



# PENSION OBSERVER

THE OFFICIAL PUBLICATION OF THE TEXAS ASSOCIATION OF PUBLIC EMPLOYEE RETIREMENT SYSTEMS

## The Case for Growth

By Janus Institutional Asset Management

Several academic studies exist that suggest that value investing generates superior returns to growth investing. However, one of the biggest factors that can influence performance data presented in academic studies is the endpoint that is chosen for a particular study. Interestingly, little research exists that analyzes how different investment styles perform at different stages of the business cycle. Specifically, at what point in the business cycle do investors begin to rotate into the growth style and what kind of economic environment helps facilitate that rotation?

*Specifically, at what point in the business cycle do investors begin to rotate into the growth style. . .*

We analyzed three past business cycles along with the common trends that existed when investors rotated out of value and into growth stocks historically. We believe the same economic conditions may exist in today's business cycle.

Three distinct periods were reviewed following the recessions of 1974-1975, 1981-1982, 1990-1991. Growth and value returns were analyzed in order to identify inflection points when investors rotated out of value and into growth. Key economic metrics like

*(Continued on page 4)*

## Small-Cap Liquidity Management

By Todd Sanders

In the management of smaller capitalization equities, effective liquidity management is essential to success over time. Liquidity management also plays a vital role in determining investment product characteristics such as capacity limitations, the number of securities held in portfolios, and the level of trading turnover experienced. To this end, it is important to develop an effective strategy to mitigate small-cap liquidity risk without sacrificing alpha potential.

A key distinction of this approach is the focus on providing diversified exposure across the spectrum of smaller capitalization opportunities. Unlike managers who tend to emphasize the larger tier of companies within the small-cap universe, it is wiser to maintain a balanced distribution across the size spectrum.

*In both domestic and international portfolios, it does not pay to concentrate in a few small-cap stocks.*

For any particular benchmark of investible securities (such as the Russell 2000 Index of U.S. companies or the Citigroup Extended Market Index of international companies), this strategy segregates the universe into five distinct tiers, or capitalization quintiles. In turn, it seeks to maintain exposure to each tier of the universe within narrow ranges of the benchmark distribution. This is in addition to maintaining sector and country allocations within narrow bands of the universe. The objective is to neutralize systematic biases in portfolios and focus efforts on superior stock selection as the primary source of alpha.

This strategy offers a somewhat unconventional view of strategic diversity and superior liquidity management with the goal of building portfolios of companies that demonstrate superior fundamental investment characteristics relative to capitalization weighted benchmarks. These portfolios represent a carefully selected sub-set of the market universe, emphasizing companies with improving business fundamentals and rising investor expectations without paying valuation premiums. The depth and breadth of the research process is the key to identifying companies with these

*(Continued on page 5)*

### MARK YOUR CALENDARS!

#### TEXPERS SEVENTEENTH ANNUAL CONFERENCE

Sunday - Wednesday

**March 12 - 15, 2006**

The Austin Marriott at the Capitol  
701 East 11th Street

Richardson, Texas 78701

800-228-9290 • 512-478-1111

Fax: 512-404-6979

**\$137 Single or Double**  
TEXPERS Members-Only  
eligible to attend

Register online: [www.texpers.org](http://www.texpers.org)

## WASHINGTON OUTLOOK

By Matt Aukofer

### Retirement Plans Can Make Loans, Hardship Distributions to Katrina Victims

**F**or the first time ever, the Internal Revenue Service (IRS) and the U.S. Departments of the Treasury and Labor are providing broad-based relief to retirement plan participants affected by a major disaster, Hurricane Katrina.

Employer-sponsored retirement plans such as 401(k)s can make loans and hardship distributions to victims of Hurricane Katrina and members of their families. Among those who may be eligible to take advantage of these streamlined loan procedures and liberalized hardship distribution rules are 401(k) plan participants, employees of public schools and tax-exempt organizations with 403(b) tax-sheltered annuities, and state and local government employees with certain 457 deferred-compensation plans. Although IRA participants are barred from taking out loans, they may be eligible to receive distributions under the liberalized procedures.

*Plans will be allowed to make loans or hardship distributions before the plan is formally amended to provide for such features.*

Retirement plans can provide this relief to employees and certain members of their families who live or work in the disaster area. To qualify for this relief, hardship withdrawals must be made by March 31, 2006. There was no word at press time if the government would extend this program to victims of Hurricane Rita.

"As in other areas, we are doing everything we can to help Hurricane Katrina victims rebuild their lives," said IRS Commissioner Mark W. Everson. "This relief will make it possible for people to get their retirement money more quickly with a minimum of red tape."

The IRS said it also is relaxing procedural and administrative rules that normally apply to retirement plan loans and hardship distributions. As a result, eligible retirement plan participants will be able to access their money more quickly and with fewer bureaucratic hassles.

In addition, the six-month ban on 401(k) contributions that normally affects employees who take hardship distributions will not apply.

This broad-based relief, spelled out in IRS Announcement 2006-70, means that a retirement plan can allow a Katrina victim to take a hardship distribution or borrow up to the specified statutory limits from their retirement plan to repair or replace a home or for some other purpose. It also means that a person who lives in another part of the country can take out a retirement plan loan or hardship distribution and use it to assist a son, daughter, parent, grandparent or other dependent who lived or worked in the disaster area.

Plans will be allowed to make loans or hardship distributions before the plan is formally amended to provide for such features. In addition, the plan can ignore the limits that normally apply to hardship distributions, thus allowing them, for example, to be used for food and shelter. If a plan requires certain documentation before a distribution is made, the plan can relax this requirement.

Ordinarily, retirement plan loan proceeds are tax-free if they are repaid within five years. Under current law, hardship distributions are generally taxable. Also, a 10% early-withdrawal tax usually applies, but Congress is currently considering possible modifications to this tax. The U.S. Department of Labor's Employee Benefits Security Administration (EBSA), along with the IRS, released guidance for employers and plan officials to take advantage of this program.

The Department of Labor will not treat any person as having violated the provisions of Title I of the Employee

(Continued on page 7)

## PRESIDENT'S CORNER

By Randy Stalnaker

**T**EXPERS has just concluded another very successful Summer Educational Forum in San Antonio. Attendance was terrific, with over 400 individuals registered, and the program was highly informative. As always, San Antonio was a wonderful host city.

Ted Seidle made one of the most interesting presentations at the conference. While the title of his presentation was "Impact of SEC Findings on the Pension Consulting Industry," Ted talked in expert detail about some of the fraud that has been perpetrated on public pension plans. Needless to say, his presentation generated a lot of questions and discussion.

*There was a common theme to the stories of fraud: relationships and the flow of money were hidden from staff and trustees.*

Some of the instances of fraud Ted discussed cost public pension plans many millions of dollars. There was a common theme to the stories of fraud: relationships and the flow of money were hidden from staff and trustees.

I think there are some lessons for staff and trustees from these instances where their plans have been victimized:

- Always ask questions, you can never know too much about any of the companies, individuals and financial relationships of those entities with which your public fund does business. Don't worry about making someone you're questioning feel uncomfortable.
- Check the answers. Do independent investigations. Just because an answer to a question might seem acceptable on its face, it may not be truthful or complete.
- Ask detailed questions about the financial relationships between any two companies with which your fund does business. These

(Continued on page 3)

# STATE CAPITOL REPORT

By Neal T. "Buddy" Jones

**A** Second Called Session of the 79th Legislature was convened in July by Governor Rick Perry to deal with public education finance, public education reform, property tax reductions, and revenue measures to pay for these items. On August 19, 2005, this Session was adjourned sine die by the House and Senate with no legislation being passed dealing with these issues.

The Governor and legislative leaders have expressed great disappointment that no agreement was reached in the Texas House or Senate. Heavy lobbying by special interest groups have kept both houses of the Texas Legislature from reaching any compromise on education, property tax reductions, and new taxes.

It appears now that Governor Perry will wait to call another special session until after the Texas Supreme Court rules on the constitutionality of our present public education funding system. That ruling is expected to be handed down in October. Some political observers believe the next special session will be called immediately after the Supreme Court hands down its decision while others believe Governor Perry will wait until after the 2006 first primary election and call the session in April 2006. The Supreme Court usually puts a time limit by which the legislature must act and this could govern the timing of the next special session.

It should be easier to pass the currently stalemated issues once the Supreme Court has ruled. The education lobby will know the parameters which were set by the ruling and will not be speculating a "better deal" could be achieved, as they have with the anticipated Supreme Court ruling.

*This committee is proposing information be reported on a quarterly basis and afford the Pension Review Board a method to identify plans when there are questions and to identify those plans that need help.*

The many differences concerning property tax relief and a tax bill to fund the additional money required will still remain a problem. As a result of the Supreme Court ruling, the Legislature will have to act on all of the issues which have been unsolvable to date.

The Pension Review Board held its quarterly meeting on September 7, 2005. All members except one were present.

The Board's first order of business was to review the El Paso Police and Fire underfunding problem. A deputy city manager gave an overview of actions being taken. He testified a total solution has not been found and this prompted Chairman Rowe to comment this was "more of the same."

The executive director of the El Paso fund testified there was no communication between the city and the fund. Senator Whitmire observed "all stakeholders are not working together."

At the request of Chairman Rowe a lawyer with Vinson and Elkins from Dallas spoke to the commission. He stated "people who are responsible for the fund need to pay attention to it. If it doesn't make common sense, figures don't add up—there is a duty to inquire further; governing bodies who don't will find problems."

Commissioner Parrish gave a report on his committee's developing an early warning system. This committee is proposing information be reported on a quarterly basis and afford the Pension Review Board a method to identify plans when there are questions and to identify those plans that need help.

The form his committee developed, which was adopted by the Board during the meeting, will be filed in the Texas Register for comment. The Board plans for the first report due with the new form to contain data collected in the first quarter of 2006.

Robert Miller, representing several pension systems, testified about the proposed form. He stated several areas in regard to the form are of concern to public pension funds he represents. He stated a willingness by the funds to work with the Pension Review Board on improving this form.

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

## President's Corner

By Randy Stalnak

(Continued from page 2)

relationships may contain conflicts of interest that can cost you a great deal of money. Many of these arrangements are complex and can involve multiple individuals and entities.

- Keep your eyes and ears open. You should constantly be checking up on those with whom you do business by talking to others and actively listening.
- Read industry periodicals to keep yourself informed. There are often reports or hints that could help you uncover a problem before you're victimized.

Ted hosts an excellent website with a lot of helpful information — <http://www.benchmarkalert.com> — that is worth reading regularly.

*What you don't know not only can hurt you, but likely will.* 🇺🇸

## MARK YOUR CALENDARS

### Upcoming Conferences

#### TEPERS Summer Educational Forum

August 20 & 21, 2006

San Antonio, TX

#### TEPERS 18th Annual Conference

March 18 - 21, 2007; Austin, TX

## The Case for Growth

By Janus Institutional Asset Management  
(Continued from page 1)

GDP growth, Federal Reserve rate actions and inflation were then analyzed to identify economic trends common to each time period.

### Key Findings

Trend analysis revealed that investors have historically demonstrated a tendency to rotate into the growth style of investing during the transition from the recovery phase of the business cycle to the prosperity phase. This transition phase is typically characterized by moderating GDP growth, rising interest rates and rising inflation

In each time period analyzed, as the business cycle was transitioning from the recovery phase to the prosperity phase, characterized by aforementioned economic metrics, an inflection point was reached whereby the growth style of investing began to outperform value for the rest of the business cycle. This rotation usually occurred approximately two to three years after the

end of the recession.


Interestingly, the economic landscape outlined above— moderating GDP growth, rising interest rates and inflation — very closely mirrors the economic environment that exists today.

However, today the markets appear to be acting in contradiction to the historical trends. As of September 2005, the economy is now almost four years past the end of the last recession (11/01); yet the value style continues to outperform growth on a year-to-date basis.

The reluctance of the current market to rotate back into growth stocks suggests that investors are hesitant to embrace the notion that the economic recovery can be sustained, that volatility has declined and that the business cycle has reverted back to its historical patterns of expansion and contraction. Some could still be feeling the aftereffects of the

bursting of the stock market bubble in the late 1990s.

However, with each passing quarter, data is accumulated which may provide compelling evidence that the recovery will be sustainable, that business activity has settled into a more “normal” pattern, and that valuations are reasonable.

Based on this analysis, it would appear that all of the pieces are in place for a potential rotation into growth stocks. If the bull market extends into a third year during 2005, investors could be sufficiently convinced in the durability of the recovery to move back into growth stocks. 

*Janus Institutional Asset Management is based in Denver, Colorado.*

# Small-Cap Liquidity Management

By Todd Sanders

(Continued from page 1)

characteristics on a timely basis. This is the primary source of alpha.

Many small-cap managers focus on bottom-up stock selection, yet the discipline of constructing portfolios that embrace strategic diversification is very distinctive. The small-cap universe is extremely fragmented and not particularly efficient. The Citigroup EMI World Ex-US Index is utilized consistently in this article for all of the illustrations and tables. However, the same arguments apply to the U.S. marketplace and thus the global marketplace as well.

The largest tier of the small-cap market is composed of just 87 companies, representing 20% of the total market capitalization of the benchmark. These tend to be fairly widely held stocks with research coverage provided by multiple sell side analysts. At the other end of the spectrum, the smallest tier of the market is composed of over 2,100 individual companies, most of which are relatively unknown and not widely followed by sell side analysts. Simply put, greater inefficiencies exist in the smaller tiers of the universe, leading to greater opportunities to add value through active management. Exposure to the smaller tiers is also essential to capturing the elusive return premiums and lower correlations afforded by small-cap stocks.

Over the last 15 years, the number of companies in the smaller cap quintiles (M4 and M5), have both doubled.

While it is not uncommon for some small-cap managers to emphasize micro-cap

stocks, these tend to be niche strategies with very limited product capacity and therefore not accessible to larger institutional investors. Among most mainstream core and style specific small-cap managers, the tendency is to navigate toward the larger end of the capitalization spectrum, particularly as assets under management grow in size. A better approach is to consistently maintain strategic diversity across the size spectrum, and do so without unnecessary concentration risk or liquidity risk. Under this approach portfolios would tend to invest in a greater number of smaller companies than a typical small-cap manager. Specifically, this approach seeks to maintain benchmark coverage ratios of less than 20%, rather than targeting a specific number of securities in portfolios. Benchmark coverage is defined as the overlap between a portfolio and the benchmark as a percent of total assets.

In both domestic and international portfolios, it does not pay to concentrate in a few small-cap stocks. Instead, superior risk-adjusted returns are achieved by owning a broader selection of stocks within the smaller tiers of the capitalization spectrum. If strategies are skewed toward one end of the distribution or another, there would be fairly substantial market risk.

In addition to limiting concentration, liquidity risk is further mitigated by limiting holdings in a particular company to two to three times its average daily trading volume at the time of purchase. This liquidity management strategy is also distinct in that it is tailored to specific client needs. In general,

larger portfolios will tend to hold a larger number of individual securities, and vice versa. Portfolios with high daily cash flow needs (e.g. high liquidity portfolios), such as pooled funds for 401(k) investors, will have higher liquidity needs than relatively static portfolios, such as a defined benefit mandate that represents a fairly constant allocation relative to the total plan's assets (e.g., stable portfolios). Importantly, however, the differences in the number of holdings across portfolios are among the smallest tiers of securities. Portfolios are essentially identical among holdings and position sizes in the larger tiers

In other words, larger portfolios with higher liquidity needs will hold a larger number of the smallest stocks in smaller proportions compared to portfolios with modest short-term liquidity needs. This approach actually mitigates the disparity of returns among similarly managed portfolios by accommodating specific client liquidity preferences, rather than forcing clients toward one middle-of-the-road "model" portfolio.

Target alpha is directly related to the stock selection process. This, in addition to consistently neutralizing top-down exposures, allows an identical target alpha for two portfolios with different numbers of holdings. In both domestic and international portfolios, the benchmark coverage ratio is consistently within the targeted range of 20% or less.

(Continued on page 6)

Citigroup EMI ex-U.S Capitalization Quintiles		
Distribution of companies within each capitalization quintile		
Capitalization Quintile	% of Total Capitalization	# of Stocks
M1 (Largest)	20%	87
M2	20%	208
M3	20%	391
M4	20%	723
M5 (Smallest)	20%	2,148
<b>TOTAL</b>	<b>100%</b>	<b>3,557</b>


## Washington Outlook

By Matt Aukofer

(Continued from page 2)

Retirement Income Security Act solely because they complied with the provisions of IRS Announcement 2005-70. The IRS announcement, in conjunction with the DOL statement, expands the circumstances under which hardship and loan distributions can be made from a plan to participants and beneficiaries affected by the hurricane. The announcement also eliminates the need for obtaining otherwise required documentation in advance of a hardship or participant loan distribution.

“Helping Hurricane Katrina’s survivors get back on their feet is our highest priority,” said Secretary of Labor Elaine L. Chao. “These actions will make it easier for those in need to get hardship withdrawals and loans from their 401(k)s and similar plans so they can begin rebuilding their lives.”

For more information on Hurricane Katrina relief, contact the Department of Labor at 1-866-4USA-DOL, or EBSA at 1-866-444-3272. Questions about the IRS announcement should be directed to the IRS at 1-877-829-5900, or on the Web at <http://www.irs.gov>. 

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


## Small-Cap Liquidity

By Todd Sanders

(Continued from page 6)

### Product Capacity

A superior liquidity management strategy also provides sensible guidance for the appropriate management of product capacity in terms of assets under management. Product capacity is determined by both internal portfolio construction decisions and external market factors. Internal controls include limiting individual security concentration to two to three times the average daily trading volume at time of purchase and target benchmark coverage ratios of less than 20%. Because external market forces dictate capacity, product capacity can change over time, particularly as the market experiences continued growth in the number of stocks and trading volume.

This powerful and thoughtful approach to small-cap liquidity management is just one aspect of the disciplined risk management and focus on individual security selection that are the hallmarks of an effective equity investment philosophy. 

*Todd Sanders is Portfolio Manager—Small-Cap Core Equity Portfolios—at Principal Global Investors in Des Moines, Iowa.*

---

# www.texpers.org

---



## The TEXPERS® Pension Observer

**William J. “Bill” Blythe, Jr.**  
*Executive Director & Editor*

One Riverway, Suite 1401  
Houston, Texas 77056-1904  
Telephone (713) 622-8018  
FAX (713) 622-7022  
E-Mail: [texpers@texpers.org](mailto:texpers@texpers.org)

© 2005, TEXPERS®

*The TEXPERS Pension Observer* is the official publication of the Texas Association of Public Employee Retirement Systems, published quarterly for TEXPERS members. Contributions to *The TEXPERS Pension Observer* are welcome, but the right is reserved to select material to be published. Publication of any article or statement is not to be deemed an endorsement of the views expressed therein, nor shall publication of any advertisement be considered an endorsement of the product or service involved.