decisions are critical. Many investment professionals predict single-digit returns for most asset classes for the foreseeable future. As such, many plan sponsors have turned to new asset classes and/or investment approaches to meet their return and liability needs.

One of the hottest topics being discussed today is portable

costly federal bailout financed by U.S. taxpayers.

The House Education and the Workforce Committee held a hearing in September following the General Accounting Office's (GAO) decision in July to place the PBGC on its list of "high-risk" programs that require additional federal oversight.

Witnesses from the PBGC and GAO testified before the committee. GAO noted there are structural problems in the defined benefit pension system that are jeopardizing the financial health of the PBGC.

Committee Chairman John Boehner (R-Ohio) noted that the PBGC is being asked to support more and more underfunded defined benefit plans, which increases the pressure on the agency and threatens its ability to protect and insure worker pension benefits.

"Today's defined benefit system is in a precarious state," Boehner said. "Though the PBGC has enough resources to make benefit payments for the near future, this poses a serious question of whether a

taxpayer bailout of the agency would be

*..the PBGC is being asked to support more and more underfunded defined benefit plans which increases the pressure on the agency and threatens its ability to protect and insure worker pension benefits.*

necessary if its financial condition continues to deteriorate. It is critically important that we work to

alpha. Although portable alpha has been around for a few years, recent market conditions have brought it back to the attention of plan managers. Historically, few plan sponsors subscribed to portable alpha strategies for a number of reasons:

- Strategic allocation changes were cumbersome and time consuming.
- The equitization process via futures/swaps was difficult to implement and manage.
- Both passive and active strategies led to funding surpluses for most plan sponsors-why bother?

What a difference a few years makes! Today, both passive and active plan managers are eager to identify viable sources of alpha without compromising risk budgets and other plan needs. Portable alpha is a solution for both parties. Utilized in an overlay format, portable alpha strategies do not disrupt plan allocations or risk parameters. Rather, because portable alpha strategies are beta neutral, in many cases the enhanced returns are generated while lowering the overall risk profile of the portfolio. Another strategy involves targeting alpha to a specific asset class or manager. Although more complicated, this strategy allows the plan to reallocate alpha to a specific asset class (e.g. port alpha from an active small cap portfolio to indexed large cap portfolio) by using futures or swaps.

Although simplified and less onerous than in the past, implementing a portable alpha strategy still has many steps and details to consider. For many, deciding between an overlay strategy versus an equitization program is the largest hurdle. For others, limited resources or plan provisions preclude them from entering into the futures market. Regardless of experience, expertise or resources, the following example outlines a simple portable alpha approach to enhancing fixed income returns.

Example: Using Portable Alpha as an overlay for enhancing fixed income returns

Portable Alpha Objective: Utilize a futures based portfolio that seeks to deliver 1% of pure alpha while not taking any credit, duration or convexity risk.

Assumptions: Fixed income assets are represented by the Lehman Aggregate Index and have a balance of \$100,000,000. In practice, the margin requirement for trading fixed income futures is 3%.

The investment process is as follows:

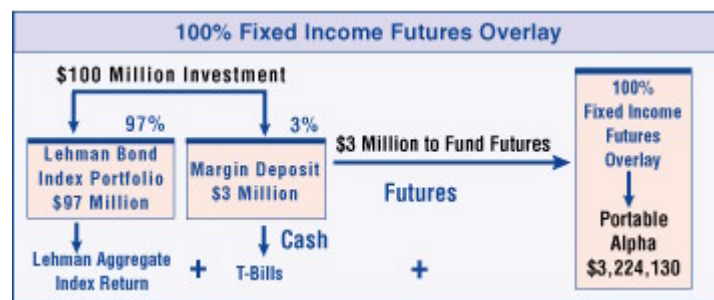
prevent another S&L-style bailout that saddles hard-working taxpayers with a tab for billions of dollars.”

Rep. Sam Johnson (R-Texas), chairman of the Employer Employee Relations Subcommittee, said: “My greatest fear is not the record deficits we’re hearing about today. My greatest fear is not what we know; it’s what we don’t know about looming liabilities of plans on the brink. What will we hear about next and how will we pay for it? We need to have a full and honest accounting for just how much help PBGC will need and how we can fix it.”

U.S. Comptroller General David Walker, the head of the GAO, presented the agency’s findings at the hearing, saying, “the long-term viability of the program is at risk.” There are two reasons for the predicament, Walker said. “First, and most worrisome, the high level of losses experienced in 2002, due to the bankruptcy of companies with large underfunded defined-benefit plans, could continue or accelerate,” he said. “Second, PBGC might not receive sufficient revenue from premium payments and its own investment to offset the losses experienced to date or those that may occur in subsequent years.”

Walker said Congress should consider several reforms to address the situation, including measures to 1) improve the availability of information available to plan participants and others about plan funding, plan investments, and PBGC guarantees; 2) strengthen funding rules that apply to poorly funded plans to help ensure that plans are better funded should they be terminated in the future; and 3) reform PBGC by restructuring its benefit guarantee and premiums.

- Step 1: The investment manager deposits \$3,000,000 or 3% of \$100,000,000 to satisfy the margin account with a broker.
- Step 2: The investment manager employs the futures based fixed income portable alpha strategy on a Lehman Aggregate portfolio with market exposure equal to \$100,000,000. Exhibit 1 (shown below) illustrates how portable alpha works through fixed income futures overlay. The index portfolio provides a market return. This is combined with T-bill returns and the return from portable alpha. In this hypothetical example, a Plan would benefit by an additional \$3,224,130 (1% compound on \$100 million for 3 years) from portable alpha with a minimum amount of invested capital.



In this case, the portable alpha overlays the fixed income portion of the plan. In practice, investors can tailor the overlay to cover all or part (50%, 150%, etc.) of the portfolio based on their investment objectives.

Summary: Portable alpha programs are an innovative approach to meeting plan sponsor return needs. Additionally, a portable alpha program enables institutional investors another method to enhance alpha and manage risk budgets without overhauling their existing manager structure. In fact, as the above example shows, new applications for portable alpha as an overlay can increase returns while lowering risk—all with a minimum investment.

*John F. Brown is Director of Sales and Ed Kung is Senior Manager Product Management at PanAgora Asset Management in Boston, MA.*

Steven Kandarian, executive director of the PBGC, testified that the agency's record deficit "has been caused by the failure of a significant number of highly underfunded plans of financially troubled and bankrupt companies," and noted that "PBGC premiums have not kept pace with the growth in pension claims or in pension underfunding."

Kandarian also echoed the need for reforms, saying, "We must make fundamental changes in the funding rules that will put underfunded plans on a predictable, steady path to better funding. Improvements in the funding rules should set stronger funding targets, foster more consistent contributions, mitigate volatility, and increase flexibility for companies to fund up their plans in good economic times."

"At the same time," Kandarian added, "we must not create any new disincentives for companies to maintain their pension plans. We are crafting proposals to get pension plans better funded, especially those at risk of becoming unable to meet their benefit promises."

But James A. Klein, president of the American Benefits Council, which represents companies' interests in the pensions debate, said Congress should focus on the many threats to defined benefit plans rather than on the PBGC "crisis."

"Certainly, the PBGC's financial solvency is important and should be examined very carefully," Klein said. "However, the current deficit does not represent a serious long-term threat to the agency's viability, and in fact there are numerous more critical threats to the defined benefit pension system."

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#### **TEXPERS Summer Educational Forum**

Aug. 22 - 23, 2004; San Antonio, TX



#### **TEXPERS 16<sup>th</sup> Annual Conference**

March 19 – 23, 2005; Austin, TX



#### **TEXPERS 17<sup>th</sup> Annual Conference**

March 12 – 15, 2006; Richardson, TX



#### **TEXPERS 18<sup>th</sup> Annual Conference**

March 17 – 21, 2007; Austin, TX

The companies sponsoring such plans want the 30-year Treasury Bond interest rate, which is used for a variety of pension plan calculations, replaced. The Treasury rate is obsolete and has made the sponsorship of defined benefit plans difficult, he said. They want to use the long-term interest rate calculation that has been proposed as part of the Pension Preservation and Savings Expansion Act (H.R. 1776), sponsored by Reps. Rob Portman (R-Ohio) and Ben Cardin (D-Md.). “A faulty and antiquated interest rate is only the most immediate threat to the defined benefit system,” Klein said.

*Matt Aukofer, journalist and consultant, is based in Washington, D.C.*

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## State Capitol Report

*By Neal T. "Buddy" Jones*

On Sunday, October 12, the Texas Senate and the Texas House of Representatives adjourned sine die, ending the Third Called Special Session. Several bills were passed during this Session, including the controversial congressional redistricting bill.

The fight over congressional redistricting had bogged down the First Called Special Session. At its end, eleven Senators left Texas for Albuquerque, New Mexico, thus preventing consideration of a redistricting bill. They remained in New Mexico during the 30 days of the Second Called Special Session, and no legislation was passed.

## Where Do We Go From Here?

*By Todd E. Petzel*

Moods are a little better around the public pension world these day thanks to a stock market that showed considerable spunk in the past two quarters and a bond market that at least didn't mess it up.

A good indicator for this period is the S&P 500 Index, which started the year at 880 and promptly fell to 800 by mid-March. This 10% decline worsened people's gloom and had most funds bracing for another terrible year. All was not doomed, however, and a small string of reasonably good economic and earnings numbers encouraged stock investors to start nibbling. This grew to full bites and then to outright feasting. Since March, the S&P has

After one of their colleagues, Senator John Whitmire of Houston, returned at the beginning of the Third Called Special Session the remaining ten Democrats came back from

*The outcome of the judicial process concerning this redistricting plan is anybody's guess.*

Albuquerque, and the Senate was able to meet. Both Houses passed different versions of the redistricting bill. A conference committee was appointed to work out differences between each House's version.

After failing to reach a deal over the October 3-5, 2003, weekend, the conferees decided to take a break from Saturday afternoon until Monday. U. S. House Majority Leader Tom DeLay arrived at the Capitol on Monday to try to facilitate an agreement between Senate and House conferees. The impasse was over two districts in West Texas. Speaker Tom Craddick wanted a district that removed his hometown of Midland from a congressional district based in Lubbock and put it into a separate district. Senator Robert Duncan (R-Lubbock) did not want the newly-elected Congressman from Lubbock, Randy Neugabauer, to be paired in a district with long-time Congressman Charlie Stenholm (D-Abilene).

When Senator Duncan finally agreed to the pairing, he wanted the district to be heavily weighted toward the west to give Neugabauer the best chance of winning. It boiled down to three counties —Deaf Smith, Eastland, and Palo Pinto. On Wednesday, October 8, Lieutenant Governor Dewhurst announced that Senate and House conferees had reached an “agreement in principle” on a congressional redistricting plan. He and Senator Staples credited Congressman DeLay with the breakthrough.

The conference committee map was finally finished around 2:30 a.m. on Thursday, October 9. The Governor, Lieutenant Governor, and the Speaker held a press conference on Thursday to discuss the agreement.

The House adopted the conference report on Friday, October 10, by a 77 to 59 vote. Two

rallied 25% to around 1000 today — an impressive performance that included virtually all sectors of the stock market: domestic and foreign; large, mid and small caps.

Interest rates have been on a similar roller coaster ride this year. The 10-year note began the year just below 4%, fell to an extreme near 3.1% in mid-June, and now stands just above 4%. We said last year that Treasury bond holders would be lucky to earn their coupon over the foreseeable future, and, so far, they have not earned that. The brightest spot in this sector has been corporate bonds of all qualities, as credit spreads have continuously narrowed. At the extreme, junk bonds and emerging market debt have been the best performers.

With stocks up 10 to 20 percent, and diversified bonds up a handful of points on the compression of spreads, most basic stock and bond portfolios have posted pretty solid returns. Assuming things don't fall apart in the next 3 months, many investors should earn rates around 10% or more, which will cover most investment goals. The question, as always, is, “What's up for the future?”

Generally speaking, the last six months' rally in stocks has built in a lot of the future benefits our growing economy will produce. P/E ratios remain high and other fundamental measures look a lot less compelling today than they did six months ago. The stock market investor who has been on the side- lines waiting for the all-clear signal probably missed the best opportunity of this year and perhaps the next several. From here the market will rally, if at all, on the basis of earnings growth, and there is little in the crystal ball to suggest those will be above normal for the foreseeable future.

On the interest rate side the picture has gotten slightly darker. Treasuries are not yielding very much right now and credit spreads on investment grade bonds have come in to the narrowest point since 1999. There may be a few more benefits left from further spread tightening, but for now everyone's expectations for bonds of all stripes should be limited.

Democrats voted for the redistricting plan and seven Republicans voted against the agreed upon maps. The Senate passed the measure on Sunday, October 12, by a 17 to 14 vote. All Democrats voted against the plan, joined by two Republicans opposing it.

Democrats in Texas and Washington D.C. immediately announced plans to challenge the newly passed redistricting plan. The new map will automatically go to the Justice Department for pre-clearance. Once the Justice Department has ruled on the plan, court challenges are sure to ensue.

If the plan stands up in courts, HB 3, the redistricting bill, will also move the Texas primary from March 2, 2004 to March 9, 2004. This is necessitated because of the delay in getting agreement on the map and the approval time for the Justice Department and the courts to consider the plan. Texas' primary date will be moved back to March 2 after this one election. The March 2nd primary date had been established in legislation passed during the 77th Regular Session.

A final decision on the validity of the redistricting map will need to be made by early December when filing for office begins. The outcome of the judicial process concerning this redistricting plan is anybody's guess.

*Neal T. "Buddy" Jones, attorney and industry consultant, is based in Austin, Texas.*

Taken together, you have a fairly dull picture. If bonds earn their coupons and stocks grow a bit faster than corporate earnings, a basic stock and bond portfolio should earn in the middle single digits next year. This is down considerably from what we've earned so far in 2003, but is completely consistent with what our economy can produce. It also falls well short of what most pension investors need from their portfolios.

To do better will require an expanded set of tools. Alternative investments, including hedge funds, private equity and real estate are playing increasing roles in the most sophisticated portfolios. Public pensions will sooner or later have to come to grips with how big a role this area will play in their investments if they are to achieve their long-term goals.

Please note that statements within this article should not be construed as an investment recommendation or solicitation of or offer to buy securities.

*Todd E. Petzel is the Chief Investment Officer and a Managing Director of Azimuth Trust in New York, NY.*

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