

T H E T E X P E R S



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Adding Private Equity to the Portfolio: An Overview

By Paul Oliver

As institutional investors continue to lower their investment return expectations for the public fixed income and equity markets, the interest in alternative assets in general and private equity specifically as a means of increasing portfolio returns is increasing. This acceleration of institutional interest in private equity is the latest phase in a trend which traces its origins to the post World War II era.

Originally known as venture capital, the sector in the post war 1940s was uniquely the purview of wealthy families who invested directly in young, privately owned companies. This was not an asset class known to institutional investors. During the 1950s, however, as awareness of the sector grew, several developments occurred which encouraged the involvement of institutional investors, including the formation of the Small Business Investment Company (“SBIC”) program and the establishment of the first venture capital firms who began raising small funds from third party investors.

This trend continued during the 1960s, spurred on particularly by the hot stock markets of that era which provided private company investors attractive exits through the IPO process. In 1969, \$171 million was committed to new venture capital funds. During the 1970s, changes to ERISA and the Investment Advisors Act provided more flexibility for institutional investors to participate in this asset class.

The explosive growth of leveraged buyout transactions (originally referred to as “boot strap deals”) and the development of buyout funds which were typically larger than venture capital funds, continued the growth trend in the 1980s. By the beginning of the 21st century, the asset class had evolved into an institutionally dominated sector and had been renamed “private equity”, with venture capital having become one of the sub-sectors of the

Navigating the Trading Costs Iceberg

By Eric M. Efron, CFA

Originally, commissions were set by the various stock exchanges until, in May 1975, the SEC allowed commissions to be negotiated. From that point on technology and competition have driven a commission “free-for-all” that continues to this day. Commissions have never been lower than they are now and are expected to continue to decline. However, while low commissions are easy to quantify, they may not generate the lowest trading cost to the portfolio.

asset class. In the year 2000, commitments to new private equity funds totaled \$178 billion, reflecting the institutional dominance of the sector.

Along with the quantitative growth, the asset class has seen increasing specialization of investment strategies, resulting in the development of private equity sub-sectors including:

- **Venture Capital:** the original investment strategy of the asset class, involving the investment of equity in young companies at various stages of their early development;
- **Leveraged Buyouts:** using debt in addition to equity to finance the acquisition of private companies;
- **Mezzanine:** investing in the subordinated debt issued by private companies, typically with warrants or other forms of equity “kickers”;
- **Distressed:** investing in the debt and/or equity securities of companies experiencing operating or financial difficulties;
- **Industry Specific:** utilizing any of the above investment strategies, but focusing on one or several specific industries;
- **Fund of Funds:** investing in a “manager of managers”, who creates a portfolio of private equity fund investments.

Investor interest in private equity stems from the fact that the asset class has generated extremely attractive long-term, risk-adjusted return characteristics. According to Thomson Venture Economics and the National Venture Capital Association, the ten and twenty year horizon returns for venture capital for the period ending 12/31/04 were 26.0% and 15.7%, respectively. For the same time horizon all private equity returned 12.7% and 13.8%, respectively. Both asset classes continued to outperform both the NASDAQ and the S&P 500 index for the long term.

Finally, the addition of private equity provides diversification benefits to a portfolio. Studies by the Yale University Investment Office have shown that the historical correlation between returns from private equity and those of other major asset classes is very low.

Paul Oliver is Managing Director at AA Capital Partners, Inc. in Chicago, IL.

In many cases, best execution— with higher commissions— may be more desirable. To understand why, it is important to view trading costs as an “iceberg” with itemized commissions being only the tip. Three quarters of the true trading costs incurred are beneath the surface— not represented on the monthly statement. A round-trip trade may also be diminished by inside spreads (payments to dealers or other market functionaries for conducting the continuous market); market impact (discounts/premiums on transactions that compensate for undesired changes in dealer inventories) and opportunity costs (the cost of failing to complete a desired trade before the price increases due to delay or missed trades). The Plexus Group estimates that commissions represent roughly 10% of the total trading cost to the portfolio. Invisible costs include market impact (25%), delay (50%), and missed trades (15%).

Therefore, a trade may actually cost the portfolio up to ten times more than the stated commission.

To defray the true costs of trading, it is important to require the discretionary asset manager to seek best price and best execution at all times. More importantly, boards should be careful not to handcuff managers by implementing certain policies that may sound good on paper, but have detrimental hidden costs. Obstacles to best price and best execution include:

1. Directed Brokerage: Directed brokerage is the misdirected requirement to utilize a specific broker/dealer to appease a political concern or support certain relationships. Remember, no two trades are the same. Certain broker/dealers are better suited to handle certain trades. A knowledgeable portfolio manager should be able to determine which broker/dealer is best

suited to execute a given trade.

2. Soft Dollars: Soft dollar trading is the practice of shifting administrative and research expenses from the management firm to the client by agreeing to excessive commissions in exchange for certain benefits, such as a Bloomberg system. Trustees should require discretionary money managers to limit "soft dollar" contracts with broker/dealers.

3. Commission Recapture: Commission recapture essentially is a combination of directed brokerage and soft dollars. The sales pitch sounds very compelling. However, studies indicate that for every penny recaptured, the portfolio loses \$0.03-\$0.05 in performance.

Trading costs are often overlooked when analyzing portfolio performance; however, these costs can be substantial. Of note, the U.S. Department of

Labor considers commissions to be plan assets requiring fiduciary oversight. While trustees may not be able to quantify these hidden costs precisely, they can limit their impact by maneuvering around obstacles to best price and best execution with the goal being to experience gigantic— not Titanic— results.

Eric M. Efron, CFA, is Co-portfolio Manager at Texas Institutional Investment Management, LLC in San Antonio, TX.

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Dynamic Cash Flow Analysis Leads to Greater Funding Security

By Robert G. Smith, CIMC

According to the Bureau of Labor Statistics there are 76 million baby boomers. These individuals are now beginning to reach retirement age at an increasing rate. Public sector retirement plans must grapple with meeting the financial challenges associated with this demographic trend. Notably, close to half of all government workers are currently aged 45 or older, while about half of private sector employees are under 35 years of age. Hence, public sector retirement plans will feel the cash flow impact of the aging of the “Boomer” generation much earlier than in the private sector. Aside from having a comparatively older work force, government employers must also deal with the fact that public sector employees generally retire at an earlier age than commonly found in the private sector.

As we look ahead these unique public employee demographic trends represent a significant funding challenge for a number of public retirement systems. For many public funds these conditions have forced trustees to consider new or enlarged allocations to investment categories with greater risk/reward potential such as hedge funds, fund of funds, real estate and private equity. In making such decisions, trustees must balance these long term investment decisions with the new paradigm of rapidly rising short term cash flow demands due to the escalation of Boomer benefit distributions. Consequently, trustees must assume both a long and short term perspective. Their investment decisions should take into account the risk of failing to efficiently meet near term funding requirements. Unfortunately, in many organizations this goal is generally perceived as a constraint on investment tactics rather than a primary consideration. It is important to note that trustees carry the fiduciary responsibility to invest plan assets in order to have sufficient funds to meet all commitments as they fall due. Looking ahead, what should matter more as plans enter the coming age of the great Boomer benefit drawdown, are the cash flow dynamics of plan asset allocation and investments relative to the behavior— current market value— of plan liabilities; beginning with tomorrow’s plan distributions through to the longest plan distribution projections available.

Some retirement plans still operate and invest primarily within a mean variance asset optimization framework, which was developed nearly 50 years ago by Nobel laureate Prof. Harry Markowitz. The core investment strategy that has typically emanated from his influence is that plan assets are invested for the long term, and that equities over the long term outperform fixed income assets. Historically, this “assets only” analysis has led to plan allocations that are typically geared toward equity and equity-like alternatives, with low cash flow predictability versus fixed income instruments. While this basic investment model was appropriate for past demographic environments, trustees should now be questioning its appropriateness as a primary asset allocation model to meet the mounting cash flow related asset/liability management challenges in the years ahead. Dynamic cash flow modeling and testing is an operating staple and regulatory requirement for every banking and insurance entity in the U.S.

These institutions are required to regularly assess operating solvency and efficiency on a cash flow basis under a variety of interest rate and market scenarios. These basic operating standards protect the benefit interests of depositors and insureds alike. However, some public retirement plans which are charged with meeting ever rising short term benefit distributions, may not routinely and dynamically test cash flow efficiency in conjunction with long range funding adequacy. By making dynamic cash flow analysis and optimization a routine part of the investment review process, fund trustees will overcome the risk of ignoring a growing and substantial risk in meeting the long run requirements of the plan. By better understanding the plan’s specific asset/liability cash flow dimensions and mismatches over time, a more dynamic approach can be implemented to maximize plan operating efficiency while enhancing long term funded status. This will help assure a more focused investment process which seeks superior investment performance relative to the specific liabilities that the plan exists to meet, at a sensible level of risk.

Robert G. Smith, CIMC, is President and CIO of Sage Advisory Services, Ltd. Co. in Austin, TX.

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Washington Outlook

By Matt Aukofer

Judge Sides With AARP, Blocks EEOC Rule on Employers' Retiree Benefits

A federal judge has blocked the government from allowing companies to provide younger retirees with better health-care benefits than they give older ones who qualify for Medicare.

Ruling in a suit brought by AARP against the U.S. Equal Employment Opportunity Commission (EEOC), Judge Anita Brody of the U.S. District Court for the Eastern District of Pennsylvania in Philadelphia found that the EEOC may not finalize a proposed regulation that would have allowed companies to provide generous health care benefits to young retirees, but less coverage—or none at all—to pensioners old enough to qualify for the federal Medicare program.

The AARP, an advocacy group for people 50 and older and the nation's largest advocacy group for retirees, sued in February to block the proposed rule change, saying giving differing packages to the young and the old amounts to age discrimination.

While the lawsuit centers on whether the EEOC has the legal authority to make the rule change, the deeper debate is over how to slow the growing trend of companies eliminating retiree health benefits. The percentage of companies with more than 1,000 workers offering health coverage to retirees has dropped from 80 percent in 1991 to 57 percent in 2003, according to a study by the benefits consulting firm Hewitt Associates and the Henry J. Kaiser Family Foundation.

In her finding in favor of the AARP, Judge Brody said the EEOC lacked the power to make the change. She ruled the EEOC may not exempt the application of the Age Discrimination in Employment Act (ADEA) when employer-sponsored health plans provide more generous benefits to pre-age 65 retirees than to retirees who are over age 65 and therefore eligible for Medicare.

AARP had called the proposed rule change "age discriminatory," claiming that the EEOC is charged with preventing age discrimination, not with making health care policy choices that could result in employers eliminating benefits for those retirees who become eligible for Medicare.

"The law is clear that if they choose to provide retiree health benefits, they cannot deny them to some of their retirees based on age," said

State Capitol Report

By Neal T. "Buddy" Jones

With fewer than 40 days left to go in the Texas 79th Legislative Session, no major piece of legislation has passed both the Senate and the House, with the exception of the appropriations bill.

The House has passed House Bill 2 which reforms education funding and lowers local property taxes from \$1.50 per \$100 valuation to \$1.00 per \$100 valuation. They have also passed House Bill 3 which raises the sales tax and reforms the franchise tax to pay for the education reform and property tax reductions. The Senate has had hearings on both bills but has not voted on either.

The 79th Legislature must pass an appropriations bill to fund Texas government for the next two years. Many observers feel this funding bill will be the only major piece of legislation passed this session.

The education bill and

Laurie McCann, an AARP attorney.

The lawsuit was filed in response to a final rule the EEOC adopted on April 22, 2004, which would exempt employers from the federal age discrimination law if they decided to abandon retirees' health coverage when the retirees become eligible for Medicare at age 65. AARP felt that some retirees could lose their retiree health benefits and would be barred from challenging their former employer's actions.

The EEOC, which is appealing the ruling, was quick to point out that, without this exemption, employers would reduce or eliminate health benefits for all retirees. In its ruling, the court characterized that argument as "persuasive," but found that the EEOC did not have authority to issue such a rule under the ADEA.

Cari M. Dominguez, chair of the EEOC, said the proposed rule allowing employers to provide different treatment to different age groups was part of an attempt to get companies to stop eliminating retiree health benefits altogether. Companies often provide a less comprehensive package, or nothing at all, to workers once they turn 65 and qualify for free or low-cost care through Medicare.

Dominguez said the proposed rule change has drawn strong support from both the employer and labor communities as well as from members of Congress on both sides of the aisle. "The major teachers unions continue to urge the [EEOC] to act because the benefits of thousands of teachers nationwide remain in jeopardy without the Commission's rule," Dominguez said.

"The new rule will help safeguard existing and future health benefits for America's retirees by ensuring that the ADEA does not impede employers' ability to offer retiree health plans," Dominguez said. "Specifically, the rule will clarify that employers may continue to coordinate retiree health benefit plans with eligibility for Medicare or a comparable state health benefit without violating the ADEA. It does not change current employer practices or plans, nor does it affect any other legal obligations an employer may have. On the contrary, the rule removes an impediment to employers so that they may continue providing retirees with critical health care coverage."

But Judge Brody pointed out that the proposed regulation would violate a legal precedent that companies may offer different health plans to retirees of different ages only if the plans are of equal value or provide equal benefits.

The Society for Human Resource Management (SHRM) said it was disappointed with the ruling and said little incentive remains for employers to offer retiree benefits. Retiree health care benefits are not mandated, but some organizations offer the additional benefit as an

tax bill have legislators taking different approaches in the House and Senate. No agreement can be reached on major workers compensation legislation. An agreement has been reached only recently in the Senate on an asbestos tort reform bill.

Many observers believe the Legislature will not reach agreement on education reforms and/or a tax bill. If this occurs, it will give Governor Perry two choices. He can immediately call a special session to deal with these issues or he may wait until the Supreme Court rules on the education reform issues and then call a special session.

Pension legislation introduced this session has been considered in both the House Committee on Pensions and Investments and the House Urban Affairs Committee. House Bill 1473, by Representative Wong, was referred to the House Urban Affairs Committee, of which Representative Wong is Vice Chairman. The bill changes completely the governance of the Houston Municipal Employees Pension System and requires administrative changes for the pension system.

incentive to recruit and retain valuable employees.

“Unfortunately, the ruling ... will further erode the number of employers who offer retiree benefits,” said Michael P. Aitken, SHRM’s director of governmental affairs.

American Benefits Council Health Care Legal Counsel Susan Relland agreed. “Should [the] decision stand, it would hurt all retirees who participate in these plans and further erode employers’ ability to offer these benefits,” she said. “The EEOC rule is a sensible one that validates a long-standing practice supported by unions and employers alike.”

“The early retiree’s employer-sponsored benefits may be more extensive, but they are often the retiree’s primary or only source of coverage,” Relland continued. “The Council does not want more pre-age 65 retirees to lose their health care benefits because of soaring health care costs and regulatory uncertainty. The Council will continue to vigorously support the EEOC in this matter.”

For further information, contact: Charles Robbins, EEOC, (202) 663-4900; David Grinberg, EEOC, (202) 663-4921; Deanna Johnson Keim or Jason Hammersla, American Benefits Council, (202) 289-6700; Frank Scanlan, SHRM, (703) 535-6043; Jen Jorgensen, SHRM, (703) 535-6356; Linda Rozett or Eric Wohlschlegel, U.S. Chamber of Commerce, (202) 463-5682. On the Web at: www.aarp.org, www.eeoc.gov, www.uschamber.com, www.shrm.org,

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

The bill was heard in committee and left pending. It was voted out of committee without amendments and sent to the House Calendars Committee. It has not been scheduled for floor action. The companion bill for SB 1731 by Senator Kyle Janek has not had a hearing.

Other bills filed by Representative Wong which affect public pension funds are House Bill 109 and House Bill 113. House Bill 109 calls for two actuary studies on any public pension bill which is introduced in either House. It also calls for a referendum to be held by the city council of the pension fund affected by legislation as to their position on the legislation.

The bill states the proposed legislation may not be referred to committee until this referendum is attached. The bill has been heard in the Pensions and Investments Committee and is pending.

House Bill 113 was sent to the House Elections Committee. This bill calls for extensive lobby reporting by vendors of pension funds. It also calls for financial reporting by trustees of a pension fund. This bill

has been heard in committee and action is pending in subcommittee.

Several other bills affecting public pension funds have been heard in committee. Thus far in the legislative session, no punitive public pension fund bill has approached passage in either the House or the Senate.

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

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President's Corner

By Randy Stalnakar

When I turned 50, I received an AARP membership application in the mail and happily mailed in my application, dreaming of discounts on hotels, airfare and a myriad of other things. When my membership card arrived in the mail a few weeks later, AARP also included a membership card for my wife, who was still several years short of turning 50. She recoiled in horror when I handed her the card and promptly threw it away.

Lately, some of AARP's actions make me think that maybe my wife had the right idea. Maybe AARP is not a friend of public employees.

First, they have taken a strong position in support of mandatory Social Security coverage of newly hired state and local government employees as part of their solution to Social Security's solvency, an idea TEXPERS and its members have long opposed. As reported on the National Conference on Public Employee Retirement Systems' website, "AARP just doesn't get it— mandatory coverage adds to the financial burdens of Social Security; it does not help with the long-term financial solvency," stated NCPERS President Bob Podgorny. "AARP is not a friend of public sector

employees and retirees— they sold us out on prescription drug, sold us out on the EEOC rule on health benefits for retirees, and now they are selling us out on mandatory coverage.”

Mr. Podgorny’s reference to the EEOC rule on health benefits for retirees refers to a lawsuit that AARP has filed against the Commission concerning a ruling on retiree health benefits— an action that gives me pause. NCPERS’ website reports that, “AARP filed lawsuit to prevent EEOC from publishing the rule that protects the health benefits of millions of retirees, including state and local government retirees. Without the EEOC rule, retirees would lose their health benefits. NCPERS supports the EEOC rule along with unions, employers and many other organizations. AARP seems to be the only group that doesn’t understand the need for this protection.

“Because of an earlier court decision, called the Erie County Decision, employers would not be allowed to provide greater benefits to pre-65 retirees (not yet covered by Medicare) than post-65 retirees, for whom Medicare becomes the primary payer. The EEOC rule corrects this problem so that employers may provide these benefits without being in violation of the Age Discrimination in Employment Act. The rule has already been delayed because of AARP’s opposition and the lawsuit is a new attempt to prevent it from becoming final.

“AARP is no friend of government workers,” stated Mr. Podgorny. “Their action could cause millions of retirees to lose their health benefits. They also support mandatory Social Security coverage, which would destroy the pension plans of many public safety officers— firefighters and police officers— and teachers. I don’t understand this organization that claims to support seniors. They support two actions that would hurt government workers/retirees and sold out seniors on the Medicare prescription drug benefit. Who do they represent?”

I believe Mr. Podgorny raises a good question. Perhaps we all should be questioning AARP’s actions.

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