

T H E T E X P E R S



# PENSION OBSERVER

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## **International Style Diversification**

*By Robert A. Gillam, CFA*

### **An Analysis of Correlations**

Growth and Value Style investing was originally developed for U.S. equities in the 1970s. Although the concepts have been around for over 30 years, they have only been widely used in asset allocation for the last ten to twelve years.

Style investing gained favor as investors found opportunities that could be exploited by allocating to different asset classes within an overall strategic asset allocation plan. During that same time frame, as the U.S. markets became increasingly segmented by style, the international markets did not for a number of reasons. First, the overriding issue for international managers was whether or not to underweight Japanese equities in their portfolio. Even though Japan was a large weight in the benchmarks, Japanese securities performed poorly on a relative basis.



Managers could outperform simply by

## **Manager of Partners Programs**

*By Charles H. Wurtzbach*

### **Identifying Unique Real Estate Investment Opportunities**

The substantial decline of equity market valuations from 2000 to 2002, in addition to the modest level of bond yields, has led many institutional investors to temper their long-term return expectations for these assets and to re-evaluate their portfolio allocations. Real estate's attractive risk-adjusted returns, diversification benefits and ability to deliver solid distributable cash flow returns have heightened interest in property investments.

The current low-cost debt environment has resulted in an influx of private investors into real estate markets. The abundance of equity and debt capital in the marketplace has created an extremely competitive acquisition environment, with multiple bidders pursuing quality core investment opportunities. The low interest rate environment and readily available financing offers a degree of flexibility in aggressively pricing assets. Buyers utilizing debt often have the upper hand in acquiring properties in the competitive bid process and all-cash buyers tend to be priced out of the market.

*Acquisition opportunities that are below the radar, and therefore are not being*

Although fundamentals and competition suggest a challenging environment, real estate does, and will continue to, provide attractive investment opportunities, albeit with lower total return expectations than has

underweighting Japan in their portfolio. In other words, why bother with the idea of diversification when one is outperforming? The second reason for the lack of style diversification was the extreme concentration of many smaller markets. Determining value and growth representation in a market where the largest stock makes up almost 50% of the country benchmark seems an improbable idea. Third, style indices, although accepted in the U.S., were neither well known nor generally available for the large international universes. Why bother with style investing if there is no readily available means to determine if the manager is doing a good job? With little benefit to be gained by differentiating between international styles, pressure to do so was largely absent from the money management and consulting communities.

The contention of this writer is that many of the reasons for the lack of attention to style investing in the

*...as the U.S. markets became increasingly segmented by style, the international markets did not for a number of reasons...*

international markets are no longer valid. First, there is a greater emphasis on cross-border stock comparison as opposed to country-by-country investing. If one is investing in General Motors, it is now as important to understand how GM compares to Volkswagen in

been the case in recent years. As a result, while yesterday's real estate investor looked to the open market for investment opportunities, today's investor must increasingly look beyond traditional acquisition methods for better risk-adjusted returns.

Acquisition opportunities that are below the radar, and therefore are not being pursued by multiple parties, are gaining in popularity. Institutional investors typically have preferred to partner with large, well-established operators. The investor provides the operator with an efficient, reliable source of capital in exchange for access to the operator's current and future investment pipeline.

While offering some advantages over open-market acquisitions, certain characteristics of these ventures are not optimal for some institutional investors, including the significant commitment of capital that is commonly required. In addition, as more investors are seeking structured relationships with a limited number of major real estate operators, these operators can be selective in establishing partnerships with institutional investors.

Dissimilar objectives of the parties can also create difficulties in establishing and maintaining a relationship. If the objectives of the organizations are aligned at the formation of the venture, they may diverge at a future time. So, exit strategies are a critical component to structured relationships.

An alternative to traditional large-scale partnerships is building relationships with established niche or specialty real estate operators. This allows investors a degree of exclusivity in accessing current and future investment flow and to benefit from the expertise of the operator and the opportunity for more attractive risk-adjusted returns. While identifying and analyzing prospective partners can be a difficult and resource-intensive process, accessing these opportunities through an investment management organization with a formal manager of partners program helps mitigate these concerns. A manager of partners program combines the specialized, entrepreneurial skills found in smaller real estate operating companies with the discipline and structure of larger institutional investors through the identification, underwriting and management of unique investment opportunities.

### **Partnering with Smaller-Scale, Niche Operators**

Germany as it is to its U.S. peer, Ford. The growth or value classification GM might receive in the U.S. would likely be the same as that of its counterparts overseas. Second, international managers are beginning to advertise themselves as disciples of one style or the other. Third, more international companies are becoming shareholder friendly. Better disclosure on a more frequent basis supports the effort to ascertain value and growth characteristics. Finally, the increasing global popularity of participant directed (401k-type) retirement programs have resulted in higher levels of investor sophistication and awareness of Style investing.

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Ideal candidates for these ventures are established firms in the growth stage of their business plans, with a demonstrable competitive advantage in their core business and a track record of consistently delivering stated return goals. They have strong, stable management teams with long-term commitments to the firm, solid financials and excellent growth potential. However, they lack the stable source of capital that is necessary for the continued growth of the firm.

Relationships with these smaller firms offer exclusive access to early stage projects. In exchange for a stable, more efficient and less costly source of capital, investors receive a degree of exclusivity in accessing current and future projects, the expertise of the operator and the opportunity for better risk-adjusted returns.

In the past, investors have avoided relationships with these smaller operators due to the difficulty in identifying, underwriting and managing multiple prospective candidates. Participating in a well-developed manager of partners program can greatly reduce this concern, with an assurance that both the investment opportunity and the potential partner are thoroughly evaluated through in-depth analysis. These investment opportunities offer an appropriate risk-adjusted return and the interests of the investor and the real estate operator are clearly aligned.

*Charles H. Wurtz bach is Managing Director at Henderson Global Investors in Chicago, Illinois.*

[Back To Top](#)

- Page 2 -

## **Washington Outlook**

*By Matt Aukofer*

### **Greenspan Stirs Hornets' Nest in Suggesting that Social Security Pay for Swelling Budget Deficits**

## **President's Corner**

*By Randy Stalnaker*

Texas public pension plans have been in the news a lot lately. I follow, with the help of others, what's in

Federal Reserve Board Chairman Alan Greenspan's recent suggestion that Social Security benefits should be cut to help pay for spiraling budget deficits unleashed a firestorm of dissension, mostly from the political left but also from mainstream groups.

Greenspan, an unelected official who wields immense power, occupies a position that traditionally is nonpolitical. But his remarks were seen largely as an endorsement of a conservative agenda.

Greenspan, who supports the Bush administration's efforts to make permanent the president's recently enacted tax cuts, suggested that the tax cuts should be paid for by cutting the guaranteed benefits of Social Security.

Specifically, Greenspan called for raising the eligibility age to over 67 for people to receive Social Security benefits, as well as slowing the rate at which benefits are adjusted for inflation.

Raising the eligibility age would make fewer Americans eligible for benefits each year. Today, roughly one in six Americans receive a Social Security benefit, or nearly 45 million people altogether. Nine out of 10 individuals age 65 and older receive a Social Security benefit.

Greenspan, who called for the cuts during testimony to the House Budget Committee, said Social Security is over-obligated for the future and that some models show it becoming insolvent by the middle of the century. President Bush stated that his position on Social Security benefits is that they "should not be changed for those at or near retirement." The president did not give specific details of his plan. A group of 15 Democratic senators sent a letter to President Bush urging him to repudiate Greenspan's remarks and commit to protect the benefits for future generations. The president has not responded to the letter.

"Social Security is the last place we should be looking for savings—not the first," said Sen. Jon Corzine (D-N.J.), one of the signatories. "Over the next 75 years, the Bush tax cuts, if made permanent, will cost more than three times the entire Social Security shortfall. It is simply wrong to claim that we can afford huge permanent tax breaks for the most fortunate among us, but we can't afford to honor our commitment to America's seniors."

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many newspapers in Texas as well as on television and I don't recall any period when so many plans across the state have received so much coverage.

Unfortunately, most of the recent coverage hasn't been the kind we like to get. That so many pension plans are unfounded has received a lot of attention. This includes a very inaccurate and damaging article that appeared in the Dallas paper about my fund.

Whenever negative press appears about any public pension plan in Texas, it affects us all. The public tends to use a broad brush so when they hear about one fund's problems, they tend to apply it to every fund. Consequently, it is in our best interest to be supportive of each other in times of difficulty and to always speak well of any Texas public pension fund.

How can you deal with the current spate of publicity? Like any good Boy Scout would do—be prepared.

First, arm yourself with some facts so that you're ready when the reporter calls. If you can't provide the reporter with facts, he or she will fill that void with information that may be very unflattering to your fund. Have facts at hand to give the reporter

Though the average recipient receives only \$900 per month, Social Security keeps many seniors out of poverty. "Some believe that \$900 per month is too much to promise America's seniors. We disagree," Corzine said.

While critics suggest an impending crisis in the program, the Social Security Trust Fund is actually projected to remain solvent until 2042. In other words, while the rest of the government is running huge deficits, the Social Security system is currently taking in more money than it spends. The reason? During the 1980s, the Greenspan commission persuaded Congress to increase the payroll tax that supports the program. Now that Social Security is flush, it is being targeted as the source for balancing the deficit.

"Greenspan was asked to give reasonable economic policy advice to Congress," said Rep. Dennis J. Kucinich (D-Ohio), who ran an unsuccessful bid for the Democratic presidential nomination. "Instead, he advocated a policy of intergenerational theft, passing on the burden of this administration's fiscal irresponsibility onto future generations." Kucinich, who called for Greenspan's resignation due to his remarks, said Greenspan's idea to increase the Social Security retirement age "will put the threshold for full benefits on an escalator that will slash the value of Social Security benefits for certain racial and ethnic groups because their life expectancies do not increase at the national average life expectancy."

Targeting Social Security funds to fix future budget deficits that are unrelated to the program is "irresponsible," AARP CEO William D. Novelli said. "Social Security is designed as a self-sustaining program, and should be strengthened to ensure its long-term solvency. Social Security should not be a resource for negotiators over the federal

budget deficit. In fact, Social Security's own growing surpluses currently make the deficit in the rest of the federal budget appear smaller.

Because Americans are not saving enough for retirement, and because nearly half of all working Americans have no pension coverage, future retirees need the guaranteed, inflation-protected benefits of Social Security, Novelli added.

"AARP favors a balanced approach to reaching future solvency for Social Security. But simply cutting benefits ignores the retirement picture for most current and future retirees and would be unfair to boomers and younger workers, pulling the rug out from under their retirement security," he said.

*Matt Aukofer, journalist and consultant, is based in*

when that call comes.

For example, in Wilshire Associates' most recent report on the funding levels of state pension plans, they found that 93% of them are underfunded!

Underfunding is now the rule for public pension plans, not the exception.

You should learn your fund's funding level and its trend over the last several years. Most plans are underfunded because of three years of stock market losses, something that hadn't happened in 60 years.

Be ready to talk about your fund's approach to investing. Know the asset allocation and why your board adopted it. Tell the reporter how you established it with managing risk in mind.

The reporter may also ask you about your fund's benefits. My suggestion is that you prepare yourself to discuss how they are reasonable and proper for your organization.

I keep a folder next to my phone that contains a list of "headlines" that I want to convey to any reporter about my fund. I hope that by doing so I won't ever be caught off guard or forget important points that I need to make.

Washington, D.C.

By following these steps, the publicity we receive may prove beneficial rather than harmful.

[Back To Top](#)

- Page 3 -

## State Capitol Report

By Neal T. "Buddy" Jones

The 2004 Democratic Primary election provided some real surprises in Texas House primary races. Five Democratic incumbents were defeated and two more face runoffs after trailing in the first election.

Three valuable Democratic committee chairmen for Republican Speaker Tom

Craddick were chastened for their bipartisanship during the 78th Legislative session. Ron Wilson, chairman of the powerful House Ways and Means Committee, lost his race with State Board of Education member Alma Allen by a 56-44 percentage margin.

Glen Lewis, chairman of the House County Affairs Committee, lost to Marc Veasey, a former aide to Congressman Martin Frost by a 54-46 percentage margin. Jaime Capelo, chairman of the House Public Health Committee, narrowly failed to make the runoff in a 3-person race. Miguel Wise, from Weslaco, and Timoteo Garza,

## Equity Pullback, Dollar Strength a Buying Opportunity

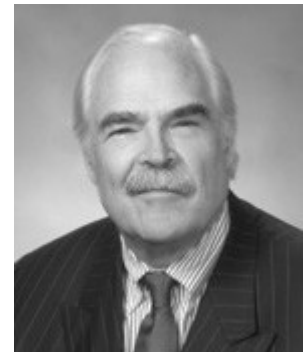
By J. Thomas Madden, CFA

### Model Portfolio Has Increased International Equity Exposure

March was a month for anniversaries. Four years ago the Nasdaq hit an all-time high. And one year ago an uncertain equity market pulled back as coalition forces launched an offensive in Iraq—an offensive that ultimately brought down Saddam Hussein and whose aftermath triggered a memorable stock run-up.

But more recently, equities have been wobbly in the face of concerns over geopolitical risk and economic slowdown. In fact, stocks pulled back significantly in mid March, sending the Dow and Nasdaq into negative territory year to date. The dollar strengthened. And bond prices moved up. The Madrid terror attack sent stocks lower again as gold rallied along with Treasuries.

Notwithstanding all of that, some managers increased the equity weighting and reduced bond exposure in diversified global asset allocation models. We also added two percentage points of exposure to international stocks, trimming two points from domestic



from Eagle Pass, are other incumbents defeated in the March 9th Primary.

Two other Democratic incumbents, Roberto Gutierrez and Gabi Canales, face runoffs after trailing in their first primary race.

Only two Democrats who were targeted for working with House leadership in the last session survived primary challenges. Allan Ritter, from Nederland, chairman of the House Pensions and Investments Committee, defeated former State Senator David Bernsen by a 56-44 percentage margin. Representative Dan Ellis, from Livingston, defeated his opponent by a 60-40 percentage margin.

All of the Democrats with serious primary races, except Canales and Wise, saw their opponents heavily financed by Texas trial lawyers and the Democratic Party itself. Back when Democrats controlled the Texas House and Republicans cooperated with the Democratic leadership the Republicans might be opposed by far right opponents with strong philosophical differences but never by the Republican Party itself.

It now appears that party leaders will not take kindly to bipartisanship.

In the Republican Primary all House and Senate Republicans were easily re-nominated to run in the general election. All Democratic Senators were also easily re-nominated in their party's primaries.

Many people involved in politics in Texas are expecting Governor Perry to call a special session in early April. This special session is expected to deal with education reform and possible new taxes to pay for this reform. Many

investment grade bonds.

### **Don't buy into the gloom**

Why not? Start with job growth, widely cited as the cause of the mid March equity decline. The slow pace of hiring is a concern, but is likely a temporary phenomenon. In fact, the recent jobless report recorded only 341,000 new claims— well below the sub-400,000 level usually associated with a strengthening labor market. Claims have been in that favorable range since the beginning of the year.

Many believe the second half of 2004 will be stronger than the first half, buoyed by better capital spending. Job creation is likely to accelerate as businesses ramp up purchases of new equipment and facilities. In the meantime, pressure for higher wages is low. Stable labor costs and high productivity further boost corporate profits. And they mute inflationary pressures, probably extending the recovery and delaying the next round of Federal Reserve rate increases.

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What about bonds?

Large-scale purchases of bonds drive up bond prices. And March's large purchasers seemed to be other central banks, attempting to protect their export markets. When the dollar weakens, foreign firms tend to get hurt. A weak buck makes the local prices of U.S. goods cheaper overseas, even as it raises the prices of foreign imports to Americans. By propping up the dollar, the central banks of some nations hope to shore up the competitiveness of their own industries.

### **Hedge the weak dollar with international equities**

Barring a change in the fundamental causes of dollar weakness, such intervention is unlikely to be effective in anything but the short term. Those fundamentals include

current legislators ran on a platform to do away with Texas' much maligned "Robin Hood" system in which property rich school districts are required to take part of their collected ad valorem taxes and give them to poorer districts.

No solid agreement has surfaced on how to pay for the education reforms. While a state income tax seems to be off the table other revenue raisers, such as a business activity tax, expansion of the sales tax, and an increase in the present sales tax, have all been discussed as possible revenue sources. Increases on all sin taxes, such as cigarettes, beer, and liquor, are also being strongly discussed. Another revenue source being considered is to allow slot machines at Texas horse and greyhound tracks.

It will be interesting to see what comes out of a special session. Legislators and their leaders will continue to work towards an agreement on how to increase revenues for education reform which will be essential for the special session to be successful.

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a massive U.S. trade deficit and a federal budget bleeding red ink— conditions virtually everyone thinks will continue. As if to underscore the point, the Bureau of Economic Analysis and Census Bureau reported a record \$43.06 billion trade deficit in January.

The outlook for long-term dollar weakness was a major factor in the decision to increase international stock exposure in some portfolios. In addition, relative to their U.S. peers, overseas equity valuations are quite low. Some of those portfolio changes were made prior to the terrorist train bombing in Spain. As noted before, such events—horrific as they are—have the ability to move markets. However, that ability tends to have little staying power.

Where equities are concerned, the market was due for a correction given the massive run-up of 2003. And, exacerbated by the terror event, that's what appears to be occurring. As my colleague, equity trader Dave Briggs, told the Wall Street Journal, the mid March market action could be "setting up a nice little trading opportunity."

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[Back To Top](#)

## **Has Recent Outperformance Blunted the Emerging Markets' Edge?**

*By Henry S. D'Auria*

During a sharp global rebound from the three-year-long bear market for equities, emerging markets have rallied nearly twice as much as developed markets. In 2003, the MSCI EM Index gained 56%, compared to the 33% gain for the MSCI World. Given the magnitude of their out performance, it is natural to wonder



whether there is still significant potential for emerging markets to outperform.

Analysis suggests that fundamentally, the emerging markets continue to be more attractive than many developed markets, and their relative valuations—despite the rally—remain compelling.

The key to the emerging markets' continued attractiveness is the strong earnings growth of the past few years. Following the collapse of the emerging-markets bubble in 1997, companies in the emerging markets were forced to generate cash flows for investment internally rather than rely on foreign investors. The result was a reduction in debt and increased focus on profitability that has paid off handsomely: Debt levels are down and profitability is up as emerging-market firms restructured. (Chart A)



Since the emerging-markets bubble burst three years before the tech bubble in developed markets, widespread restructuring began earlier in the emerging markets. As a result, emerging-markets companies in aggregate have higher profitability than their developed-market counterparts. Consensus earnings estimates for

And yet, the valuation discount of emerging-market equities relative to developed-market equities on a price-to-earnings basis remains quite large. The gap has closed somewhat from the record lows seen over the past two years, but emerging-market equities are still selling below their long-term relative discount. (Chart B)



Bottom up investors, however, focus primarily on finding compelling opportunities in individual stocks. Our research has uncovered a number of companies with strong earnings outlooks selling at attractive valuations, such as Taiwan's Compal Electronics.

One of the world's leading notebook assemblers, Compal has positioned itself to benefit from two trends: the increasing popularity of notebook computers relative to desktop machines and the increasing consolidation of the assembly business. Although overall unit growth for PCs is expected to be only about 8% this year, unit growth in notebooks is much higher at approximately 20%. With its strong design capabilities and economies of scale, Compal is expected to outstrip the industry with unit growth for notebooks of nearly 40% this year. Its rapid growth has not been at the expense of profitability: Compal's return on equity is in excess of 20%. Despite its strong earnings growth and exceptional profitability, the company's valuation is still slightly below the average for the global technology sector.

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2004 suggest an average return on equity of 14.6% for emerging-market firms versus 12.7% for developed-market firms.

*AllianceBernstein in New York, New York.*

[Back To Top](#)

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### [Back to Publications, Reports, Surveys, Resolutions & Code of Ethics List](#)

[Return to Home Page](#) ● [TEXPERS' History](#) ● [The Board of Directors](#) ● [Administrative Staff Profile](#) ● [Membership in TEXPERS](#) ● [Directory of Associate Members](#) ● [Directory of Retirement Systems and Group Members](#) ● [Associate Advisors and Associate Members' Websites](#) ● [Pension System Members' Websites](#) ● [Association Business Page](#) ● [Website Links for Retirees](#) ● [Comments or Inquiries](#) ● [Education](#) ● [Calendar of Events](#) ● [Links to Financial & News Sites](#) ● [Links to Federal Government Sites](#) ● [Links to State Government Sites](#) ● [Link to 'Coalition to Preserve Retirement Security' Site](#) ● [Publications, Reports, Surveys, Resolutions & Code of Ethics](#)

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