

T H E T E X P E R S



PENSION OBSERVER

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Tale of Two Bond Markets

By Gilbert Garcia

It was the best of times, it was the worst of times”—Charles Dickens could have been writing about the fixed income markets in 2002.

As far as absolute performance goes, last year was the “best of times” for fixed income, as bonds had another good year. The LB Aggregate Index posted an excellent 10.26% total return last year. The “worst of times” was getting there—Enron, Worldcom, suicide bombings, Iraq, anthrax. All of this led to plunging consumer confidence, severe stock market losses and record volatility.

No fixed income sector was impacted more than corporate bonds. Many corporate issuers saw their yield spreads relative to comparable treasuries explode to historic wide levels. Rating services responded with a surge in corporate downgrades, leading to a record number of companies falling from investment grade to junk status. For the year, corporate bonds underperformed treasuries by a whopping 2.45%.

Thus, we were all reminded what fixed income investing is about—

Why Investment Grade Fixed-Income Still Looks Like A Winner for 2003

By Claude R. Parenteau

After three consecutive years of U.S Treasury returns exceeding those of equities, it seems that current considerations still favor fixed-income investments.

The U.S. and indeed the world, are still dealing with the bursting of a massive speculative asset bubble, and it is likely to take some time to work off the excess capacity and valuations in many industries.

Proposed fiscal and monetary policy shifts typically take about 12 months to influence the economy, even when they are effective.

Oil prices have been quite high for the past year, removing consumer dollars from the economy. South American economies are again faltering, and Japan remains in economic stagnation, with no solution expected in the near term. Equity valuations remain high, relative to historical measurements, even after three painful years of declines. Terrorism remains an uncertainty, as does corporate accounting. This adds to consumer uncertainty particularly as layoffs increase and employment security seems more and more threatened.

The Year 2002 witnessed the greatest number of U.S. corporate and personal bankruptcies since the Great Depression. The productive assets bankrupt companies owned do not disappear—one only has to look at the recent United Airlines bankruptcy filing—rather, they are re-deployed, though at far lower carrying cost. This allows the bankrupt company, in many instances, to then become the low cost provider and contributes to deflationary forces in

Preservation of Principal. Those who strayed from this objective paid dearly with extraordinary volatility and poor performance. Market practitioners re-learned many lessons in the bond market. Here are two:

There's no such thing as a "little" risk. It's easy to be seduced into buying a short "unbelievably cheap" corporate bond for "extra yield." We've heard the pitches. "Don't you think they're going to be around next year?" "What could go wrong?" Plenty. Just ask those investors who bought short WorldCom bonds. When the company started to collapse, all of its bonds declined in value and converged to the same flat dollar price. On a spread basis, the short maturities actually suffered the most.

It's better to be first in line. Some investors reach for an extra 15 basis points in yield by going down the credit ladder and purchasing subordinated debt. Again, "what could go wrong with this strategy?" Everything.

In a crisis, the market adjusts for the fact that senior debt comes before subordinated debt in liquidation. Doesn't sound like much, but ask those investors who bought Duke Capital. Instead of earning that "extra yield", they saw their investment underperform higher rated Duke debt by 15% last summer.

Dickens closes his masterpiece with "it is a far, far better rest that I go to than I have ever known." As money managers and trustees enter 2003, we will certainly rest better with our bond investments by remembering that one of the primary objectives for bond investing is the preservation of principal.

the entire industry by increasing cost pressures.

Current demographics also support fixed-income over equities. Baby-boomers, rapidly approaching retirement age, are far more concerned with avoiding losses than making spectacular gains. Predictable, safe income is likely to replace speculative gambling, with this group of investors. Life insurance and long-term care insurance are very popular with baby-boomers, and, in the interval between a client insurance purchase and the ultimate claim payout, these premium payments are invested by the insurance company. Life insurance and long-term care insurance are generally considered "long-tail" insurance, since the time between premium payment and actual realization of a claim is usually quite long. Insurance companies are typically heavily invested in fixed-income, understanding better than others how important matching assets with liabilities is. This current demand of baby-boomers for insurance products represents a strong underpinning for the fixed-income markets, just as 401-K's and IRA's have for equities.

The internet continues to represent an enormous deflationary force in the world's economies, as it provides absolute and immediate pricing information efficiency.

In summary, monetary and fiscal policy are likely to have far less effect than is expected in 2003. Investors are likely to be willing to pay less and less premium for a given level of equity earnings, due to a broad trend towards lower overall demand for, and interest in, equities, and the uncertainties surrounding them.

Claude Parenteau is Director of Marketing at SEB Asset Management America, Inc. in Stamford, CT.

MARK YOUR CALENDARS!

Upcoming Conferences

TEXPERS Summer Educational Forum

August 24-25, 2003 - San Antonio, TX

TEXPERS 15th Annual Conference

March 26 - 31, 2004 - Houston, TX

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TEXPERS Summer Educational Forum
August 22 - 23, 2004 - San Antonio, TX

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Washington Outlook

By Matt Aukofer

Opposition Grows to Pension Rules that Foster Cash-Balance Plan Conversions

The Bush administration has proposed sweeping changes to pension rules that would rescind a 1999 policy banning government approval of the conversion of company pension programs to cash-balance plans. The proposed rules would permit companies to change to cash-balance plans without requiring them to protect the pensions of “older workers,” defined as employees over the age of 40.

Unlike 401(k) and similar savings plans, traditional defined-benefit plans deliver a fixed amount based on the employee’s salary and years of service. Under cash-balance plans, workers accrue benefits evenly over the course of their careers. Defined-benefit plans allow workers to accrue disproportionately large benefits in their final years. The Bush administration and the Internal Revenue Service (IRS) are endorsing cash-balance plans, which critics contend would hurt older workers at companies that use them because they would lose the larger projected benefits.

Cash-balance plans were popular until September 1999, when the IRS, under orders from President Clinton, decided to halt approvals of the plans to study whether they unfairly discriminate against older workers. The Bush administration’s recent proposal has been sharply criticized by groups representing older workers, such as the American Association of Retired Persons (AARP), and members of Congress. “At a time when millions of employees are still reeling from significant losses to their 401(k) retirement plans because of corporate scandals and the ongoing

President's Corner

By Randy Stalnak

A conversation I recently had with a friend caused me to think back to the early days of TEXPERS. Reminiscing about the conferences and issues of twelve years ago made me realize just how far the organization and its members have come. The point of this column is not to pat ourselves on the back, but rather to make sure we realize that any organization’s success can be fragile and that we should not take TEXPERS for granted.

TEXPERS has come to be recognized as the premier public fund organization in the United States. I hear complimentary comments about TEXPERS from highly respected individuals who hail from all parts of the country. It is critical to all of us that TEXPERS continues to thrive because of the benefits we receive from it. To assure continued TEXPERS success, it is incumbent on all of us to work diligently.

You need not look far to see some of the numerous benefits of TEXPERS membership — such as extensive networking and educational opportunities. Information exchanged

weakness in the stock market, these regulations represent another serious blow to the retirement security of hard working Americans who have played by the rules in their companies only to see the rules of the game for rank-and-file employees change midway through their careers,” Rep. Tom Udall (D-N.M.) wrote in a letter to President Bush.

The regulations currently are undergoing a 90-day comment period and the IRS will convene a hearing in April before the proposal becomes permanent. Opponents are hoping that public awareness of the plan will force the Bush administration to drop the controversial idea.

Before the practice was stopped in 1999, between 300 and 700 companies comprising 8 million workers and \$334 billion in pension benefit plan assets converted their defined benefit plans to cash-balance plans. In 2000, the General Accounting Office (GAO), the investigative arm of Congress, released a stinging report that found cash-balance plans could reduce pensions for older workers by up to 50 percent.

Last fall, 116 members of Congress wrote a letter to the IRS asking the agency to do more to enforce existing pension laws and regulations when companies shift to cash balance schemes. The lawmakers said the lack of enforcement was allowing corporations to illegally slash the pensions of employees by hundreds of millions of dollars. The letter came on the heels of a federal court ruling that Xerox Corp. had illegally cut the pensions of 13,000 of their employees by more than \$280 million by converting to a cash balance plan. It was the third favorable court ruling for employees who have seen their pensions fall in value by as much as 50% as a result of cash-balance conversions. Earlier, courts had ruled that Georgia Pacific illegally cut the pensions of their workers by more than \$50 million by shifting to cash-balance plans, and that the Bank of Boston illegally cut the pensions of 8,000 of their employees by at least \$7 million. All of these decisions were based on the regulations that the congressmen asked the IRS to enforce.

“Workers and retirees shouldn’t have to go to court to enforce their rights under the law,” Rep. Bernard Sanders (I-Vt.) said. “This is the IRS’ job and they need to get it done ... These cash balance pension raids must be brought to an end.”

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between trustees and staff of different funds who are members of TEXPERS has been of enormous assistance to those fund members. Benefits have been improved and investment performance enhanced as a result of conversations held and relationships developed through TEXPERS membership.

The advantages of TEXPERS membership come at a low cost. Attendance at the highly rated conferences—which have earned consistently high ratings from attendees—is free as are the numerous publications and access to the highly informative TEXPERS website with useful links pointing you to even more information.

TEXPERS has assisted many of its member funds through difficult times by providing helpful contacts and numerous kinds of critical support. The cooperation shown between TEXPERS member funds has proven invaluable in overcoming trying situations that seem to regularly confront public pension plans. Many of our member funds have found that there’s almost certainly someone in TEXPERS who has dealt with the very situation in which they find themselves and that those individuals are eager to help.

I urge you to do your share to assure that TEXPERS continues to be successful. Work to support the mutual respect and cooperation that are the hallmarks of the organization. Develop your knowledge of an area of interest and share it with fellow members. Help to assure that misinformation and misperceptions are corrected. By doing these things, we will all continue to benefit from a valuable organization.

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State Capitol Report

By Neal T. "Buddy" Jones

The 78th Texas Legislature convened on January 14, 2003. Both the Texas Senate and House galleries and floor were packed as both Houses of the Legislature swore in their members.

The Senate was gaveled to order by Lieutenant Governor Bill Ratliff. He presided over the Senate until David Dewhurst, Texas' Lieutenant Governor-elect, was sworn in on January 21, 2003.

The Senate elected Senator Eddie Lucio from Brownsville as Senator Pro-Tem. He will preside over the Senate in the absence of the Lieutenant Governor. The Senate also adopted their permanent rules, and Lieutenant Governor-elect Dewhurst assigned each to standing committees.

The Senate committees, in which most pension related legislation will likely be considered, are State Affairs and Intergovernmental Relations. Senator Bill Ratliff, from Mt. Pleasant, will chair the State Affairs Committee. He chose not to run as Lieutenant Governor again and was re-elected Senator. Senator Frank

The Challenges of a Long-Term View

By Derek Sasveld

Imagine you are a U.S. pension fund executive. The year is 1969. Imagine further that you have been given the unique opportunity to look into a crystal ball telling you precisely what the return and risk characteristics will be for the major asset classes over a period of more than three decades. (See table below) Armed with this information — and knowing the long-term nature of your liabilities, the liquidity needs of your plan, and your organization's tolerance for risk — you could formulate an excellent long-term investment policy mix for your fund. Depending on your liability structure, it might have been prudent to have a hefty portion of the fund invested in U.S. equities, with a small allocation to U.S. bonds and cash. However, consider the challenges you would have faced over the years as you moved through time with different constituents evaluating your decision.

Asset Class	Return:	
	12/31/69 -12/31/2002	Risk
Cash—Salomon 30-Day T-Bill	6.2%	0.8%
U.S. Bonds—Salomon BIG Index	9.1	5.9
Global (Ex-U.S.) Bonds — Salomon World Government Bond Index Non-U.S.	9.8	10.4
U.S. Equities —Wilshire 5000	10.6	16.4
Global (Ex-U.S. Equity) — MSCI World ex-U.S. Free Index	9.5	16.6

1970 to 1974: These first five years are trying indeed. U.S. equities underperform all other asset classes by returning -4.3%, and have the highest risk at 17.9%. Bond returns are positive at low levels of risk, but your small allocation is not enough to mitigate the damage. Your faith in your crystal ball's 30-year vision is damaged as is your current track record.

1975 to 1979: You convince your constituents that patience, disciplined philosophy and processes and a long-term perspective will pay off. The period from 1975 to 1979 sees you vindicated in two ways: U.S. equities produce strong returns (and high volatility) cash and bonds, the stars of the early 1970s, were the worst relative

Madla, from San Antonio, will return as Chairman of the Intergovernmental Relations Committee.

On opening day of the Session, the House was called to order by Secretary of State, Gwyn Shea. Their first order of business was to elect a new Speaker of the House. Tom Craddick, as expected, was elected Speaker by a 149 to 1 vote. Later in the week, the House adopted their housekeeping rules and permanent rules. Their new rules call for four new committees, bringing the total committees to 40.

Pension-related legislation will likely be referred to the Pension and Investments Committee. Its members were reduced from 9 to 7 in the newly adopted rules. Speaker Craddick is expected to announce the Chair of Pension and Investments and its committee members during the last week of January or the first week of February.

After Governor Rick Perry and Lieutenant Governor Dewhurst were sworn in on January 21, 2003, Governor Perry issued an emergency proclamation of legislation to be considered immediately by the Legislature. The Legislature can only focus on these items for the first 60 days of the Session without suspending constitutional rules by a four-fifths vote.

TEXPERS and the Committee for a Secure Retirement continue to work on

performers over this period.

1980 to 1984: U.S. equities again show favorable absolute returns. During this period, U.S. equities post a return of 14.2%, with risk of 16.0%. Interestingly, however, cash offers 77% of that return with almost no risk. Fortunately, you did not listen to those who were talking about the value of international diversification, as the risks of international investing were too high to justify the returns. During this period, international equities' risk is at 16.4%, with returns substantially below those found in the U.S. market.

1985 to 1989: Globalization is en vogue and the U.S. dollar loses value. International equities post returns in excess of 30%, and international bonds outperform U.S. bonds by almost 10%. At the pressure and urging of your board, you move some of your U.S. equity exposure into international equities, hoping to gain some diversification benefits and lever up the returns.

1990 to 1994: As you enter the 1990s, it seems that capital markets are fairly rational. Bull markets follow bear markets, and vice versa. With one exception: Your foray into international stocks turns out to be a bust. Volatility remains high overseas and returns again are barely above zero. On a relative basis, international equities were the worst place for you to be. The perils of performance chasing are once again reinforced during this period.

1995 to Present: Looking toward the 1995 to 1999 period, your priority is immediate-term liabilities due to aging beneficiaries — you decide that a higher allocation to bonds is appropriate. Despite the onset of the dot-com era, you resist the temptation to put more into equities. Voices are raised that equity allocation, specifically to technology, needs to be bolstered. Instead of shifting money between asset classes, you decide to lever up your beta slightly with growth and technology exposure near the end of the 1990s. This move proves to be unfortunate. As the technology and growth bubble bursts, value is back and bonds show their worth once again.

The evidence shows that pension executives are continually learning how difficult it can be to stick to a long-term asset allocation policy. Changes in leadership and directorship, timing of capital market shifts, advances in technology, and several other factors can sway investors from their targeted paths, despite seasoned judgment. The psychology of the market is hard to fully comprehend, and investors that attempt to precisely time the market's psychological shifts have historically met with little success.

Long-term success, however, is less elusive for those who stay grounded with an appropriate investment philosophy, and do not rely too much on the perspective of only the immediate past. Shorter time

passing a constitutional amendment to protect the retirement benefits promised public employees at their retirement. Potential bill sponsors are being sought and legislative leaders are being educated about this important legislation to public employees across Texas.

Retirees and employees of municipalities across Texas are being asked to participate in this important effort. Please consider investing your time, money and efforts in support of the constitutional amendment to protect your pension benefits.

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periods are still important, of course, and this is why wise investment management calculates and continually revises three-year historical and three-year expected returns for major asset classes. This helps in the determination of intrinsic values for all assets in the portfolio universe, and helps in the implementation of the best solutions through active management. Currently, even though many people may be shying away from equities, analysis suggests that this might be a good time to increase certain equity allocations.

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The Pension Crisis

By Ron Ryan, CPA

America is facing a pension crisis that may threaten the solvency of our corporations, cities, states and even the federal government. It appears as poor asset allocation results but the roots of this crisis lie within the actuarial and accounting rules that confuse and direct the pension industry towards equity tilted asset allocation strategies.

Asset allocation results in the last three years have been dismal. Using the Treasury STRIP curve as the generic proxy for liabilities (Ryan Labs Liability Index), and using a static asset allocation model, pension assets have under performed pension liabilities by about 68% for the last three years cumulative. (See chart below) This poor performance will result in higher contributions, potential budget problems and may even require issuance of POB (Pension Obligation Bonds) bonds or tax increases to balance current budgets.

Index	Weight	2000	2001	2002
Ryan Labs Cash	5%	6.49	4.97	1.75
Lehman Aggregate	30%	11.63	8.44	10.25
S&P 500	60%	- 9.09	-11.86	-22.08
MS EAFE	5%	-13.87	-21.11	-15.64
TOTAL ASSETS	100%	- 2.50	- 5.40	-11.41
Ryan Labs Liability		25.96	3.08	19.47
Assets-Liabilities		-28.46	- 8.48	-30.89
Cumulative Difference		-36.94	-67.73	

(NOTE: Uses Treasury STRIP curve as the generic proxy for liabilities (Ryan Labs Liability Index))

The Problem

The pension industry has been misled into believing that the pension objective is to earn a rate of return superior to the discount rate used to price liabilities. This is a mistake. The discount rate applied to liabilities is a forecast of long-term liability growth. As a result, it is a guess — a bad one. This is not how liabilities behave or grow and the idea should be corrected before it is too late. Liabilities behave like a portfolio of high-quality zero-coupon bonds whose maturities match the liability payment date and whose par values match the liability payment amount. Lotteries are a good model here as they buy only government zero-coupon bonds to match their liabilities yet we never hear of any lottery deficits. Since pension liabilities tend to have average lives of 10 to 15 years, they will behave like a 10 to 15-year average duration zero-coupon bond portfolio. This means they are highly interest rate sensitive. If interest rates move up or down 100 bps in a year on an average duration of 10 years, liability will grow by -5% to +15% (i.e. price return + income return) and not the discount rate used on liabilities. Until liabilities are priced at the market, pensions will never know the true growth of liabilities.

The companion problem to the discount rate is the Return On Asset (ROA) assumption. This is once again a forecast of the returns on all assets as a portfolio. This is some achievement — to forecast the returns on assets a year in advance for all asset classes. Naturally, such forecasts are false. In an attempt to reduce the volatility of these erroneous forecasts, smoothing is used between the actual results vs. the forecast. Such difference is then amortized over the life of the plan (@15 years). With 9% ROA forecasts common over the last three years, the return on asset difference vs. the market return is -46.31% which is now being amortized as an annual actuarial loss.

The Solution

Until pension assets and liabilities are priced at the market, you will never know the true economic growth and behavior differences. Since each pension fund has liabilities unique to its plan, a Custom Liability Index should be required as the proper benchmark for liability growth and for asset classes to fund. To outperform the S&P 500 but lose to liabilities is a loss. Until assets and liabilities connect, there is no relative performance measurement that can be achieved. The shape of liabilities, as measured by a Custom Liability Index, would be the foundation of asset allocation such that percentage in long assets matches the percentage in long liabilities —same for short and intermediate assets.

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