

T H E T E X P E R S



PENSION OBSERVER

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Institutional Asset/ Liability Management

By Robert K. Murray

Public Fund Institutional Investors have always had investment objectives. In 1974 ERISA defined a whole set of responsibilities that corporate defined benefit plans are bound to implement and all other institutional plans tend to follow as well.

Asset/Liability management confuses many people involved in the process causing them to focus on the Asset side rather than the Liability side. If a plan had no liabilities there would be no need for the assets, and would just dissolve itself. Conversely, if a plan has more liabilities than assets it is considered under funded. Severely under funded plans may be taken over by Pension Benefit Guaranty Corporation in Washington, D. C.

Let's take a look at the liability side to gain further understanding. In a Defined Benefit retirement plan the liabilities are those retirees who receive a retirement benefit payment every month. This payment is defined as a specific amount annually, paid monthly over a lifetime, generally calculated based upon years of employment and earnings that the individual contributed to and accrued with the plan. A plan also has "potential liabilities" which are those individuals who are presently

Unfunded Pension Liabilities:

Hope Is Not a Strategy

By Obie L. McKenzie.

For the first half of the year, many investment managers and consultants engaged in repeated discussions with public fund trustees about the unfunded pension liability problem. Most of these discussions outlined the problem in detail and we left TEXPERS conferences hoping that a new bull market environment might make the problem go away before we were forced to find a different strategy for managing our pension funds.

The number of public and corporate pension plans that are underfunded continues to grow as the advantages of actuarial smoothing disappear from the numbers. Double-digit returns in the roaring nineties created an environment where it appeared unnecessary for public fund financial officials and corporate treasurers to make contributions to their pension plans. Actuarial assumptions began to rise as many thought the music of double digit returns would never end. When the technology bubble burst and other economic and financial fundamentals began to deteriorate, we became riveted on declining

accruing defined retirement benefits and will someday be receiving annual payments from the plan upon eligibility. The plan generally uses the services of an actuary to calculate the present and future costs of these liabilities to the plan. These present and future costs of the plan, within the actuarial predictability of a mathematical model, become the absolute liabilities of the plan going forward. The fiduciary duties of an institutional plan's board of trustees are defined extensively by law, but to clarify further, the Prudent Man Rule is generally accepted in common practice. This rule queries: What is the decision that a prudent man would make on behalf of the plan, given the same facts that were available at the time of the decision?

A fiduciary is required by definition to meet fund obligations, meet actuarial return and to benefit the stakeholders. Many boards employ experienced staff and outside consultants to help them achieve their objectives.

While the role of a fiduciary is consistent throughout various business and investment cycles, what changes is the economic environment the fiduciary presently lives in. For example, during the decade of the 1990s it was relatively easy to fulfill the role. Then came the beginning of the decade of the 2000s with a severe correction in the equity markets and a declining interest rate in the bond market. We read in the January 21, 2002 issue of *Pensions & Investments*, the international newspaper of money management, that "Assets of top 200 U.S. pension funds sink 14%", that "Governors look to state funds to relieve shrinking budgets" and "U.S. pension fund real returns for 2001 were -5.7%". The January 20, 2003 issue mentions "Global Pension returns negative for 3rd year running".

portfolio valuations, while the precipitous decline in interest rates was driving accrued actuarial liability through the roof for many pension plans. Some of us forgot that there is an inverse relationship between interest rates and accrued actuarial liabilities. As rates dropped, the discount rate used by actuaries to calculate accrued liabilities also dropped.

The problem became more acute for corporate plans because the schedule required to amortize underfunded liabilities was much shorter than for public plans, resulting—in some prominent cases—in lower corporate credit ratings. At the same time, many investment bankers began to warn public entities that the rising contingent liability of pension fund obligations would eventually increase their cost of borrowing for roads, schools and water systems. What a predicament—what ever happened to the good old days? Reality suggests loudly that they are gone and we are in a period of renewed emphasis on portfolio risk control. Trustees should make sure, as they monitor their investment managers, that portfolio management and risk management are distinctly separate functions in order to better prepare for future surprises which will always arise to reveal risks that may be overlooked today. Risk management, separate and apart from portfolio management, has several benefits including:

- Assisting portfolio managers in generating incremental value, or alpha, within a well analyzed acceptable level of risk
- Helping ensure style

To fulfill the role became more challenging and required thinking outside the box.

If we examine the primary fiduciary responsibility to meet fund obligations (current and future liabilities), we need to identify what cash flow is required to satisfy that funding obligation need and what sources of cash flow are available. The average real rate of return for U.S. pension funds is 6-7%, or 6-7% above the current inflation rate. Traditional sources of cash flow are cash contributions, total returns from equities, bonds and alternative investments. If cash flow is negative (liabilities vs. contributions) of required returns, the difference is return shortfall. The fiduciary's role is to find investments that produce the required return or ensure that contributions match the shortfall. Their dilemma is determining how to protect plan members and plan capital.

What is more predictable is the liability cost side of the equation. What is less predictable is the asset return side. Seeking absolute returns (predictable) vs. relative returns (unpredictable) seems a suitable solution—accomplished by attempting to narrow the predictability gap in an environment where the baby boomers are soon eligible for retirement benefits (increase in liabilities) and interest rates are very low and may rise (decrease in bond values).

The direction of the market is no excuse for loss of capital. Traditional investment management styles tend to buy and hold long positions in stocks and/or bonds. The portfolio management team tries to buy undervalued securities that they suspect will go up in value over time. Good money managers track to a specific benchmark, which they hope to out

consistency and truth-in-labeling of investment products

- Facilitating historical and forward-looking analysis—allowing portfolio management teams to evaluate performance relative to benchmarks and under varied market conditions; and
- Providing independent, objective input into the portfolio management process.

An approach to separate risk management might begin with the use of quantitative models to evaluate the performance of your investment portfolio compared to an appropriate benchmark or peer group. The objective is to determine how the selection of individual securities and weightings of industry groups contribute positively or negatively to a portfolio's relative performance and risk profile. As a result of this analysis, a portfolio manager acquires a quantitative understanding of which positions worked and which did not. In addition, the manager can develop a trend analysis for use in future decisions to better manage risk and returns.

The second phase of a risk management process includes analysis of individual portfolio securities to understand each holding's contribution to absolute returns. This in-depth analysis helps to maintain style consistency protecting your portfolio against style drift by ensuring that all holdings align with the sponsor's investment philosophy and objectives. Lastly, an independent risk management

perform.

Absolute Return investment management styles tend to seek a market neutral position with positive returns not relative to any benchmark. The primary goal is to preserve capital and create a positive return profile with low volatility whose correlation to any market or index is minimal. The portfolio management team tries to buy undervalued securities long, in the hope they will go up in value over time, while simultaneously selling overvalued securities short, in the hope that they will go down in value in the same time period. The management team seeks to achieve positive returns by extracting value from arbitrage opportunities (spreads) in the market. Absolute Return investment management styles tend to hedge away tail risk to achieve preservation of capital and risk management.

How do trustees measure risk? Institutional investors and their consultants use standard deviation of monthly returns as a measure volatility/risk. They use Sharpe Ratio as a measure of risk/reward. Market neutral fixed income arbitrage managers generally score very well in these measurements compared to traditional long only managers. Hedging implies risk management vs. taking large bets on market movements. Trustees have defined the ingredients for success in hiring absolute return strategy investment management firms as experience, expertise, consistency, quality and performance. Trustees believe a due diligence visit to the firm confirms the qualities they are seeking and a prudent man would take the time and effort to do it right. Please note that statements within this article should not be construed as an investment recommendation or solicitation of or offer to buy securities.

process should include an assessment of how specific portfolios might behave in a variety of hypothetical economic and market scenarios. This process should be a collaborative one with portfolio managers and risk managers actively sharing information, and based on a well thought out view of economic and market scenarios. A risk management process that is independent and collaborative, will result in portfolios more likely to be reflective of returns which exhibit the most appropriate units of investment returns for units of acceptable risk. Hope is not a strategy for better scrutiny of investment risk but, risk management, separate and apart from portfolio management, is.

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Washington Outlook

By Matt Aukofer

Controversial Pension Bill Awaits Uncertain Future in the Senate

The pension overhaul legislation passed by the House of Representatives in May continues to be mired in controversy. The bill's sponsors say it will help workers by giving them more control over their retirement assets and provide them with improved investment advice.

But critics deemed the bill a "loophole" for Wall Street firms that would continue a basic conflict of interest: providing both the investment advice and the investment vehicles. In other words, the advice could come from the same company that provides the mutual funds for a retirement plan. This will be allowed under the bill (H.R. 1000), so long as this fact is disclosed to employees.

Recalling the recent \$1.4 billion Wall Street settlement over other conflicts of interest involving analysts at investment banks, Rep. George Miller said now was not the time to allow such "conflicted" investment advice.

"The main purpose of the Republican bill is to increase the market for investment companies wanting to manage and advise 401(k) plans,

President's Corner

By Randy Stalnaker

Almost four years ago, the TEXPERS Board of Directors began discussing what to do about the problem of Depression-era case law, still on the books in Texas, that allows the governing body of a public pension plan to modify, reduce or eliminate pension benefits that a worker has earned.

The board believes that Texas public employees deserve the same protection that private sector employees who participate in defined benefit pension plans have and that public employees in nearly every other state receive— including 41 states that have taken steps to protect the pensions of public employees.

After consulting with legal experts, the board concluded that the most reliable way to overcome the old law was through a state constitutional amendment. After thorough deliberation, we decided to undertake passage of an amendment that would ensure that once a public employee in Texas has earned a pension benefit, it cannot be taken away.

Because TEXPERS is a non-profit entity, its political activities are severely restricted, requiring establishment of a separate entity to spearhead our constitutional amendment campaign. Thus, the Committee for Secure Retirement was created. Under Texas law, it is what's known as a special purpose political action committee. This designation is advantageous since it allows corporations to make contributions to it, whereas corporations are prohibited from contributing to standard political action committees.

We drafted a bill presenting our constitutional

something that is prohibited under law today,” Miller said. “They [Republicans] do not do anything to stop conflicted investment advice to average investors - in fact, they make it legal.”

The House passed the Pension Security Act 271-157, and it is backed by the White House. It is similar to legislation introduced last year by Reps. Rob Portman (R-Ohio) and Ben Cardin (D-Md.). The fate of the legislation is uncertain in the Senate this year, which is more closely divided along party lines and where the Finance Committee has yet to take up pension legislation. The bill has been referred to the Senate Committee on Health, Education, Labor, and Pensions.

State and local government pension plans should closely watch the federal notice requirement in the bill, Cindie Moore, Washington counsel for the National Council on Teacher Retirement (NCTR), wrote in a memo to members.

The provision would require an annual notice that describes generally accepted investment principles. It would apply to both public and private plans with “self-directed” accounts and also to governmental 457 plans, she said. “Self-directed” accounts permit participants to direct the investment of some or all of their account in the plan. NCTR opposes such a notice as redundant to what public employee plans already provide and an unnecessary intervention in the regulation of such plans. “We will work to have this provision stricken when the Senate acts on it,” Moore noted. The bill includes a repeal of the sunset on the pension sections of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), Moore added. This repeal makes the sections permanent. If no change were made, the sections would expire in 2011. “This is very good news as many NCTR members have adopted the helpful

amendment and found sponsors for it. Working the bill through the legislature was an arduous process. Many of you provided invaluable assistance with your letters, emails, phone calls and personal visits to legislators. We never would have succeeded without your efforts. Please accept my thanks for all you did. I was regularly amazed at the responsiveness of TEXPERS members when we called upon them for help.

We worked primarily with three people at our consulting firm, Hillco. Each of them did a marvelous job and worked with the tenacity of bulldogs. The three from Hillco who deserve our thanks are Christine Simmons, Clint Smith and Buddy Jones. They are truly an impressive group.

I would like to give special recognition to the committee’s members. These individuals worked very hard to achieve success. Each of them gave large amounts of their personal time, including nights and weekends, and resources to assure everything possible was done to give us the greatest chance of passing the amendment. They all showed great patience, creativity and persistence while working on the project. The committee members are:

- Jerry Brown, Dallas Police & Fire Pension System
- Paul Brown, Big Spring Firemen’s Relief & Retirement Fund
- Jim Cowgill, Texas Silver-Haired Legislature
- Bruce Cox, Ft. Worth Employees’ Retirement Fund
- Curtis Creed, San Antonio Fire & Police Pension Fund
- Larry Eddington, Dallas Police & Fire Pension System
- Bill Elkin, Houston Police Retired Officers Association
- Sam Jordan, Austin Police Retirement System
- John Lawson, Houston Police Officers’ Pension System
- Dwight Walker, Dallas Police & Fire Pension System
- Bill Blythe, (coordinator) TEXPERS

It was my honor to serve as chair of the committee. Another person deserves special mention is Cindy Gremminger who serves as treasurer of the Committee for Secure Retirement. Cindy, a retired City of Dallas employee, with the assistance of her husband Jerry, who is a retired Dallas firefighter, worked many hours handling the contributions that were made.

portability enhancements and other provisions of the Act,” Moore wrote.

TIAA-CREF, the main pension system for education and research employees, applauded the bill because it would encourage individuals to save for retirement. Provisions to increase IRA contribution limits to \$5,000 and 401 (k), 403(b) and other defined contribution limits to \$15,000 are “sorely needed,” as maximums have barely increased since these vehicles were introduced decades ago, said Herb Allison, chairman and CEO of TIAA-CREF.

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

We owe all of these individuals a great debt of gratitude for the many hours of hard work they did on our behalf.

The process that began almost four years ago is nearly over. We have succeeded in obtaining the legislature’s approval of the protections we seek. The last step is obtaining the approval of the voters of Texas at an election to be held on September 13th.

Our amendment to protect Texas public employee pensions is Proposition 15 on the ballot. We need you to help us get out the vote. It would be a tragedy to have worked so hard and long to fall short because we didn’t work quite hard enough at the end.

I hope I can count on you to help us succeed at the polls in September.

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State Capitol Report

By Neal T. "Buddy" Jones

Depending on whose frame of reference you use, it was either a great session or a very bad one. The 78th Legislature adjourned sine die on June 2, 2003.

Our Republican leadership is hailing it a great session. Speaker Tom Craddick said, “We think it was a great session. We did everything we said we would do at the start of the session, when people said we could not do it.” Governor Perry issued a statement saying, “We did what we set out to do. We kept the trust by keeping promises.”

Many Democrats are criticizing legislative leaders for a session they describe as cruel and harsh. They feel too many cuts were made to the citizens of our state. They wanted to see maintenance of present services even if it meant higher taxes. Probably the biggest success story of the 78th Legislature was the fact our lawmakers overcame a \$9.9 billion shortfall and appropriated \$117.4 billion from all fund sources for 2004-05. This is a \$1.6 billion, or 1.4 percent, increase over the present budget. They accomplished this with no new taxes being raised in the state. This is the lowest percentage increase of our state budget in years.

Several other important legislative items passed including HB 4, the comprehensive tort reform bill which caps non-economic damages on medical malpractice at \$250,000. Homeowners could be seeing an immediate rate reduction on homeowners insurance thanks to passage of SB 14, the insurance reform bill.

Municipal pension legislation fared well during the 78th Texas Legislature. Several important bills passed which are beneficial to local pension funds and their pensioners.

HJR 54, by Representative Phil King and Senator Kim Brimer, passed both Houses of the legislature by strong margins. This legislation puts Texas among 40 other states protecting public and municipal pensions. The constitutional amendment, which will be Proposition 15 on the ballot, will be voted on by Texas voters on September 13, 2003. If the proposition passes, cities will have until May 2004 to opt out of the provision.

It is very important Texas municipal employees actively support passage of this constitutional amendment in September. Make sure you, your friends, and your neighbors all get out to the polls to vote for Proposition 15!

Also passing was SB 1696, by Senator Jeff Wentworth. This bill allows cities to issue pension obligation bonds to deal with unfunded liabilities.

Finally, please don't forget Proposition 15, insuring municipal employees pensions, will be up for a vote by Texans on September 13, 2003. The language on the ballot will be "The constitutional amendment providing that certain benefits under certain local public retirement systems may not be reduced or impaired." Please do all you can to insure this important amendment is passed by Texas voters.

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

Hedge Funds: The Good, The Bad and The Ugly

By Vaquero Investment Management Company, Inc.

Today, many institutional investors and consultants are taking a closer look at hedge funds. And why not, since these funds offer investors a vehicle to enhance portfolio performance. Although not an asset class unto themselves, many consultants consider them as such due to their limited correlation to traditional equity investments. Hedge funds also offer an innovative way to further diversify a portfolio through active management.

The traditional goal of a hedge fund is to protect certain positions by limiting both the upside and downside, or "hedging". For instance, airlines hedge their operating costs by purchasing jet fuel months in advance. A pension fund could theoretically follow a similar strategy by hedging gains in order to meet certain future obligations. However, as trustees debate potential hedge fund allocations, they must be aware of certain issues associated with these types of investments.

First, the term "hedge fund" now represents numerous alternative investment strategies. Many of these strategies do not hedge anything, and can be risky. Even hedge funds that claim to be market-neutral are still risky. The issue is the definition of risk. Financial analysts tend to look at risk mathematically. For instance, a market-neutral or long/short position may appear to be mathematically risk-free. But in reality, the position could fail leading to potentially significant losses. How can this be risk-free? It's not!

Second, management fees tend to be extremely high. Typically, hedge funds charge a hefty 2% fee plus 20% of any profits. This can be very expensive. For instance, if a hedge fund earns 10%, the actual net return to the investor is reduced to less than 6%.

Third, investors tend to chase returns. But how have hedge funds actually performed? With so many complex hedge fund strategies, it is nearly impossible to benchmark returns. More importantly, the numerous hedge fund indices that do exist suffer from ‘survivorship bias’. Historically, about one in five hedge funds fails each year due to poor performance: However, industry performance indices track only the returns reported by going concerns. This has interesting implications. Let’s assume a representative hedge fund index indicates an 8% return. If the non-reporting, failed funds lost an average of 15% each, then the actual index performance was only 3.4%!

Finally, there is the claim that hedge funds systematically capture or extract alpha. Alpha represents the realized return of an actively managed portfolio, over time, relative to a market index. Alpha cannot be quantified without a representative benchmark. A fund that claims to provide “absolute returns” due to “exceptional management” is not generating alpha unless it has outperformed an identifiable passive investment strategy. Many hedge funds use an incorrect definition of alpha for their marketing efforts.

As noted, some hedge fund exposure can provide improved portfolio diversification. However, pension trustees must be aware of the risks associated with hedge fund investments. Earlier this year the SEC’s extensive hedge fund industry investigation revealed potential conflicts of interests, asset valuation concerns, and questionable marketing tactics. Until the hedge fund industry is properly regulated, the SEC advises investors to be sure to investigate the backgrounds of hedge fund managers and the fees they charge. Good advice.

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Assessing the Relative Value of Real Estate Investment Trusts

By Michael J. Acton, CFA, Director of Research

Despite a generally weak economy and deteriorating property market supply and demand fundamentals, real estate investment trusts (REITs) continue to post strong absolute and relative returns, building on the strength of the past several years. The prolonged nature of this period of out-performance has led some investors to question whether REITs are becoming over-valued, thereby representing greater risk.

To help answer this question, we developed several years ago the AEW REIT Relative Value Index. This index combines three common measures of relative value— earnings multiples, dividend yield and premium to underlying net asset value— and combines them into a single measure. This tool is intended to easily assess the value of REITs relative to other parts of the capital markets in a consistent and measurable format. At the most fundamental level, the index is simply an equally-weighted index of three pricing metrics: the ratio of the REIT earnings multiples to the S&P 500 earnings multiples; the yield spread between REITs and Baa corporate bonds; and the ratio of REIT share prices to the value of the real estate held by the REIT. Since all of these measures are

represented on different scales, we employ a statistical transformation to place them on a common “mean-zero” scale.¹ A beneficial bi-product of this transformation is the creation of a scale for the index that is expressed as standard deviations from fair value. In other words, when the index is above zero, REITs are expensive relative to stocks, bonds and private real estate. Conversely, when the index is below zero, REITs are cheap relative to the other assets. How Are REITs Valued Today?

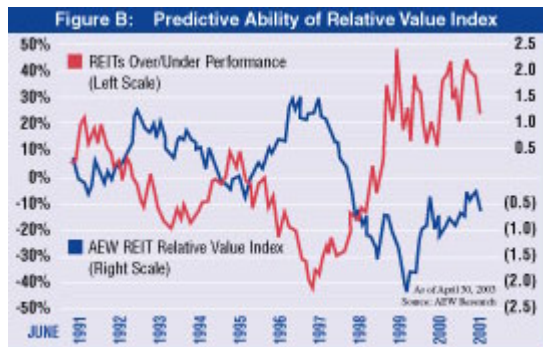
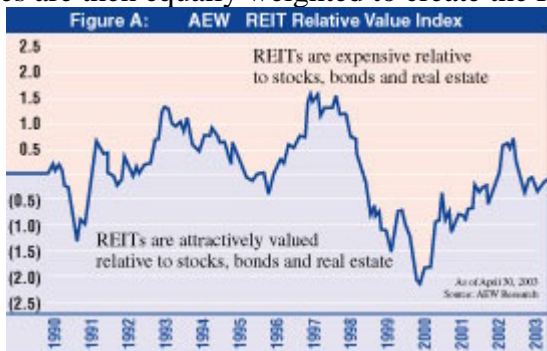
As of the end of April 2003, the Relative Value Index suggests that REITs as a group are, roughly, fairly valued relative to other stocks, bonds, and underlying real estate, with the index showing a value of 0.17 standard deviations below “fair value.” (Figure A below)

While the index was developed as a tool to highlight periods when REIT valuations have deviated from “fair value” relative to other investment options, it appears to have generally reliable predictive properties with respect to REIT performance relative to other assets. Specifically, the index has performed well in suggesting the magnitude of REIT out-performance for the twelve-month period beginning six months in the future. Figure B (below) illustrates the relationship between the index and the twelve-month over-/under- performance of REITs relative to the S&P 500 with a six-month forward lag. The correlation between these two lines is -0.72, a strong negative correlation. That is, when the index is negative (i.e., REITs are under valued), the future out-performance is positive. Similarly, when the index is positive, the future relative performance is negative. Obviously, the degree of future out-performance is directly related to the degree of current under-/over-valuation. With the current level of the index at -0.17, only modest REIT out-performance is suggested for 2004. (Figure B)

Without advocating the efficacy of market timing, the information embodied in the index is important for investors to consider. Today, the index suggests that REITs are generally fairly valued; perhaps slightly expensive relative to other equities and private real estate and clearly under-valued as a yield instrument. In the near-term, this suggests more “normal” returns from the sector, roughly in line with current yield plus price appreciation approximating inflation.

Michael J. Acton, CFA, is Director of Research at AEW Capital Management. L.P. in Boston, Mass.

¹ The transformation is commonly referred to as a “Z-Score” in which each the variation from the mean value is expressed as a ratio to the standard deviation of measure for each observation. The Z-Scores are then equally weighted to create the RVI.



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