

T H E T E X P E R S



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It's Deja Vu All Over Again

By David S. Spika, CFA

Do you remember the '70s? Platform shoes, psychedelic shirts, long hair, disco music and hip hugger jeans were all the rage. Those are certainly things that come to mind when one waxes nostalgic about that tumultuous decade. But what about the economy, government, and stock market?

A market crash followed by a recession, a war in a foreign land, skyrocketing oil prices, rising inflation, and increased government regulation come to mind.

Sound familiar? Unfortunately for those who would like to forget the '70's, the current decade is shaping up a lot like that decade 30 years ago.

We have had the recession, the stock market crash, the war in a foreign land, the rising oil prices and the increased government regulation. The next step is inflation, and we are starting to see the impact of higher prices as we speak. What does this mean for the economy, and more importantly, for the financial markets over the next 5 years? How can we use lessons learned in the '70s to manage these near-term risks?

The economy and markets have been on a wild ride the past few years. Following the recession and market crash, both the Federal Reserve and the Bush Administration injected extreme amounts of liquidity, in the form of lower interest rates, tax cuts and increased government spending, into the economy in order to reignite growth. It worked in spades, with the

Leveraged Loans; An Attractive Alternative

By Ron Ernst

In investment markets, "intuitive" thinking is often just conventional wisdom—which, more often than not, is wrong. For instance, because leveraged loans are rated below investment grade, they are simplistically considered to be highly risky. Intuitively, if high-yield bonds are "junk," their loan counterparts must be "junk," too.

Not so. It's hard to imagine a worse trial by fire than the early years of this decade—the most trying period of bankruptcies, defaults, and credit downgrades since the Great Depression. But the maelstrom clearly demonstrated that leveraged loans are less volatile than virtually any other asset class. That makes them an exceptionally attractive alternative investment to reduce a portfolio's overall volatility.

Several characteristics make leveraged loans less risky than believed. They are, first of all, secured by all of the issuer's assets and capital stock, and are thus the most senior claims on the issuer's capital structure. They also have tighter covenants than high-yield bonds, which are generally unsecured and have limited covenants. Leveraged loans default less

economy growing rapidly in 2003 and 2004. The stock market reacted in kind, producing very strong returns in both years in large and small cap stocks alike. Bond investors, due to the falling interest rates, have also fared relatively well while specialty asset classes, including high yield bonds and REITs, have likewise generated very impressive returns.

But, like all good things, these stellar returns must come to an end. In 2004, the Fed began raising interest rates, increasing the Fed Funds rate by 1.25% to 2.25%. Economic and corporate earnings growth, while still healthy, has declined from the robust levels seen in 2003 and early 2004, and inflation is beginning to rear its ugly head, with the CPI now running at 2.5%, vs. a run rate of 1% or less during 2003.

What does all this mean? We think it means much more modest returns in the years ahead. The tailwinds of falling interest rates and low inflation have now reversed and have become headwinds.

Government regulation, a byproduct of the bursting of the '90s stock market bubble, has increased the cost of doing business for companies in most industries, thereby limiting earnings growth potential. The war in Iraq could divert government resources from providing growth stimulus in other areas of the domestic economy, and higher energy costs will surely put a damper on consumer spending.

What's an investor to do? Well, using the '70s as an example, buying stock in companies that are leveraged to real assets, e.g. commodities such as oil & gas, copper, and iron-ore, is a good way to hedge against inflation. It is also a good way to invest in the explosive growth of emerging nations like China and India, where such commodities are being consumed at a rapid pace. In addition, it is prudent to focus on industries with pricing power, i.e. the ability to pass along to their customers the higher costs they are incurring.

Companies in the industrial sectors of the market are having a much easier time of this today than are companies in the service sectors, which are more dependent on slowing consumer spending.

frequently and have higher recovery rates. They also have lower duration than bonds and are floating rate instruments with frequent resets, which helps insulate them from rising interest rates.

They've proven to be less volatile than investment-grade corporates or 10-year Treasuries—and are certainly less volatile than public and private equity. Overall, leveraged loans offer attractive risk-adjusted returns and are virtually uncorrelated with other asset classes, which makes them an ideal ingredient in professional portfolios.

An added allure is that leveraged loans are underrated by the rated agencies, which typically apply, and issuer's senior implied ratings to loans, which do not take into account the benefits of being secured. If leveraged loans were rated separately, on their own merits, they would probably win ratings one to three notches higher. In other words, loans have a price advantage: They're usually priced low relative to their actual risks.

Moreover, leveraged loans have never posted negative annual returns. That's remarkable, since even 10-year Treasuries have losing years. In their worst year, 2002, loans returned a positive 1.12%. By contrast, in 1994, when the Merrill Lynch investment-grade corporate bond index lost 3.34%, loans racked up 10.32%. According to a study by Credit Suisse First Boston, Treasury bills constitute the only other financial instrument that has stayed in the black, year after year.

The \$1.4 trillion market you've never heard about

A common question is, "Why haven't I heard about leveraged loans before?" The reason is that the arena used to be dominated by commercial banks until a well-developed institutional market

Finally, it is appropriate to invest in companies that value their shareholders. Such companies tend to return more of their profits to shareholders in the form of dividends. High dividend paying stocks will look very attractive in an environment marked by lower than normal absolute returns.

Risk management is important in any environment, but becomes especially so when the markets become tougher to navigate. By focusing on companies that can produce consistent earnings—even in rising interest rate and inflationary environments—as well as on companies that produce strong cash flow and are willing to share it with investors, you can mitigate a lot of the risk inherent in equity investing.

For the next several years, then, it's a good idea to use the '70s as an example for investing in the markets, but please resist the urge to pull out those old Bee Gees albums.

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emerged in recent years.

Loan syndications developed chiefly in the late 1980s, when loans for leveraged buyouts became too large for individual banks to hold on their own. A fledgling secondary market emerged around 1988, when insurers and other non-bank institutions became investors.

The big growth in loan trading, however, started when investment banks came in to the market in the mid-1990s. A dealer quote-based pricing system was established, along with standards for documentation, settlement, syndication and trading practices.

As nonbank participation soared, “institutional” loan tranches were tailored with prepayment fees and other protections for nonbank investors. Although loans are not securities, the Securities & Exchange Commission in 2000 directed fund managers to mark the value of loan holdings to market, which made loan spreads sensitive to secondary market supply and demand pressures, and made institutional investors more comfortable with loan valuations.

Together, these developments transformed leveraged loans, already a distinct asset class, into a fully developed capital market. By the end of 2003, leveraged loans outstanding totaled \$1.4 trillion, larger than the \$881 billion high-yield bond market. Annual volume of secondary par loan trading, as monitored by Loan Pricing Corp., has climbed more than 30-fold in the past dozen years, from some \$3.6 billion in 1991 to \$113.5 billion today.

Liquidity continues to deepen as more institutional buyers and traders enter the arena. According to the Loan Syndications & Trading Association, more than 135 nonbank institutions now

participate in the market, including insurance companies and reinsurers, mutual funds, private equity funds, and other asset managers. Newer participants include public and private pension funds, foundation, endowments, and hedge funds. Nonbank players now far outnumber commercial banks.

The net result is that leveraged loan returns are exceptionally stable and aren't closely correlated with other asset classes. Studies show that returns on the S&P 500 can jump to 6.5% on the volatility scale, while High-yield bonds can go to nearly 4% and 10-year Treasuries to almost 3%. By contrast, the volatility of leveraged loans oscillated around 1%. Since 1992, the correlation of the CSFB leveraged loan index has been only 0.13 with the S&P 500, 0.23 with convertible securities, and 0.49 with high-yield bonds, high-grade corporates, and mortgage- and asset-backed securities.

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Aging Baby Boomers Providing Investment Opportunities

By Mark V. Petersen and Edgar J. McDougall, Ph.D.

Because of their vast number, "Baby Boomers," those born between 1946 and 1964, have a dominant economic impact in our society. The United States Census Bureau estimates that the population age 50 and over will increase from approximately 70 million today to approximately 96.3 million in 2010, and that all Baby Boomers will have reached their 50s by 2020. Baby Boomers are creating intriguing investment opportunities through changing needs in their spending behavior as a result of their aging.

Members of this generation are healthier, wealthier, better educated, and more active. They want to spend their retirement enjoying the fruits of their labor. The over-50 age group has 75 percent of the

nation's discretionary income and 77 percent of the nation's personal financial assets.¹ This same group boasts \$2 trillion in annual income and \$7 trillion in wealth, and their discretionary spending per capita is 2.5 times higher than the average for younger households.²

Therefore, as a study by the Milliken Institute suggests, "higher wealth accumulation and grown children will permit many to enjoy a retirement lifestyle significantly different from any previous generation."³ Two-thirds believe they will maintain or increase their current lifestyle after retirement.⁴ In addition, according to a survey for the American Association of Retired People prepared by Roper Worldwide Research "more than 73 percent of Baby Boomers expect to have a hobby or special interest that they will dedicate a lot of time to when they retire."⁵

In research conducted by Age Wave, noted author and industry expert Dr. Ken Dychtwald cites key motivating factors for the Baby Boom Generation, including a shift from acquiring material possessions toward purchasing enjoyable and satisfying experiences.⁶

They are particularly likely to spend more time and money than previous generations on leisure activities, travel, lodging and dining. For example, ski resorts are expected to benefit from this demographic shift. According to The Timeshare Beat, "The hottest thing to hit ski resorts in America in recent years is the 'Mountain Village' concept, and Baby Boomers with enough money to pay for it are gobbling it up."⁷ These villages offer a new level of luxury and convenience with gourmet restaurants, upscale boutiques, specialty shops, and entertainment.

The aging Baby Boomer population is also expected to spend more time on activities such as golf. They are expected to contribute to the growth in total rounds played due to their increasing concentrations of wealth and leisure time, as well as the suitability of golf as a sport for an aging population. Along the same lines, as the Baby Boom Generation ages, it is expected to significantly increase the demand for large sailboats and powerboats, boosting the demand for boat slips and other marina services.

Studies also show that Boomers want to travel, and are willing to spend significantly more than the typical consumer to accomplish that. According to the National Tour Association, "Among all age groups, Boomers are the most likely to stay in a hotel or motel, to travel for business, and to fly. They account for 40 percent of all travel, and that figure is expected to increase."⁸ Consequently, the lodging industry should benefit from this trend.

The Baby Boom generation is healthy, wealthy, expected to live longer, and enjoy more years of retirement than any generation before. With an aggregate growth rate of 30.1% through 2015, Boomers and their tendency to spend will clearly dominate the U.S. economy."⁹ Thus, meeting their needs should provide a favorable investment environment in the recreation, travel, and hospitality markets.

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5 "Baby Boomers Envision Their Retirement: An AARP Segmentation Analysis,"

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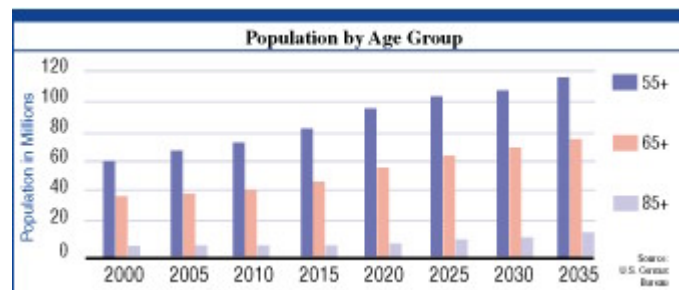
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Washington Outlook

By Matt Aukofer

Congress More Likely to Pass Private Pension Reform than Social Security Fix

The Bush administration's proposed legislation to shore up the Pension Benefit Guaranty Corp. is much more likely to pass Congress this year than

State Capitol Report

By Neal T. "Buddy" Jones

The 79th Texas Legislature convened on January 11, 2005. The previous legislature, the 78th, had started with a large deficit and was faced with making drastic cuts at the beginning of 2003. This Legislature received good news from Texas Comptroller Carole

its controversial plan to partially privatize Social Security.

That's because there is a general consensus between the parties that something must be done soon to ensure the long-term solvency of the PBGC, but there is no consensus on what should be done about Social Security.

Republicans and Democrats cannot even agree on whether Social Security faces an imminent crisis. President Bush thinks so, but most Democrats disagree. Neither side has so far budged from its core belief: Most Republicans think privatizing the system is the best way to save it from a certain catastrophe, while Democrats oppose privatization and say the program is not in crisis and will remain solvent for decades.

Bush and key Republican lawmakers know they cannot go it alone on Social Security if they hope to accomplish any type of reform this year. They know they will need bipartisan support, if for no other reason than to protect the party from future political attacks if their plan fails. Some Republicans, such as Rep. Ron Simmons (Conn.), former House speaker Newt Gingrich (Ga.) and former Rep. Jack Kemp—a GOP vice presidential nominee and housing secretary—have already warned that Bush's plan could cost the Republicans control of Congress.

Needless to say, in this climate, politicians on both sides of the aisle have decided it will be much easier to band together to reform the PBGC, the federal agency that insures private pensions. One reason for this is that PBGC reform is on the radar screen. The recent highly visible PBGC takeover of United Airlines' pilots' defined benefit pension plan will make PBGC liable for roughly \$1.4 billion in guaranteed benefits, making the United pilots plan the third-largest claim in the history of the insurance program.

This and other corporate failures more than doubled PBGC's deficit in the last year to \$23.3 billion, making many in Congress wary of the long-term financial stability of the agency.

Keeton Strayhorn advising the state had a \$300-600 million surplus starting this session. This allows the Legislature to fund all state agencies and programs at a minimum of the level they were funded in the last session.

With the state facing a court order to change how our Texas public education system is funded, Governor Rick Perry has declared education reform legislation as an emergency item. This will allow legislators to begin hearings on this item immediately and to vote on proposed legislation as soon as it is reported from committee.

Under our Texas Constitution, bills not declared an emergency by the Governor may not be heard in committee until later in the session without a suspension of House or Senate rules. Other items declared an emergency by Governor Perry were adult protective services and child protective services.

The Senate and its leader, Lieutenant Governor Dewhurst, have come out with an education package to address the court order to reform education funding by October 2005. Their package includes a statewide property tax for education reduced from the present \$1.50 to \$1.00. The Senate proposal calls for a tax package which will raise about \$7 billion, including a new business tax covering all Texas businesses except sole proprietorships.

Both the Texas Senate and House convened with election contests pending before each House. The Texas Senate quickly disposed of its case and found no election violations in the case brought against Senator Mario Gallegos, of Houston.

The house had three cases filed. The first two, by defeated Republican incumbent Jack Stick and Republican Eric Opiela, have been dropped. The case of voter fraud brought by Republican Talmadge Heflin, former Chairman of the House Ways and Means

“At a time when Social Security and retirement savings are at the top of the national agenda, I welcome the administration’s announcement on pensions,” said Rep. George Miller (D-Calif.), the senior Democrat on the House Education & the Workforce Committee.

“For three years, I’ve been warning of the deterioration of private pensions and the risk to taxpayers of a multi-billion dollar pension bailout. Until the president puts his full weight behind this issue, the economic security of America’s workers will be at risk.”

John Boehner (R-Ohio), chairman of the House Education & the Workforce Committee, commended the Bush administration for formally introducing its proposal. “It’s clear that today’s outdated pension laws have failed to protect the interests of workers, retirees, and taxpayers, and it’s essential that Congress take action in the coming months to reform and strengthen the defined benefit pension system on behalf of workers and employers.”

Under the Bush administration’s plan, the premiums companies pay to the PBGC to insure their plans would be increased from \$19 per participant to \$30—a 58 percent increase. The PBGC now takes in \$600 million from premiums, which could increase to \$1 billion under the plan.

In addition, the proposal calls for higher premiums for companies with underfunded plans, or whose business is considered at risk.

The administration did not outline any specific definition of what an underfunded plan or at-risk firm would be.

The proposal also calls for changes in how companies estimate their pension obligations, and shrinks the time companies have to strengthen underfunded retirement plans. Again, the specifics were not delineated.

The plan also would improve corporate disclosure to workers, investors and regulators about pension plan status, but many of the details need to be

Committee, is still pending and will be considered by the special committee set up by Speaker Tom Craddick. The committee is made up of 5 Republicans and 4 Democrats. Representative Will Hartnett, from Dallas, was appointed by the Speaker as Master of Discovery for these contests.

Besides public education, finances, and child and adult protective services, other important issues facing the 79th Legislature include workers compensation reform legislation, economic development legislation, and additional Child Health Insurance Program (CHIP) funding legislation.

Several bills have been filed in the pension arena. Representative Martha Wong, from Houston, has introduced legislation calling for additional actuarial information to be furnished on any legislation dealing with municipal pension funds. She has also introduced a bill which calls for new ethics registration and reporting of trustees and vendors of public pension funds. Legislation calling for more open information on hedge funds and alternative investments by public pension funds has been introduced by Representative Dan Gattis, of Georgetown, and Senator Robert Duncan, of Lubbock.

More legislation is expected in the public pension arena during this session. The mayor of Houston has stated publicly that he will seek legislation to change the governance of Houston’s public pension funds. Some legislators have also stated an interest in introducing legislation dealing with actuaries and actuarial practices in Texas.

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The Impact of a Weak U.S. Dollar on Asia By *Daniel Tubbs*

In the last two years the U.S. dollar has

worked out.

“Outdated and ineffective pension rules allow employers and unions to underestimate future pension liabilities and make promises they cannot keep,” Secretary of Labor Elaine L. Chao said in a speech at the National Press Club in Washington, D.C., Jan. 10. “In fact, current estimates place the total amount of underfunding in private, defined benefit pension plans at \$450 billion.”

Chao also stated that the administration’s proposal “will require employers to provide the resources necessary to make good on the pension promises they have made in the past. But we also propose to give employers a reasonable transition time to reach their funding targets.”

While this implies that the funding requirements may be tightened, Chao offered little guidance on what may be proposed.

In addition, she did not provide enough detail to determine how significantly the broad universe of underfunded companies would be affected this year and in the future.

While Chao said the new disclosure rules on the funded status of the plans would force companies to make information about the financial health of pension plans more widely available and timely, she did not say exactly how widely available and how timely.

Most of these details likely will be determined only through the final legislative process.

Boehner did not immediately embrace the Bush administration’s plan, saying only, “We plan to review the administration’s proposal very carefully as we move ahead with the process of putting together a comprehensive legislative package for Congress to consider.”

Today, roughly 34 million Americans participate in single employer defined benefit pension plans.

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declined approximately 34% against the euro and around 28% against the yen. The current consensus view in the financial markets is for the long-term trend to persist. The latest available consensus forecasts for EUR/USD and USD/JPY for end-2005 are 1.39 and 98 respectively. The weakness in the dollar is largely blamed on the recent strength of the U.S. economy, funded by current account and fiscal deficits. With artificially low interest rates and generous tax breaks, U.S. consumers have been on a spending spree, causing the current account deficit to widen. Meanwhile the fiscal deficit is growing as the Federal Reserve Board finances the economic expansion by selling massive amounts of Treasury notes to foreign central banks, particularly to the big Asian economies.

The weak dollar has helped keep Asian economies and stock markets buoyant. The negative sentiment towards the dollar caused liquidity to gush into emerging markets, leading to surging fixed investment (especially in China), resulting in higher commodity, property and stock prices. Many market participants have plied this trade and in the absence of an alternative trend for financial markets to focus on, the weak dollar is likely to persist.

In November 2004 the greenback was sent to 4 year lows against the euro and yen after a board member at the People’s Bank of China declared China was planning to trim its purchase of U.S. treasuries. The appetite of other big Asian economies to continue buying dollar assets is also waning. Asian banks are rushing to diversify their huge reserves as fears of a disorderly decline in the U.S. dollar intensify. The dilemma for the export-dependent Asian economies, is that if they stop buying dollars and send U.S. interest rates higher, they could potentially suffer the most, as their biggest trading partner experiences a slowdown.

For global recovery to continue on a sustained long-term basis, the U.S. current-account deficit needs to be reversed, either by further

weakening of the dollar or sub-trend U.S. growth. The timing of when the dollar finally bottoms, will determine the level of success for financial investors in 2005. If the weak dollar persists throughout 2005, this year could turn out to be similar to 2004 with risk assets (e.g. property, commodities, emerging markets, etc) continuing to increase in value and the global economy remaining strong. When the dollar eventually bottoms, it could signal the peaking of all risk assets in the world.

Irrespective of the fluctuating strength of the U.S. dollar, Asia is currently still attractive from a relative-return standpoint, as it is significantly cheaper than America, Europe and Japan. The MSCI AC Asia ex-Japan index is trading at 10.7x consensus 12-month forward earnings, compared with 16.5x, 14.6x and 15.6x respectively for the MSCI USA, Europe and Japan indices. Asia ex-Japan also continues to enjoy a dividend yield of around 3.6%, which is higher than that on offer in many other countries and greater than most available bank deposit rates and bond yields.

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President's Corner

By Randy Stalnakar

I have used this column in the past to warn of the imminent threats to defined benefit pension plans such as those that are members of TEXPERS. Unfortunately, those threats are growing and, in some

cases, proving to be very real.

In California, legislators have begun to consider the conversion of CalPERS, the largest pension fund in the U.S., from a defined benefit plan to a defined contribution plan. This change could effectively wipe out the promised level of benefits to thousands of public employees in that state. According to Fundfire in its January 11, 2005 issue, the governor of California has been quoted as saying the state's pension system is "archaic and enormously expensive," and that changing the state pension plan to a defined contribution system would be "fair to employees and taxpayers." This idea has spread as far as New York, where the conversion of New York City's defined benefit plans has also been discussed.

Clearly, the threat of conversion of Texas plans from defined benefit to defined contribution is real. Municipal leaders and legislators in Texas are constantly looking for ways to cut their budgets. Pension contributions by the employer are a tempting target for potential budget reduction.

If you think this can't happen in Texas or to your fund, I urge you to reconsider. The Chair of the Texas Pension Review Board recently testified before the Texas Senate Finance Committee regarding what he sees as problems in the Texas public pension fund arena. Every trustee and staff member of a Texas public plan should hear what he had to say. Among the topics he and the committee discussed were:

- Assuming powers now held by Boards of Trustees,
- Changing the role and the makeup of the Boards of Trustees,
- Eliminating defined benefit plans in favor of defined contribution plans, and
- Eliminating safeguards of benefits now in place.

The staff of TEXPERS has made this testimony available on the TEXPERS website. To hear the testimony, go to www.texpers.org and then click on Association Business Page. For access, you will need your user name and password; they are available from your pension system administrator. I strongly encourage you to listen to this startling discussion among individuals who will affect our future.

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