



PENSION OBSERVER

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

REITs Go Global

By Michael J. Acton, CFA

Over the past decade, the real estate equity securities or REIT market has grown significantly, both within the U.S. and internationally, making the sector a viable and attractive investment option. The U.S. experiment with REITs since the early 1990s is widely regarded as a success. Information transparency has increased significantly, the real estate capital markets are more efficient and the growth in investor interest and confidence in the asset class has been significant.

Public market penetration ranges from a high of nearly 50% in Australia to less than 5% in Continental Europe.

The U.S. experience has been closely watched around the world and most major industrialized countries are moving quickly to develop some form of tax-advantaged vehicle, similar to the REIT structure in the U.S. A "REIT-like" structure currently exists or is being considered in most major industrial countries. France and Hong Kong added REITlike vehicles during 2003 and the United Kingdom and Germany are expected to introduce REIT-like structures in the near future.

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Special Situations: Classifying Non-traditional Private Equity Strategies

By Karl Beinkampen, CFA

The past three decades have witnessed the evolution of private equity from a cottage industry to a multi-billion-dollar asset class and the development of multiple new investment strategies. Many believe these new strategies, or "Special Situations," can represent an important, tactical allocation within a diversified private equity portfolio. As part of a broader examination of innovation in private equity, developing a definition and a simple framework for classifying non-traditional private equity strategies is useful.

While it is difficult to capture the entire universe of Special Situations with a single



statement, Special Situations can be broadly described as the non-traditional use of private capital at a particular point in time. Private capital is, for our purposes,

any unregistered security. Traditional private equity strategies have generally focused on acquiring interests in (i) start-up firms (venture capital), (ii) rapidly expanding mature or post-venture companies (growth capital) or (iii) buyout financing of mature companies (leveraged buyouts, or LBOs). Non-traditional strategies have expanded the use of private capital to a variety of other applications that either are differentiated by sector focus and structure, or are derivatives or extensions of more traditional private equity strategies.

If one accepts that attractive returns are more likely to be generated where intelligent

capital is scarce, then innovation and differentiation become critical to our overall investment thesis for private equity. Over time, three primary types of fund differentiation have emerged. These three types of differentiation, which are not mutually exclusive, are sector, structure and strategy.

Sector focused funds are differentiated primarily by a narrow focus on a specific sector, industry or asset. A fund that invests only in power sector assets or consumer products companies would be an example.

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WASHINGTON OUTLOOK

By Matt Aukofer

Work Begins on Pension Protection Act to The Din of Partisan Rancor

If the early signs are any indication, the partisan potshots in Congress over pension reform will likely exceed any meaningful give-and-take on the issue among lawmakers from the two parties.

The House Committee on Education & the Workforce approved the Pension Protection Act (H.R. 2830) on June 30, the first step in creating comprehensive pension reform legislation intended to protect the interests of workers, retirees and taxpayers. All 27 Republicans on the committee voted in support of the bill, while the committee's Democrats simply voted "present."

"Our committee took action today to protect the retirement benefits of American workers," said Education & the Workforce Committee Chairman John Boehner (R-Ohio). "Our Democratic colleagues chose to be spectators in that process instead of participants. That's disappointing, but the good news is that Congress is a giant step closer to fundamental reform of the outdated pension laws that have left workers and taxpayers vulnerable."

The Pension Protection Act includes a number of critical protections aimed at shoring up the defined benefit system. . .

But the top Democratic ranking member on the committee, Rep. George Miller (Calif.), said, "I think it is fair to say that we [Democrats] have been given very little time to review this legislation. We have insufficient information on how this bill affects employer contributions to their pension plans. We have insufficient information about how effectively this bill addresses the \$23 billion PBGC shortfall."

Then he told Boehner, "I hope that you view this bill as I view it: a work-in-progress that will allow us time to find common ground on reforming the laws that govern defined benefit plans.

"As I said at the one hearing that you convened on your legislation a few weeks ago, I am concerned that this bill relies on benefit cuts to employees and billion-dollar

tax hikes for employers," Miller added. "These actions would undermine the use and attractiveness of defined benefit plans for both employees and employers and would fail to provide the protection employees need for their hard-earned nest eggs."

Boehner countered: "We've had 10 hearings on this issue, and Democrats have had ample time to look at our bill and propose changes. We've worked with Democrats, met with them numerous times over the last several weeks, and accepted a number of their changes that have strengthened the bill. The status quo is clearly unacceptable, and we plan to continue to work with those on both sides of the aisle who are interested in making serious progress on behalf of workers and retirees who are counting on these hard-earned pension benefits."

Lynn Dudley, vice president of retirement policy for the American Benefits Council took a more conciliatory tone. In a statement made in conjunction with the committee hearing on H.R. 2830, Dudley said: "The fundamental question facing Congress as it begins the consideration of pension reform legislation is whether, at the end of the legislative process, enough will have been done to encourage employers to sponsor defined benefit pension plans, or whether Congress will have hastened the demise of the system."

Dudley added, "Employers that sponsor defined benefit pension plans—including well-funded plans—are concerned that [the] proposed legislation may still inject too much uncertainty and sudden change in funding obligations. And, in some respects, this bill will unintentionally discourage employers from adequately funding their plans. While we offer our critique of the legislation, we also remind Congress of our comprehensive set of proposals to improve pension funding." That proposal is contained in a council

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PRESIDENT'S CORNER

By Randy Stalnaker

As I write this column, the Texas Legislature has just begun a Special Session. The only issue they're working on is school financing so we can all breathe a sigh of relief that public pension fund issues are not on the table. However, it always behooves us to be prepared to deal with the issues that confront Texas public funds and which the Legislature may choose to address.

TEXPERS should be part of the solution.

As I see it there are two major issues that are of common interest and about which we should be knowledgeable. The first is an "early warning system" to give a timely indication that a public pension plan is beginning to get into financial difficulty. The Legislature has mandated that the State Pension Review Board develop an early warning system and they are investigating how to develop and implement such a system. I believe that TEXPERS should provide every assistance to them while assuring that the system developed is not onerous to Texas public plans.

The second issue is retiree health care. Of course, this is not just an issue confronting Texas public pension plans, but our country as a whole. The rapidly increasing cost of health care is a serious public policy issue confronting the United States.

The situation for public employees in Texas is somewhat unique. While Texas public plans generally do not provide the health insurance for their retirees, increases in cost must be a concern for the trustees and staff members of the plans who want to assure that retirees' pensions are not completely consumed by the cost of health care coverage.

My thought on this subject is that TEXPERS should be part of the solution. That is, we should serve as an active, credible and reliable resource to the Legislature, cities and other entities that are looking for ways to provide quality health care coverage to retirees at a reasonable cost.

I welcome your thoughts on these and other topics of interest and encourage you to be actively involved in guiding the future of Texas public pension plans and their members.

The 79th session of the Texas Legislature adjourned *sine die* around 7:00 PM on Memorial Day, May 30, 2005. Legislators failed to reach a deal on the two most high profile issues of the session: school finance reform and property tax relief/tax restructuring. District Judge John Deitz of Austin has declared the Texas school finance system unconstitutional and ordered the legislature to come up with a new plan by October. The case is on appeal, and the Texas Supreme Court is scheduled to take it up on July 6.

A total of 5,628 bills and constitutional amendments were considered, with 1,370 measures being passed and sent to the Governor. The Governor vetoed 19 bills.

Several significant issues were addressed by the 79th Legislature. The big issue in every session is the state budget. Lawmakers agreed on SB 1, a \$139 billion balanced budget which is a \$12.88 billion (10.1%) increase over the 2004-2005 level. It provides \$36.8 billion for public education; \$50 billion for health and human services; \$250 million for Child Protective Services reforms; \$444 million for the Children's Health Insurance Program; and \$37.8 billion for Medicaid. It provides for state employee 4% pay raise in 2006 and an additional 3% in 2007 and restores the dental and vision coverage for the Children's Health Insurance Program (CHIP).

Workers' Compensation Reform was another major issue this session. HB 7 abolishes the existing Texas Workers' Compensation Commission and creates a new Division of Workers' Compensation within the Texas Department of Insurance.

There were several other important issues the legislature passed in the 79th session, including SB 15, the asbestos/silica litigation reform bill, which distinguishes between the claims of people who are physically impaired or sick due to exposure to asbestos or silica and those who are not experiencing any physical impairment relating to asbestos or silica; the Emerging Technology Fund which was created by HB 1765 to expedite the development of new technologies in Texas and is a key plank in the Governor's economic development platform; HB 2702 which raises the ceiling on the amount of gasoline

tax the state can use for toll roads, requires an election before an existing road can be converted to a toll road, and ensures access from most highways to the proposed Trans-Texas Corridor system; and lastly a provision allowing Texas consumers to order prescription drugs from up to 10 approved Canadian pharmacies passed as part of SB 410, the sunset bill for the State Board of Pharmacy. It will allow consumers to utilize a participating Canadian pharmacy for refill prescriptions only.

The Pension Review Board is very keen on trying to set up the "Early Warning System" on pension systems that are in actuarial trouble. Senators have requested the system be set up during confirmation hearings of the new chairman of the PRB.

House and Senate leaders and the governor have continued to meet since adjournment on school finance reform and property tax relief/tax restructuring. Since they are close to reaching an agreement, Governor Perry called for a 30-day Special Session which began on June 21, 2005.

We do not expect any pension issues to be addressed during the special session. Committees from both houses, the Senate Intergovernmental Relations and the House

Pensions and Investments, are in the process of formulating issues to be addressed in the interim. We expect Interim Charges to be presented by Lieutenant Governor David Dewhurst and Speaker Tom Cradick by the end of the year.

The Pension Review Board (PRB) is very keen on trying to set up the "Early Warning System" on pension systems that are in actuarial trouble. Senators have requested the system be set up during confirmation hearings of the new chairman of the PRB. We feel this topic will be addressed in any Interim Charges.

Another area that will possibly be studied during the interim is how actuaries operate in Texas. Several major problems which public pension funds face can be attributed to actuarial errors. Several legislators want to thoroughly examine how actuaries operate in Texas and what oversight is given to their vocation.

A final area that may be considered in the interim is health care provided by governmental entities. The soaring costs of health care have made it increasingly difficult for governmental bodies to economically deliver quality health care for their employees.

TEXPERS will be working with committee chairmen and their staff to help define these issues and enable them to have meaningful examinations of these topics.

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

REITs Go Global

By Michael J. Acton, CFA
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Today, the U.S. REIT market represents only half of the global listed market and publicly traded real estate currently represents less than 5% of the approximately \$15 trillion global commercial real estate market. Public market penetration ranges from a high of nearly 50% in Australia to less than 5% in Continental Europe. Clearly, the growth potential for public ownership of commercial real estate is great as the share of commercial real estate that is held in a publicly traded format continues to grow; particularly as more countries introduce REIT-like structures.

The benefits of investing in global publicly traded real estate securities are similar to that of U.S. real estate securities, including diversification, high current yield, stable price performance and inflation-hedging attributes. However, global real estate

securities also offer exceptional diversification benefits. In particular, the average correlation coefficient between U.S. and foreign listed securities is roughly half that of all equity securities. In other words, the diversification benefit in publicly traded real estate is double that of all equities.

In addition to the diversification benefit, global real estate investors have also been rewarded with higher returns over the past decade. Through the end of 2004, the UBS Global Investors Index has outperformed the U.S. REIT market over the one, three, five and ten year periods. Indeed, during 2004 the U.S. REIT market posted total returns of more than 30%, but higher returns were recorded in eight other countries. Admittedly, many of these countries are small with only a few companies to choose from but the opportunity for higher returns does exist.

Going forward, we believe that investors will continue to seek greater exposure to the return and portfolio benefits of the real estate asset class and will increasingly pursue these benefits on a global scale. To this end, publicly traded real estate securities, versus investment in direct real estate, is a likely first step for many investors as they expand their investment universe to include real estate opportunities outside of their home country. The scalability of securities allows a global real estate portfolio with real

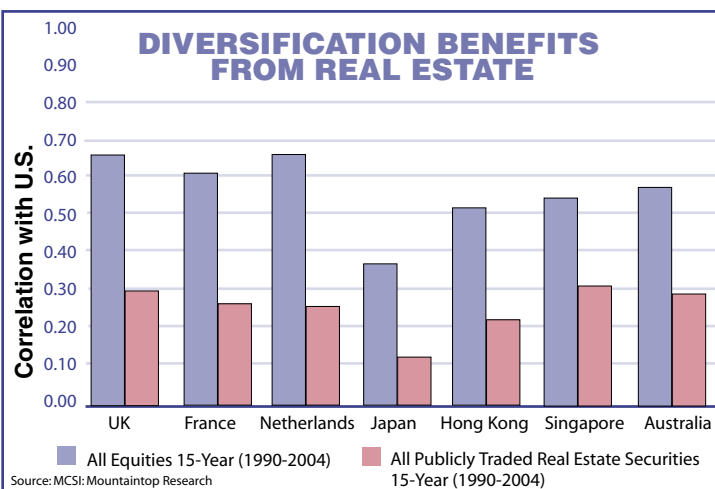
diversification benefits and significant liquidity of investment. To do that through a direct property portfolio on a global scale would require vast amounts of capital and a great deal of management time.

The U.S. experience has been closely watched around the world and most major industrialized countries are moving quickly to develop some form of tax-advantaged vehicle, similar to the REIT structure in the U.S.

As more countries adopt REIT-like structures and markets mature we will see increased standardization, improved governance, disclosure, better availability of information, etc. In our opinion, this growth is inevitable, beneficial to all real estate investors and will clearly lead to greater global investment

¹ See "International Property Companies: How Have They Performed?" Mountaintop Research - March 16, 2004

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Competitive Total Returns

	1 Year	3 Year	5 Year	10 Year
Global Real Estate Securities	37.8%	28.7%	22.5%	15.4%
U.S. REITs	31.6%	23.3%	21.9%	14.8%
U.S. Private Real Estate	14.5%	10.0%	9.9%	10.9%
U.S. Stocks	10.9%	3.6%	-2.3%	12.1%

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UBS Investors Index (\$USD), NAREIT Equity REIT Index, NCREIF Property Index, S&P500, Lehman Govt./Corp. Index

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TEXPERS 18th Annual Conference
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Special Situations

By Karl Beinkampen, CFA
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The generic sector investment thesis asserts that industry expertise allows managers with deep industry contacts to source transactions, perform due diligence and implement operational changes beyond the capabilities of a generalist fund.

Structural differentiation is largely a function of position on a company's balance sheet or customization to meet a specific regulatory or capital requirement. A customized short-term mezzanine fund or private investment in public equity (PIPE) fund could be examples of structural differentiation. The generic structural investment thesis asserts that the ability to provide a unique or customized financing solution for a particular strategic

regulatory or financing need allows the manager to extract above-market rents.

Strategy differentiation is the broadest and most complex of the three general categories of differentiation—and the most difficult to articulate. Generally these funds are distinguished by the structure of the fund or by the unique way capital is used. Many strategies that are derivatives of the standard private equity model, such as a secondary fund, fall into this general category. The generic strategy-based investment thesis asserts that the application of private capital in the absence of any alternative to a previously unmet need can dictate pricing of that capital. In other words, higher fund returns can be generated in areas where intelligent

capital is otherwise unavailable.

A structured approach to evaluating new investment opportunities can enhance both the selection and structuring of private capital fund strategies. Identifying, evaluating and committing to Special Situations require constant involvement in the private equity fund arena, as well as a disciplined, proactive effort to source opportunities. Over time, many of these once-new private equity strategies have provided the foundation for successful franchises, and some have eventually been absorbed into the investment mainstream. 🇺🇸

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Washington Outlook

By Matt Aukofer

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document, *"Funding Our Future: A Safe and Sound Approach to Defined Benefit Pension Plan Funding Reform."*

"Chairmen Boehner and [Ways & Means Committee Chairman Bill Thomas (R-Calif.)] and the other sponsors of H.R. 2830 have developed a proposal that is clearly better than the ideas set forth by the [Bush] administration earlier this year," Dudley continued. "However, the question remains: 'Is it enough?'"

"We applaud Chairman Boehner for making clear that preservation of defined benefit plans, and not allowing the system to wither, is his objective. But employers are not certain that Congress is yet on a path to arresting the slide in these vital plans."

Defined benefit plans offer valuable benefits to employees, including providing certainty to workers and their families, and address concerns about outliving accumulated retirement assets. Funded by employers, the plans are, for employees, investment-risk free and guaranteed by the PBGC. The vast majority of defined benefit plans in the United States are well-funded and maintained by healthy companies that have and will continue to meet their benefit obligations, Dudley added.

Dudley applauded Boehner for recognizing that the one crucial aspect of saving the defined benefit pension system is to once and for all establish the legal validity of so-called cash balance and other hybrid pension plans. These plans cover approximately 25 percent of all participants in the defined benefit system and make up approximately 20 percent of the premiums paid to the PBGC. Boehner's companion

legislation, the Pension Preservation and Portability Act (H.R. 2831), seeks to do precisely that.

"We urge Congress to incorporate hybrid plan legislation as part of any funding reform legislation that it considers this year," Dudley concluded.

The Pension Protection Act includes tough new funding requirements to ensure employers adequately and consistently fund their pension plans, provides workers with meaningful disclosure about the financial status of their benefits, and protects taxpayers from a possible multi-billion dollar bailout of the PBGC should the agency's financial condition continue to deteriorate.

"We understand pensions are a voluntary benefit provided by employers," said Rep. Sam Johnson (R-Texas), chairman of the Employer-Employee Relations Subcommittee. "There is a balance we need to strike here. The bill before us simply says if you offer a defined benefit pension plan, you need to put your money where your mouth is. It is time we put the brakes on over-promising and under-funding."

"The Pension Protection Act makes excellent progress toward modernizing our out of date retirement security system," said Rep. John Kline (R-Minn.), vice chair of the Employer-Employee Relations Subcommittee. "As our bill continues to move through the legislative process I look forward to working with our colleagues to assess what changes may be necessary to ensure our businesses and industries are in a strong position to provide a secure retirement for all Americans."

During consideration of the bill, the committee

approved a substitute amendment offered by Boehner to help resolve the legal uncertainty surrounding cash balance plans, a type of hybrid defined benefit plan that many American workers rely upon for their retirement security.

"Cash balance pension plans—a type of defined benefit plan that is employer-funded, insured by the PBGC, and portable from job to job—represent an important component of worker retirement security, and they account for more than 20 percent of the premium revenue paid by employers to the PBGC," said Boehner. "Cash balance pension plans are the future of the defined benefit system, and it's critically important that Congress act to resolve the legal uncertainty that is jeopardizing generous pension benefits for workers across the country."

The cash balance solution is the result of an agreement reached between Boehner and Ways & Means Committee Chairman Thomas. It establishes a simple age discrimination standard for all defined benefit plans that clarifies current law with respect to age discrimination requirements under ERISA on a prospective basis. The bill does not establish different rules for hybrid plans or conversions, but sets up a simple age discriminatory standard that all defined benefit plans must meet prospectively. The measure also prohibits employers from reducing or cutting any vested benefits workers have earned during a conversion to a cash balance plan.

"It is important to begin to address the legal status of these retirement plans," said Johnson.

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Washington Outlook

By Matt Aukofer

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The Pension Protection Act includes a number of critical protections aimed at shoring up the defined benefit system so employers can continue to offer these voluntary benefits to workers. Specifically, the bill:

- Provides a permanent interest rate based on a modified yield curve that will ensure employers more accurately measure and fund their short-term and long-term pension promises;
- Requires employers to meet a 100 percent funding target;
- Prohibits the use of credit balances for severely underfunded plans;
- Phases in reasonable increases in employer premiums paid to the PBGC;
- Provides workers in both in single and multi-employer plans with better information about the status of their pension plans; and
- Allows employers to provide rank-and-file workers with access to high-quality investment advice as an employee benefit.

The bill also includes numerous reforms to multi-employer pension plans governed by collective bargaining agreements to give trustees, both labor and management, additional tools to appropriately fund their benefit promises. These reforms have been agreed to by a broad coalition of employer and labor groups.

The Associated General Contractors of America (AGC) testified that it found that in 2001 and 2002, multi-employer pension funds were facing funding deficiencies because the maximum deductibility limit was only 100 percent, making it virtually impossible for plans to create sufficient savings in the event of a downturn in the

market. The House proposal to increase the deductibility limit would allow the plans to save more for future retirees and avoid funding shortfalls in the future.

AGC urged Congress to pass a multi-employer pension bill that would increase the maximum deductibility limit to 140 percent of current liability and ensure the fiscal health of the plans moving forward.

Chuck Clark, a member of AGC's Michigan Chapter and president and CEO of Clark Construction, Lansing, Mich., told the House committee, "If Congress would raise the maximum deductibility level to 140 percent, many of the funding problems faced by the industry in 2002 could be avoided in the future."

"The construction industry is the number one user of multi-employer pension plans because they provide portability for workers as they move to different job sites and new employers," said AGC CEO Stephen E. Sandherr. "AGC's number one priority for this bill is to ensure the increase in the maximum deductibility limit."

"We've had some difficult decisions to make with this legislation," Boehner said. "We want to preserve defined benefit pension plans to ensure workers and retirees can continue to count on these important benefits during their retirement. But we can't tighten the rules so much that employers simply stop offering these plans, jeopardizing worker benefits altogether. This is the tightrope we've been walking, and we've taken a balanced approach that addresses these difficult questions." 🇺🇸

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