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Inflation Protected Securities

By Scott Crossley

Treasury Inflation Protected Securities (TIPS) can be a good addition to portfolios for those concerned about protection from inflation and wanting increased diversification. Institutional investors such as pension plans typically maintain a sizable allocation to fixed income. With current interest rates near forty year lows, and the prospects for economic growth looking brighter, it may be prudent to look at TIPS as a means of hedging potential negative price pressure due to rising rates. This article provides an introduction to the TIPS market, explains how TIPS work and discusses the benefits of adding TIPS to a portfolio. The principal on TIPS is adjusted for inflation, so the return that investors receive includes the stated yield plus the inflation adjustment. TIPS achieve that by adjusting the underlying principal amount to correspond with changes in inflation. The TIPS fixed coupon rate is applied to the adjusted principal amount, resulting in an interest payment that is also adjusted for inflation. Investors receive an inflation-protected rate of return in the form of:

1. the semi-annual cash interest payments based on inflation-adjusted principal balances, plus
2. the greater of original principal or inflation-adjusted principal payable at maturity.

In the chart below, year one reflects a rise in inflation of 2.2%. Due to this inflation, the TIPS principal value increases from \$1,000 to \$1,022. These adjustments continue over the life of the TIPS so the final principal value will actually be unknown until maturity. What is known, however, is that the final principal value will

Commercial Mortgage Backed Securities

Exceeding Expectations

By Jeff Williams, CFA

CMBS performance was strong again in 2004, outperforming all other sectors of the Lehman Aggregate Index. In 2003 the residential mortgage backed securities were impacted by prepayment waves due to histo

In 2002, the corporate bond market was negatively impacted by accounting scandals. While strong property keeping delinquencies low in loans backing corporate credit and prepayment problems to credit risk, as well as its positive convexity protection on both the loan and bond levels. The return increase more than decrease over the coming year returns relative to other fixed income sector fundamentals.

Lower than Expected Loan Defaults

The fact that delinquency rates for private commercial mortgage backed securities transactions didn't follow in the footsteps of the public during the last recession is a testament to the strength of the mortgage since the inception of the CMBS market. The corporate market, combined with an improving corporate credit environment, which will translate that serve as collateral for the loans in CME corporate credit conditions should help keep transactions from getting much higher, just as the downturn of the early 1990s.

Lower than Expected Bond Defaults

Moody's recently published a study which indicated that of the 100 that were studied only 80 incurred a payment default. The primary cause of default was interest shortf

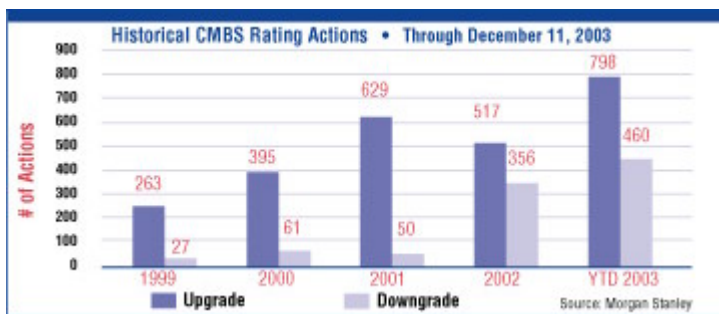
reflect the actual inflation experienced over the life of the bond. In the event of deflation, principal will be adjusted downward, but the U.S. Treasury guarantees that the bondholder will not receive less than the original principal at maturity.

US Treasury Inflation- Protected Securities:

- Introduced in 1997
- \$201 billion market value as of 12/31/03
- Represents more than half of the global inflation linked securities market
- \$40 billion estimated issuance in 2004
- Possible introduction of new maturities in 2004

There are two components, real yield and anticipated inflation, which impact how TIPS perform in varying rate change environments. If interest rates rise entirely as the result of a change in real rates, the TIPS and the nominal Treasury would experience similar negative performance. If on the other hand, the rise in interest rates were completely attributable to an increase in inflation expectations, the resulting price change on the TIPS would be minimal while the price decline of the nominal U.S. Treasury would be more drastic. This occurs because with TIPS, the investor is compensated for changes in inflation and the nominal U.S. Treasury holder is not.

The chart below illustrates the price changes experienced by a nominal 10-year Treasury issue and a TIP issue with a comparable maturity over two periods of rising interest rates. As the chart indicates, TIPS holders experienced better returns over these periods as a result of increased price protection.



TIPS have done well in a period of generally declining interest rates as well. For the five-year period ending 12/31/03, the Lehman Brothers U.S. TIPS Index principal at maturity returned an annualized rate of

principal loss. Furthermore of the defaulted period. Moody's calculated the 5-year mate CMBS to be zero, 0.23% for A, and 0.83% with approximately 1.75% in investment-gr A and Baa ratings.

Ratings Stability

Toward the end of last year, the year-to-date CMBS market stood at 1.75x, which was hi corporate bonds actually had more downgra Part of the reason for the improvement in up was the positive rating actions by the agenc 2000.

Recently, the rating agencies have been low issue deals. One of the reasons for this is th transactions outperformed their expectation defaults in CMBS transactions. Since the ag experience of same rated bonds to be simila they have been lowering the credit support 1 to an upgrade in some older bond issues bec required credit support for a similarly rated

While ratings actions for CMBS bonds have structured finance ratings in general, and CI lower percentage of downgrades than corpo conclusions that Fitch made in a recent stru For example, 91.27% of BBB CMBS bonds period and only 0.75% were downgraded. C corporate bonds maintained their rating and

The CMBS market has experienced strong t fixed income sectors over the past few year rating agencies based their expectations reg the real estate recession of the early 1990s, : underwriting instilled by the CMBS market the most recent downturn. Investors should beneficiaries of that discipline going forward

Lehman Brothers US Aggregate Index: To

Time Period	US Aggregate Index	CMBS Bonds	Corpora Agenci
1-year	4.10%	4.66%	7.70%
3-year	7.57%	9.80%	9.55%
5-year	6.62%	8.29%	7.06%

* Intermediate Treasury Index

9.58% while the Lehman Brothers U.S. Aggregate Index returned 6.62%

Along with inflation protection, an additional benefit to this asset class is its ability to provide diversification. Treasury Inflation Protected Securities, as a distinct asset class, have had low, even negative, correlations with other asset classes, including equities. Correlation measures the degree to which the performance of different asset classes move in concert, with the value for correlation ranging from +1.0 to -1.0. A negative correlation means that the historic performance of one asset class has moved in the opposite manner or direction as another asset class. TIPS' historically low correlation to other asset classes suggests that a TIPS allocation can be a very effective way to diversify a portfolio.

The strong combination of increasing inflation protection and providing portfolio diversification makes TIPS an attractive asset class that plan sponsors should consider in the current investment environment.

Scott Crossley is Director of Public Funds at Hartford Investment Management in Hartford, CT.

Jeff Williams is a Vice President with GMA Advisory Group in Alpharetta, GA.

[Back To Top](#)

- Page 2 -

Washington Outlook

By Matt Aukofer

Proposed New SEC Rules Would Force Mutual Fund Boards to Change, Increase Disclosure

The Securities and Exchange Commission's (SEC) five-member board has proposed rules to overhaul the regulations that govern the mutual fund industry. The board also will institute measures meant to check the power of mutual fund managers by making their governing boards more independent. The body also proposed new rules requiring fund advisers to adopt and enforce an ethics code.

The three new regulatory initiatives are designed to better protect the 95 million investors in mutual funds. The SEC said these initiatives

Reducing Risk with High Yield Bonds?

By Jeff Cummer

The Case for Using High Yield Bonds with Investment Grade Securities to Hedge Risks

Pensions, foundations, trusts and other fiduciaries with long term liabilities are in the midst

represent the next in a series of securities law reforms pursued by the SEC to address problems identified with the management and sale of mutual funds.

The rules would force most of the nation's mutual funds to replace their board chairmen with outsiders independent of the firms that manage the funds.

The proposal, which is expected to win final approval in the next few months, will affect not just mutual fund companies that have figured in recent federal investigations but large firms such as Fidelity Investments, the Vanguard Group and T. Rowe Price Associates, which largely have been left unscathed by the industry's scandals.

The SEC's chairman, William H. Donaldson, and the commission's two Democratic members supported the new rules, while the commission's two Republican members opposed them. The Republican members, Cynthia A. Glassman and Paul S. Atkins, argued that by removing insiders from leadership roles at fund boards, the SEC could seriously undermine those boards' effectiveness on behalf of investors.

But the three commissioners who supported the rules rejected that view, saying fund managers would still be consulted and could have a voice on the board, albeit a less dominant one.

Two of the nation's largest mutual fund groups, Fidelity Investments and Vanguard Group, said they oppose the SEC rules to require chairmen of mutual fund boards to be independent.

The rules are designed to enhance fund boards' independence and improve their ability to protect the interests of the funds and fund shareholders they serve. The rules are intended to strengthen the hand of independent directors when dealing with fund management.

Independent directors would be required to constitute at least 75 percent of the fund's board. This requirement is meant to strengthen the presence of independent directors and improve their ability to negotiate lower advisory fees and other important matters on behalf of the fund.

The board would be required to appoint a chairman who is an independent director. The board's chairman typically controls the board's agenda and can have a strong influence on the board's deliberations.

The board would be required to assess its own effectiveness at least once a year. Its assessment would have to include consideration of the board's committee structure and the number of funds on whose boards the directors serve.

The independent directors would be required to meet in separate sessions

of a challenging environment.

Deflationary winds cause questions as to whether many plans will meet their actuarially targeted returns. Below historic returns in equities and currently low yields in bonds are forcing trustees to look at hedge funds and other less traditional strategies to maintain required earnings on plan assets.

Not all bonds act alike. I am often asked, "How is the bond market?" I answer, "Which one?" There are many bond markets, domestically and globally. From a market value standpoint, in some environments, High Quality bonds and High Yield bonds prefer opposite economies. As shown in Chart A, High Quality market values generally increase in a weakening economy with accompanying declining interest rates implying low inflation or deflation. High Yield values generally increase in a strengthening economy even with moderately increasing interest rates.

What Blend of High Quality and High Yield is Best? This is similar to "what blend of paint colors is best for the room?" We blend the mix of High Quality and High Yield to the conditions, needs and requirements of the portfolio. The

at least once each quarter. This requirement could provide independent directors the opportunity for candid discussions about management's performance, and could help improve collegiality.

The fund would be required to authorize the independent directors to hire their own staff. This requirement is designed to help independent directors deal with matters on which they need outside assistance.

The SEC also proposed new rule, 204A1, and related rule amendments under the Investment Advisers Act of 1940. Rule 204A1 would require registered investment advisers to adopt and enforce codes of ethics applicable to their supervised persons.

Investment advisers are fiduciaries that owe their clients a duty of undivided loyalty. The SEC's recent enforcement proceedings suggest that some advisory personnel "may have forgotten or ignored this duty," the SEC said. The new rule is designed to prevent fraud by reinforcing the fiduciary principles that must govern the conduct of advisory firms and their personnel.

An adviser's code of ethics would have to include certain minimum provisions, such as standards of business conduct. An adviser's code of ethics would require the adviser's supervised persons to comply with applicable federal securities laws. The code also would contain provisions designed to prevent disclosure of material nonpublic information about the adviser's securities recommendations and clients' securities holdings and transactions to persons without a "need to know."

Other rules the SEC commissioners voted for are designed to enhance the information that broker-dealers provide to their customers in connection with transactions in certain types of securities.

These new rules would require broker-dealers to provide their customers with targeted information, at the point of sale and in transaction confirmations, regarding the costs and conflicts of interest that arise from the distribution of mutual fund shares, unit investment trust (UIT) interests (including insurance company separate accounts that offer variable annuity contracts and variable life insurance policies), and municipal fund securities used for education savings (commonly called 529 plans).

Brokers, dealers or municipal securities dealers would have to inform their customers about the distribution-related costs that the customer would be expected to incur in connection with the transaction. This would include separate disclosure of:

1. the amount of sales loads that would be incurred at the time of purchase, and the amount of that load that would be paid to the broker-dealer;

determining issues or constraints can include:

- Liquidity/Volatility
- Interest Income (distribution) needs
- Projected/required long-term return targets
- Investment restrictions of a plan or trust

Liquidity/Volatility

Various mixes produce various volatility and returns in different environments. Contrary to popular belief, 100% high quality does not give the best value nor the lowest volatility (liquidity) at all times. The only mix with no down quarters was a 60% (High Quality) LB Int. Gov't/Credit and 40% (High Yield) SMH High Yield. Any blend with High Yield offered higher values in more periods than a pure 100% High Quality (the LB Int. Gov't/Credit Index).

Interest Income (Distribution Needs)

Plain and simple, the more high yield in the portfolio the better it is from a cash flow standpoint. The high yield securities generally offer higher coupon rates. As of this writing, we are getting about 9% to 10% cash flow on our HY portfolio versus 5% on our AAA.

Projected/Required Long-Term Return

2. estimated asset-based sales charges and asset-based service fees paid out of fund assets in the year following the purchase if net asset value remained unchanged; and
3. the maximum amount of any deferred sales load that would be associated with the purchase if those shares are sold within one year, along with a statement about how many years a deferred sales load may be in effect.

In addition, it must be disclosed if a broker, dealer or municipal securities dealer receives revenue sharing or portfolio brokerage commissions from the fund complex, as well as whether it pays differential compensation in connection with transactions in the covered security, if the covered security is either a class B share or a proprietary security.

The new rules also would require more quantitative disclosure of the information included in the point-of-sale document. The rules require specific disclosures in purchase transactions that build on the point of sale requirements. These requirements include: cost and remuneration disclosure; revenue sharing and portfolio brokerage disclosure; and differential compensation disclosure. The rules would provide a mechanism to give investors additional context for evaluating the significance of certain information. This context would come from comparison ranges for sales compensation, revenue sharing, and portfolio brokerage commissions, so that investors can see where their particular costs and payments fall in comparison to the median and ranges in the marketplace. The SEC would need to propose additional rules to determine how to obtain and disseminate comparison range information.

For all transactions (sales as well as purchases), the rule would require disclosure of: the date of the transaction; the issuer and class of the security; the net asset value of the shares or units and, if different, their public offering price; the number of shares purchased or sold by the customer; the total dollar amount paid or received in the transaction; the net amount of the investment bought or sold in the transaction; any commission, markup or other remuneration the broker, dealer or municipal securities dealer will receive from the customer in connection with the transaction; and, when applicable, that a broker, dealer or municipal securities dealer is not a member of the Securities Investor Protection Corporation (SIPC), or that the broker, dealer or municipal securities dealer clearing or carrying the customer account is not a member of SIPC.

The SEC said these initiatives are intended to give investors “news they can use.” In addition to including a special section in the proposal soliciting comments from investors, the SEC intends to reach out to the investor community through a variety of methods, including investor focus groups. This process is intended to design requirements—including standardized disclosure forms—that average investors will find useful and informative.

Targets

One would think that a higher % of HY in the mix would make a much higher return. But over this time period, albeit one of high defaults on corporate bonds, the differences are less than many might think. Nonetheless, the higher the % of HY in the portfolio the higher the long-term return.

Investment Restrictions

A plan or trust may require an “investment grade” portfolio. As such, the HY portion needs to be 20% or less by definition. If the plan does not allow for any below investment grade (High Yield) bonds, then trustees might consider relaxing this restriction to allow the overall portfolio to be investment grade. For as the intention is good, an all High Quality portfolio provides the lowest credit risk, but may not provide the lowest overall risk portfolio.

The recent LB HY Index performance magnifies the importance of credit research and limiting defaults and significant downgrades. The argument above is based upon the high yield disciplines and performance of a managed portfolio—not the LB High Yield Index. As you can see in Chart B, an unmanaged index

Comments on these proposals should be submitted to the SEC within 60 days of publication in the Federal Register. For more information, visit: <http://www.sec.gov>.

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

has had disastrous results in recent years due to record high default rates. Plan trustees and fiduciaries need to recognize that high yield debt carries credit risk and that risk needs to be tightly managed.

Trustees and plan fiduciaries are in agreement on one thing; they all want to meet the required goals of the plan with the least risk possible. "Risk" comes from many areas: inflation, default, and interest rate changes to name a few. We see many plans where the risk containment focus on the fixed income portion of the plan is solely on default risk— by limiting the investments to investment grade or AAA paper. A high grade portfolio provides the lowest credit risk, but may not provide the lowest overall risk portfolio. This singly focused risk control does not address other risks such as sub-target returns or interest rate risks. Blending High Yield with High Quality bonds can actually give the portfolio more liquidity, higher cash flows for distributions, and higher total returns to meet plan projections.

Jeff Cummer is Senior Portfolio Manager at SMH Capital Advisors in Houston, TX.

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[Back To Top](#)

- Page 3 -

State Capitol Report

By Neal T. "Buddy" Jones

Austin was unusually busy for a January in a non-session year. Interim committees in both Houses have received their charges from the Speaker and the Lieutenant Governor and have already met or they are preparing to meet. The Joint Select Committee on School Finance has been meeting regularly since the last special session in 2003.

They are seeking solutions to school finance in order to do away with the unpopular "Robin Hood" system now in place.

Primary elections are bringing candidates to Austin regularly to raise money from the Austin lobby. Several incumbents in both parties have hotly contested primary races.

The House Pensions and Investments Committee has been given the following charges by Speaker Tom Craddick:

1. Examine the feasibility, risks and benefits associated with the use of Pension Obligation Bonds in order to reduce unfunded liabilities in municipal and state retirement systems.
2. Study the risks, benefits and impact associated with the "retire in place" practice as it relates to the Employees Retirement System, Teacher Retirement System, County and District Retirement System and Municipal Retirement System.
3. Monitor agencies and programs under the committee's jurisdiction and legislation passed by the 78th Legislature.

The Senate has no specific pension-related charges in any of their proposed interim committee work.

The pension community will need to closely monitor the House work on pension obligation bonds. It will be important that no negative recommendations come out on this useful tool for pension funds.

The Pension Review Board will continue monitoring the progress of the underfunded pension funds in El Paso and Dallas. The Chairman of the Board has requested the Mayor of Dallas to appear at their first

President's Corner

By Randy Stalnaker

The annual conference is perhaps TEXPERS' most important activity. The upcoming conference in Houston promises to be another informative, enjoyable and timely event— I hope you're planning to attend. Judging by the registration so far, it looks like attendance will be excellent.

There are a couple of reasons that I think the annual conference could be TEXPERS' most important activity. First, the education that is provided to trustees and staff is critical to their being able to meet their fiduciary obligations. The sometimes conflicting worlds of investments and benefits are growing more complex every day. We owe it to the members of our funds to stay abreast of the latest developments in both areas. Over the years I have learned many things at the TEXPERS conference that led directly to significant improvements at my fund. It's likely that these improvements would never have happened

quarter meeting to explain the solutions the city proposed to correct their current deficiency.

Dallas Municipal Employees have already voted to increase their contributions to the fund. The City of Dallas has looked into actions it could take to alleviate the unfunded liability to bring the fund into an actuarially sound position. The Pension Review Board has set a priority to assist public pension funds in funding methods to move to more actuarially sound positions in 2004.

Almost everyone in Austin is expecting Governor Perry to call a special session in April or May to deal with public school finance and possibly revamp Texas' tax systems. The Governor, Lieutenant Governor, Speaker, and their top aides have been meeting to try to reach consensus on how to end the present "Robin Hood" system and how to fund the changes.

Some of the ideas for additional revenue being discussed include: splitting the business and residence tax rolls with business ad valorem revenue coming to the state for equalization purposes, slot machines at the major Texas race tracks, a tobacco tax, a business activity tax, and a payroll tax. There seems to be no strong sentiment for an income tax.

Governor Perry has stated he will not call a special session until a general consensus is reached on how the current school funding can be changed and what new revenue sources will be used to accomplish an outstanding education system in the state.

The Texas primary election is scheduled for March 9, 2004. There are only two statewide primary races — a Railroad Commissioner's race and a Supreme Court race. Several Court of Appeals seats have primary races.

In the Texas State Senate 15 or 16 of the 31 Senators run each even numbered year. This gives Senators 4-year terms. In 2004, 15 of our Senators are up for election or re-election. Ten of the Senators up for re-election are unopposed. One seat, District 31, stretching from Amarillo to Midland/Odessa has six Republicans running in the primary to replace retiring Senator Teel Bivins, who is slated to be appointed Ambassador to Sweden by President Bush. In Senate District 30, Senator Craig Estes has no primary opposition but will face a Democratic opponent in the General Election. In Senate District 6, Senator Mario Gallegos has a Democratic Primary opponent. Senator Judith Zaffarini, in Senate District 21, and Senator Leticia Van de Putte, in Senate District 26, both have Democratic Primary opponents.

In the Texas House, there are only four open seats. Two of these seats are held by Republicans and two are held by Democrats. It is

without the TEXPERS annual conference.

The second reason I believe the TEXPERS conference is so important is its networking opportunities. I know that "networking" is an overused cliché, but I have come to realize that the most important things that I learn at some conferences are the names, faces and phone numbers of other people in the pension fund business. We have a lot to share with each other. Collectively, we know just about everything there is to know about public pensions in Texas. That knowledge becomes useful when we know where to find it and networking gives us the necessary connections. The conversations among attendees during the receptions or just over-the-table during sessions, can prove priceless when we realize the person with whom we are conversing possesses information we desperately need.

I attend 5 or 6 pension fund conferences each year. Most of them are the larger, well known national conferences. Frankly, I think the TEXPERS conferences are better than nearly all of them. Furthermore, the price is right since the TEXPERS conference is free to members —registration alone for some of the other conferences can run more than \$1,000.

not expected any of these seats will change party makeup in this year's elections.

Thirty House incumbents face primary election opponents. Twelve Republicans have primary opposition and 18 Democrats will be opposed in the March 9th Primary.

One race of special note involves Representative Allan Ritter, Chairman of the House Pensions and Investments Committee. Chairman Ritter strongly supported tort reform legislation which passed by large majorities in both Houses. Many feel trial or plaintiff lawyers are financing his opponent, former State Senator David Bernsen, as punishment for Chairman Ritter's anti-trial lawyer votes. Chairman Ritter, who did an excellent job leading the Pensions and Investments Committee during the 78th Session, is taking this race very seriously. He is working very hard for re-election and is determined to keep his seat against the challenge of his trial lawyer financed opponent.

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

At this annual conference, there will be a members meeting on Saturday. One of the items of business that day will be the election of several board seats through their respective caucuses. I encourage you to be involved in this important process. TEXPERS needs active Board members and other volunteers — they are the backbone of the organization and without them, TEXPERS would wither and die.

You probably know that the annual conference moves around the state in those years when the legislature is not in session. Two years ago it was held in Ft. Worth, which proved to be a wonderful venue. I'm particularly looking forward to the conference being in Houston this year because that's where I grew up and I'll get to visit my parents.

I'm looking forward to seeing you at the conference in Houston.

[Back To Top](#)

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



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

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