

T H E T E X P E R S



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TEXPERS Board Addresses Critical Issues

By Randy Stalnaker, President of TEXPERS

TEXPERS has a significant history of addressing timely issues of importance to Texas public pension funds. Since its inception, TEXPERS has used its unique position to identify issues facing public pension funds in Texas (as well as nationally), harnessing scholarly and industry resources which subsequently develop insightful reports and recommendations concerning how those issues may be meaningfully and practically addressed.

Today public pension funds in Texas are faced with a number of serious challenges, thus it is incumbent upon TEXPERS to find ways that our member systems can deal with them effectively. By doing so, each funds' members and beneficiaries can continue to have the financial security that the pension funds seek to provide.

Accordingly, as president, I have decided to establish three committees composed of members of the Board of Directors to address

Are TIPS Always Tops?

By John Hyll and Dan Fuss

Of late much has been written extolling what many perceive to be then unparalleled virtues of Treasury Inflation Protected Securities, often referred to as TIPS. The U.S. Treasury issues TIPS, typically in 10-year maturities. Like all Treasury-issued securities this means repayment is backed by the full faith and credit of the federal government. What differentiates them from other Treasury securities is that the principal value of TIPS is periodically adjusted for inflation, as measured by the Consumer Price Index or CPI.

A fixed interest rate is paid on the adjusted amount. At maturity, if inflation has increased the value of the principal, the investor receives the higher value. If deflation has decreased the value, the investor still receives the original face amount of the security.

Sounds like a good deal? Perhaps.

We believe TIPS are attractive from a long-term, strategic point of view, given the expected change in secular inflation trends. However, from a tactical standpoint, TIPS are currently richly priced, as measured by very high breakeven rates.

With our forecast for continued low inflation and expectation that oil prices may decline, we believe it is too early to establish large positions in inflation-protected securities. (See chart)

what I see as the most serious of these issues. Each committee has been issued a mission statement. It is intended that each committee will complete its work by the end of 2004 so that resulting reports may be used during the upcoming session of the Texas Legislature. Issues are as follows:

Deferred Retirement Option Plan (DROP) Issues

DROPs have recently come under attack from a number of directions. The funds that have DROPs consider them an important component of their benefit structures. This committee will develop a concise packet of information that will be of assistance to public pension plans that have or are considering adding DROPs, for use in justifying them as benefits. The invited members of this committee are: Steve Shaw, Dallas Police & Fire Pension System, Chair and Paul Brown, Big Spring Firemen’s Relief & Retirement Fund.

Plan Funding

The funding of Texas public pension plans has received a great amount of publicity recently. The poor investment markets that occurred in the early part of this decade and actuarial issues have hurt many plans. This committee will survey the actuarial funded status of Texas public pension plans, research and catalog approaches to addressing underfunding, and develop a report that includes a set of recommendations that can be used by underfunded plans. The invited members of this committee are: Brady Edwards, Lower Colorado River Authority, Chair; Larry Doss, Houston Police Officers Pension System; Mike Curran, MTA of



A Strong '03

Inflation expectations began to build in the market, due to the large amounts of both fiscal and monetary stimuli. Yet, judging by the actual results displayed in the chart on page 9, to date bondholders had little to fear from inflation. Still, the yield curve was very steep, traditionally signaling a stronger economy ahead and higher inflation. As investors began to look for ways to protect their fixed income portfolios from a potential rise in inflation, TIPS became a viable option as they have now been around since 1997, giving investors a track record to analyze. At just \$223 billion, the market is relatively small compared to other fixed income sectors, though, and the rise in demand may have overwhelmed available supply, bidding up prices and boosting overall total returns.

U.S. TIPS	+8.4%	U.S. Treasuries	+2.3%
1-10yr TIPS	+7.1%	1-10yr Treasuries	+2.1%
10yr+ TIPS	+11.9%	10yr+ Treasuries	+2.5%

Too Early, Too Expensive

Given our forecast for inflation to remain very low both this year and next, we believe there are better total return opportunities available in other sectors of the fixed income market at this time. Further support for our argument can be found by looking at the close relationship between the breakeven rate on TIPS and the price of crude oil. Research shows a 0.62 correlation between the two. If oil prices fall and inflation remains low as we anticipate, then TIP returns are likely to be disappointing. The securities could cheapen, providing a better entry point. Another consideration is the growth in Treasury financing needs from the federal budget deficit. With their low coupons, issuing TIPS is a cheap source of funding. Increased supply might move supply and demand into better balance, easing upward pressure on valuations. At the same time, inflation fears may ease as the Federal Reserve begins to hike rates.

Harris County; Fred Holmes, Houston Municipal Employees Pension System; and Kendall Thomas, Austin Police Retirement System.

Retiree Health Benefits

The provision of health benefits to beneficiaries of Texas public pension plans at a reasonable cost is our local aspect of the national debate now going on regarding how to provide affordable health care to older Americans. Having an adequate pension annuity is of little comfort to a retiree if it all must be spent on health care. TEXPERS recently completed a comprehensive survey on health care benefits provided through Texas public entities.

The mission of this committee will be to assess the current state of health care benefits provided to retirees and beneficiaries of Texas public pension plans, review existing laws and develop a report that includes recommendations for use in assuring health care that is affordable to retirees. The report will be for use by TEXPERS member funds, employee and retiree associations and plan sponsors. The invited members of this committee are: Barbara Chelette, Houston Municipal Employees Pension System, Chair; John Davis, El Paso Firemen and Policemen's Pension Fund; and Larry Reed, San Antonio Fire and Police Pension Fund.

In addition, any TEXPERS member may volunteer to be a member or resource to the committees. If you are interested in assisting a committee, please contact Judy Jones at the TEXPERS office.

The demand for TIPS may fade as the yield curve flattens. From a tactical perspective, we believe we may have a better opportunity later to buy TIPS under these scenarios. TIPS can be volatile. If purchased and held to maturity, TIPS investors will receive income plus inflation protection, but in the interim period, investors are subject to price appreciation or depreciation, just like any fixed income security. If an investor has to sell their TIPS prior to maturity, any inflation protection s/he may have gained could be lost. Moreover, TIPS tend to have longer cash flow duration than nominal U.S. Treasuries. As real yields decline, which they have in the past year, TIPS can and have exhibited more volatility than nominals at times.

Inflation Likely Higher

In broad terms, the years following WWII up until the late 1970s were a reflationary period while the years since have been disinflationary. The average inflation rate during the 1950s-70s was roughly 3 percent. If we thought inflation was going to return to that level, then TIPS might be an appropriate strategy; particularly with 10-year TIPS as their current breakeven rate is 2.5 percent. Longer, 30-year TIPS currently have a higher breakeven rate of 2.9 percent, making the transaction less compelling. While we believe disinflationary forces have just about run their course and that the next decade will bring higher inflation levels, we are not concerned that inflation is about to move rapidly higher, thus we are taking a measured case-by-case approach toward adding TIPS to our portfolios. Our decision on when and where to use TIPS, like any fixed income security, is based on our market views and the specific needs and risk tolerances of each of our clients.

Breakeven rates are the difference in yield between TIPS and nominal (or traditional) Treasuries. If inflation rises above the breakeven rate, then an investor earns a better return by holding TIPS. If inflation rises less than the breakeven rate, then an investor is better off in nominals.

John Hyll is Vice President & Portfolio Manager; Dan Fuss is Vice Chairman & Portfolio Manager at Loomis, Sayles & Company, L.P. in Boston, MA.

In accordance with TEXPERS bylaws, as president I will be an ex officio member of each committee. I am looking forward to these committees reports and am sure they will prove to be of significant benefit to us all.

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Washington Outlook

By Matt Aukofer

Democrats, Republicans Use Social Security Trustees' Report to Their Own Advantages

As could be predicted, members of Congress politicized the Social Security and Medicare Trustees' report issued this spring, with Democrats using it to assail the Bush administration's tax cuts and Medicare overhaul and Republicans using the report to bolster their calls for privatizing Social Security and creating personalized accounts.

The 2003 report officially projects that Social Security will become insolvent in 2042 and that the program will pay out more in benefits than it collects in taxes in 2018. Medicare's insolvency date is now 2026, but the program's expenditures will exceed tax receipts in 2010 - three years earlier than in last year's report.

Every year when this report is released, policymakers say they will fix these problems ... after the next election, said Rep. Jim DeMint (R-S.C.), a leading proponent of individual accounts, in remarks at the National Center for Policy Analysis. It's time we start legislating for the next generation, not the next election. The looming bankruptcy of Social Security and Medicare is now on Congress' doorstep.

Following the release of the trustees' reports, the Democratic staff of the Joint Economic Committee released a report, *Keeping the Social Security and Medicare Trustees' Reports in Perspective: The Administration's Tax and Spending Policies*

President's Corner

By Randy Stalnak

It was the best of times. It was the worst of times.

While I purloined these words that were written by Charles Dickens more than 150 years ago, they accurately describe the situation in which Texas public pension funds find themselves today. Last year we were successful in passing a badly needed state constitutional amendment protecting earned public pension benefits. Passage of the amendment was accomplished through the coordinated, persistent effort of many dedicated individuals from all around the state and resulted in truly the best of times.

Unfortunately, largely due to some adverse publicity and well financed campaigns, several Texas cities in May voted to opt out of coverage by our constitutional amendment. Opting out leaves the members

Are the Real Fiscal Crisis. The report estimates that the revenue loss from permanently extending the Bush tax cuts enacted in 2001 and 2003 is comparable to the estimated 75-year shortfalls in the two programs combined.

Instead of preparing for the retirement of the baby boom generation, the Bush administration squandered a \$5 trillion surplus and has pursued a reckless policy of tax cuts for the wealthy that have created crippling budget deficits, said Rep. Pete Stark (D-Calif.), senior Democrat on the Joint Economic Committee (JEC). Clearly, President Bush would rather give tax cuts to people who don't need them, than provide retirement and health care security for our seniors.

Surpluses in Social Security and the Medicare Hospital Insurance (HI) program have been used to finance President Bush's tax cuts, Stark said, thus increasing the federal debt and adding to the financial burden that will be passed on to future generations. Moreover, Social Security and Medicare surpluses will be used to meet general government expenditures over the next 10 years, he said.

Permanently extending President Bush's tax cuts will severely undercut our ability to ensure the long-term fiscal stability of Medicare and Social Security, Stark said. President Bush's policies have eroded, not improved, the solvency of Medicare and Social Security.

DeMint said Congress' 10-year budget projections must account for the impending bankruptcy of Medicare, and, in the very near future, the bankruptcy of Social Security. Congress will soon be forced to cannibalize other programs funded by general revenue funds, possibly including programs like education, veterans' benefits, and homeland security, to fund Medicare and Social Security, DeMint admitted. The time for reform is now.

Treasury Secretary John Snow used the report to bolster the administration's case for privatizing Social Security. Personal accounts are an important part of the solution to strengthen Social Security as they will enable younger workers to accumulate a nest egg towards their retirement needs, he said in testimony before the House Committee on Ways and Means.

Secretary of Labor Elaine L. Chao echoed this sentiment. All of us need to work together to look at ways to increase the solvency of these funds, she said in a prepared statement. For Social Security that includes improving benefits, such as giving workers the option to invest a portion of their wages in personal accounts.

and retirees of the local public pension funds in these cities at risk of having their benefits reduced or eliminated. I think we can all agree that would be the worst of times.

The logical question to ask at this point is - what should we do now? I think the next couple of years will be critical to the continued survival of public pension funds in Texas in their current form and governance. Our funds are at risk of attack from a number of different directions and in several different venues. There are powerful forces in the state that would like to assume control of our funds and restructure their contributions, benefits, boards, staffs and investments.

TEXPERS, and all of its members, must be prepared to act in concert to defend our plans, protect the benefits that generations of members have worked to establish and preserve the inclusive and democratic governance that has proven to work so well.

I urge you to take several actions:

Develop and maintain an effective relationship with your governing body (mostly city councils) and members of the state legislature.

Take a look at your fund to see where you might be vulnerable. Develop a plan of defense to compensate for those vulnerabilities.

But Rep. Sherrod Brown (D-Ohio) said the worsening numbers show the administration's policies are out of touch with reality. The worsening Medicare budget outlook shouldn't come as any surprise to the President, he said in a prepared statement. He pours gasoline on Medicare, then yells fire.

The Bush administration low-balled their estimates of the Medicare drug bill by more than \$100 billion, he added. They are lavishing subsidies on private insurers, even though that costs taxpayers more. They are blocking efforts to negotiate for lower drug prices, even though that costs taxpayers more.

DeMint disagreed with Federal Reserve Chairman Alan Greenspan and others who said that Congress would need to cut benefits to prevent the bankruptcy of either program.

Congress can still save both of these programs without cutting benefits or increasing taxes if we slow the growth of government spending and enact reforms that promote individual ownership, DeMint said. Yet, every year Congress hesitates, the cost of reform increases exponentially.

But Rep. Robert Matsui (D-Calif.) said the administration's proposals to privatize Social Security would cost trillions of dollars to finance and would hasten the date when Social Security will no longer be able to pay full benefits by more than two decades.

The true threat to Social Security is those who advocate private accounts without acknowledging the tradeoffs involved, he said. Privatization makes the financial challenges facing Social Security worse and requires steep cuts in benefits. Those who suggest that privatization solves the problem are misleading the American public.

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

- Maintain an open line of communication with your fellow trustees and staff members, other Texas funds and TEXPERS.
- Develop and maintain an effective relationship with your governing body (mostly city councils) and members of the state legislature.
- Take a look at your fund to see where you might be vulnerable. Develop a plan of defense to compensate for those vulnerabilities.
- Maintain an open line of communication with your fellow trustees and staff members, other Texas funds and TEXPERS. To be successful, we must all be able to keep up with the situation and coordinate our efforts.
- Be committed to taking prompt and effective action when the time comes. The best intentions are of no use unless accompanied by action.

What we have built - both in benefits and governance - is well worth saving. We can preserve the important foundation of our members' financial security that Texas public pension funds represent with thoughtful, diligent and coordinated efforts.

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State Capitol Report

By Neal T. "Buddy" Jones

The Texas House and Senate were called into a Fourth Special Session in April by Governor Perry. They were asked to pass legislation addressing school finance reform, funding for this reform, and to give Texas taxpayers property tax relief.

On May 14, 2004, the Lieutenant Governor and Senate leaders threw in the towel and announced they were unable to reach any consensus on the school finance reform and funding for this reform. On May 17, after both Houses had adjourned sine die, the Governor, Lieutenant Governor, and Speaker held a press conference and announced they would continue efforts to pass legislation.

They announced they were forming two working groups made up of equal numbers of House and Senate members. One group is charged with looking at school finance issues and the other group is to examine funding mechanisms to provide funds for education reform and property tax cuts for Texas taxpayers.

Both working groups have been meeting regularly. Neither

Global Real Estate Securities - An Opportunity for Diversification

By Lori A. Pachelli

In the aftermath of the long bear market and corporate scandals that unsettled so many investors, many plan sponsors are reviewing investment offerings that maximize diversification benefits to their investors. Real Estate Investment Trusts or REITs have become a popular option when considering their potential for diversification, income and long-term capital appreciation. REITs are publicly traded companies that own and operate commercial real estate including malls, shopping centers, office buildings, apartment buildings and industrial facilities. Under a U.S. REIT structure, a company does not pay taxes at the corporate level provided it pays out a minimum of 90% of its earnings as a dividend.

This unique pass-through structure has resulted in competitive total return over time and a stable dividend yield. But, did you know that the REIT structure is being adopted around the world?

Opportunity to Invest in a Broader, Growing Universe of Companies
The global universe of public real estate companies, as represented by the S&P Citigroup World Property Index, is nearly twice the size of the U.S. real estate securities universe, opening a significantly wider breadth of investment opportunities compared to a U.S.-only REIT portfolio. Currently, 70% of the global real estate company universe consists of REIT and REIT-like structure companies. More countries are expected to convert to the REIT structure including Hong Kong and the United Kingdom, which recently began moving toward adopting the REIT structure for public real estate companies.

The size of the universe has grown significantly in the last decade, but still only approximately 10% of the world's commercial real estate is owned by public companies, according to Prudential Real Estate Investors and UBS estimates as of March 31, 2004. The growing acceptance of tax-efficient corporate structures, like the U.S. REIT, around the world could potentially spur further growth of public companies and may potentially increase average dividend

group seems close to any agreement. Doing away with the current Robin Hood system of school finance seems to be the main point of agreement of most of our Texas legislators. How to fund a new system and provide meaningful property tax relief is the toughest issue for the legislature to solve.

It remains to be seen if sufficient progress can be made so a Fifth Special Session can be called. Many observers believe agreement will not be reached and the school finance issue will not be dealt with until the next regular session in January.

Only a handful of cities chose to hold an opt-out election of the constitutional amendment passed in 2003, guaranteeing pension rights for public employees. The City of Houston was the most notable city opting out of the provision.

With the city facing severe budget shortages, Houston's new mayor made changing pension benefits previously granted to its public employees a highly visible issue. Citizens of Houston overwhelmingly supported the mayor and voted to opt out of the constitutional provision.

Houston will have to take any changes it wants to make to its three pension systems to the Texas legislature. All changes to Houston's public pension system must be approved by the Texas legislature.

yields as well.

Double Diversification through Global Real Estate Securities

Global real estate securities provide important additional diversification - the missing piece to many public real estate investors portfolios in recent years. Diversification is provided in two ways:

1. **Low Correlation to Equities and to Bond Markets**
A portfolio of global real estate securities could offer potential benefits to investors interested in diversifying their investment portfolio through low correlation to other asset classes. Returns on global real estate securities have historically shown low correlation to the broad U.S. stock market indices and even lower correlation to U.S. bonds, causing savvy investors to recognize the potential benefits of international investing as part of a balanced asset allocation strategy.
2. **Low Correlation Among Countries and Regions**
Additionally, a global real estate portfolio offers diversification through low correlation country-to-country. A global focus may also allow investors to gain access to potentially faster growing economies outside the U.S. which may potentially experience stronger demand for real estate. Real estate is inherently a local business and an actively managed global portfolio gives investors the potential for superior returns of property stocks in other parts of the world. In fact, North American (predominantly U.S.) property stocks have recorded the best performance versus property stocks in other countries in only three of the last 13 years.

Opportunities Through Discount Valuations

A global real estate securities portfolio may also provide the opportunity to take advantage of discount valuations existing in many non-U.S. real estate markets today. Outside the U.S. and Australia, many public real estate companies are trading at discounts to the estimated Net Asset Value (NAV) of their real estate. We have observed that property and company stock tend to trade closer to NAV when REIT-type structures are adopted. This narrowing of discounts as more countries adopt the REIT structure presents a significant opportunity.

Above Average Dividend Yield Potential

Global real estate securities have historically delivered competitive total returns through time, driven by a consistently high level of current income. With a dividend yield averaging 4.3%, represented by the S&P Citigroup World Property Index

Finally, several vacancies on the Texas Pension Review Board have been filled by Governor Perry. New appointees include: Roy Casanova, a veteran San Antonio firefighter; Richard McElreath, an Amarillo financial consultant; Paul Braden, an attorney from El Paso and Norman Parish, a consulting actuary from The Woodlands.

Shari Shivers, who formerly chaired the Pension Review Board, has had her term expire; but she will continue to serve at the pleasure of the governor.

Frederick Rowe was reappointed to the Board and will serve as chairman.

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

as of 3/31/04, global real estate securities may provide a steady, dependable element to an investor's portfolio. Dividend yields vary by region and in some cases have exceeded the yield on U.S. REITs. The proliferation of REIT-type structures may boost yields in parts of Europe and Asia.

Global Real Estate Securities: A Viable Option

Global property stocks have outperformed many other equity classes in recent years as the result of the defensive investment characteristics of real estate, including high free cash flow, healthy dividend yields and stable earnings growth. This recent performance plus their excellent strategic characteristics makes global real estate securities an excellent viable option for consideration by plan sponsors.

Lori A. Pachelli is Vice President of Marketing & Client Service, Global and U.S. Real Estate Securities Funds at ING Clarion Real Estate Securities in Radnor, PA.

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Fed Rate Hikes: What's the Timing, Where's the Path?

By John Balder

Market expectations have rebounded recently in response to strong economic data, including the creation of more than 1.2 million jobs. In response, 10-year U.S. Treasury yields have risen by more than 100 basis points since mid-

Reducing Transaction Costs and Recapturing Value for Your Plan

By Ed Nicoll

Transaction costs can be a significant part of the expenses incurred while implementing an investment strategy, and a drag on the performance of a fund's assets. Every dollar spent on executing a strategy - both in brokerage commissions and hidden trading costs - is a dollar lost to the plan's participants.

March. In the past year, the release of stronger-than-expected data has often been followed by relatively weak data a month or two later.

Today, the situation appears to be different, suggesting that economic recovery might become self-sustaining without the need for monetary and fiscal stimulus.

Short-term interest rates are at 1.25 percent today. If a self-sustaining economic recovery is indeed unfolding, rates will have to increase.

Maestro Greenspan has been a busy fellow in recent months. One day, on April 20, he prepares the markets for the inevitable rise (a.k.a., normalization) in short-term rates (prompting 10-year bond yields to rise), yet on the following day, April 21, he sounds unconcerned about inflationary pressures. Jawboning, but no action.

No wonder market participants are confused. The Fed has not clarified either the timing or path for the hikes in interest rates. The truth is that path and timing are data-dependent. Fed funds futures suggest that investors expect rates to increase to 2% by year-end.

Offsetting these signs of economic recovery, the structural challenges have not improved one iota over the past year. Household debt ratios, record low savings rates and the fiscal and current account deficits have all continued to slide, increasing U.S. vulnerability.

From the Fed's perspective, the risks of raising rates prematurely dwarf the risks of remaining on hold,

Managers often apply the same level of rigor to implementing a strategy as they do to security research and portfolio construction. Moreover, given the increasing media and regulatory scrutiny of these issues, the responsibilities of investment managers are only getting more difficult. Now, more than ever, their singular focus must be on serving the customer in the most efficient, transparent and unconflicted manner possible.

Serving the investment management community well, requires working in partnership with clients to find solutions that are beneficial to both managers and sponsors. Effective solutions not only deliver value back to the investor, but do so in a manner that provides the greatest amount of disclosure of transaction costs. This transparency allows the plan sponsor to assure stakeholders that the plan money is being used efficiently, and that they are doing everything possible to avoid the loss of value due to unnecessary costs.

Decades of experience have proven one golden rule of investing: You can always return greater value to the investor by lowering transaction costs. Highly experienced, successful managers have built their business by relentlessly chipping away at transaction costs in the most open and transparent fashion possible.

Transaction costs can have a significant effect on returns. Implementation shortfall - the shortfall in the value of a security (or portfolio) that results from implementing the trade -in U.S. equity markets has been estimated to range from 20 basis points to as much as 3% of the principal value of transactions and orders.¹ Even an average 1% per year in lost performance, before inflation and taxes, compounded over the average life of a pension liability, represents substantial foregone value. If we apply it to the \$12 trillion U.S. equity market, we get approximately \$120 billion lost to transaction costs every year.²

There are three proven steps that asset managers should use to insure that they meet the fulfillment of their fiduciary duties by controlling transaction costs and reducing unnecessary plan costs.

- Identify transaction costs for clients
- Explain to clients where costs are incurred along the trading cycle.
- Transaction cost disclosures should allow the asset

especially given market valuations and extensive leverage.

Other factors, including a sizable output gap, strong productivity growth and declining unit labor costs, also support the on hold approach.

The risks today are that market participants (a.k.a., bond vigilantes) bid long-term Treasury yields up and/or foreign investors shift their massive holdings of U.S. dollars to other currencies. Either way, bond yields appear likely to rise.

Investors' inflationary expectations appear right, but early. Given balance sheets and the amount of leverage currently outstanding in the global financial system, inflation appears inevitable. Inflation directly reduces the value of public and private-sector debt. And with the U.S. dollar remaining the chief reserve currency, the results of this policy choice can be foisted off on other countries as the U.S. currency steadily loses value.

Robust growth may provide a temporary respite from these pressures. While we have been living on borrowed time in recent years, the bill has not yet come due. Being right, but early about inflation is not much different from being wrong, but early.

It is important for investors to have long investment horizons and sufficient tolerance for interim volatility. Inflation will come - not this year and probably not next - but it will come. And if it does not, the Fed will have failed in its task, given its decision to conduct mop-up operations only after the bubble

manager and the client to compare brokers and investment strategies that have been successful in the past.

- Transparent broker selection
- Ensure that clients understand how brokers are selected and how commissions are allocated. Information provided could include average commission rates, a list of approved brokers, the services purchased from each broker, and how the asset management firm chooses commission allocations.
- Show how plan brokerage dollars are supporting client objectives
- In addition to showing how costs are minimized, it may be helpful to show clients how the brokerage expenditures are directly benefiting their plan.

Because costs can never be completely eliminated, plan sponsors should see the connections between their investment strategy and their fund's expenses.

In an environment of increased public scrutiny of investment management, there are a number of steps advisors can take to ensure that the money they oversee incurs the minimum amount of transaction costs. While these costs will never be completely eliminated, reducing them can lead to higher net returns for the end investors - the individuals that the plan sponsor represents.

¹ Securities and Exchange Commission, Request for Comments on Measures to Improve Disclosure of Mutual Fund Transaction Costs; Proposed Rule (December 24, 2003). Also, Wayne Wagner, Cost versus Liquidity: The Quest for Best Execution, AIMR Publications (2003).

² John C. Bogle, Whether Markets are More Efficient or Less Efficient, Costs Matter, CFA Magazine (Nov-Dec 2003). Bogle figures the total cost of financial intermediation in the U.S. equity market - money management fees, transaction costs, custody charges, etc.- to be some \$300 billion annually or nearly 3% of the value of that \$12 trillion market. We estimate that the transaction costs account for about a third of total intermediation costs.

Ed Nicoll is CEO of Instinet Group, in New York, NY. will

collapsed.

John Balder is a Senior Vice President and Fixed Income Product Manager at State Street Research & Management Co. in Boston, MA.

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