



PENSION OBSERVER

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

Manager Searches: Practical Considerations

By Tim Sharpe and Tim Ng

Trustees involved in selecting investment managers for institutional funds must ensure that they are doing the best job possible to fulfill fiduciary responsibilities. Perhaps nowhere is fiduciary accountability more scrutinized—or more prone to impact a fund’s long-term objectives—than in the manager selection process.

This article explores some of the criteria and methods used by practitioners, plan sponsors and other fiduciaries today and identifies a set

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of “best practices” and potential “red flags.” Selecting appropriate managers requires examining a number of important factors—not simply reviewing past performance. Among key qualitative factors (those based upon judgment by the evaluator) requiring careful consideration are: experience and qualifications of the firm’s investment personnel and their compensation structure, overall investment philosophy and process, research and client service capabilities, and the firm’s commercial viability. Some key quantitative factors (those that can be measured statistically) to consider are

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New TEXPERS Board Members Installed at Annual Conference

In conjunction with the TEXPERS Board of Directors meeting at the 2006 TEXPERS Annual Conference in March, it was announced that new leaders and recently elected members have taken their places on the board. Newly elected members are Gerald Brown, Eyna Canales-Zarate and Rector McCollum. Paul Brown and Brady Edwards were chosen president and second vice president, respectively. Dwight Walker is now presidential advisor to the board.

TEXPERS’ new top officer, **Paul R. Brown**, is Chairman of the Board of the Big Spring Firemen’s Relief & Retirement Fund and president of Big Spring Professional Firefighters’ Association.



Gerald “Jerry” Brown has served on the Dallas Police and Fire Pension System Board of Trustees since 1983 and currently serves as Chairman. Since 1975, he has been a Dallas firefighter, and holds the rank of lieutenant. Lt. Brown was elected First Vice President of the TEXPERS Board of Directors.



Sgt. Rector McCollum was appointed Police Trustee of the Dallas Police and Fire Pension System in 2000. After three years on the Board, he was elected to position of trustee in 2003. He has served Dallas since 1979.



Eyna Canales-Zarate currently serves as Assistant Director of Austin Public Library. She has over 20 years of experience working with the City of Austin and has served on the City of Austin Employee Retirement System Board of Directors since 1998.

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WASHINGTON OUTLOOK

By Matt Aukofer

Entitlement Programs Face Tough Choices, But Is Congress Up to the Task?

The 2006 Social Security Trustees Report concludes that by 2017 Social Security will begin to pay out more in benefits than it collects in taxes and will be insolvent in 2040, one year earlier than previous estimates. Meanwhile, the Medicare Trustees Report estimates that Medicare reserve funds will be exhausted by 2018, two years earlier than previously believed. As they have done for more than a decade, the Trustees recommend that projected trust fund deficits be addressed in a timely way to allow for gradual changes and advance notice to workers.

The reports' release on May 1 appeared to have no effect on bridging the gap in the heated political debate. Republicans reacted by asserting that Social Security has reached a critical stage and needs quick and comprehensive intervention to be saved, while Democrats said those claims are overblown, the program's future is not in doubt, and urged the rejection of GOP efforts to privatize Social Security.

The Social Security report underscores the "fundamental truth" that Social Security can pay full benefits well into the baby boomers' retirement years and about 70 percent thereafter; Rother said. "As the trustees remind us, the fact that Social Security is solvent until 2040 gives us the opportunity to get serious about strengthening Social Security for the future."

"This report is another wakeup call that Medicare and Social Security are in critical condition," said Sen. Jim DeMint (R-S.C.). "Democrats who stick their

heads in the sand and applaud their own obstruction are putting the retirement security of millions of Americans in jeopardy. We cannot allow cynics with no solutions to deter us from real reform. We are driving Social Security and Medicare over the cliff of financial instability, and we are losing precious time to change course."

Senate Democratic Leader Harry Reid (D-Nev.) said, "The real threat to Social Security comes from Republicans, most of whom support and voted for privatizing Social Security. Instead of working to dismantle Social Security, we should join together to strengthen both Social Security and Medicare to build a secure retirement for all Americans."

AARP Policy Director John Rother said the Social Security report should reassure Americans approaching retirement that the system remains strong. But the Trustees' Medicare Report signals an even greater need to bring system-wide health care spending under control.

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PRESIDENT'S CORNER

By Paul R. Brown

The TEXPERS 2006 Annual Conference came to a close with a change in leadership and newly elected members on the Board of Directors. I would like to welcome those new board members; Jerry Brown, Eyna Canales-Zarate, and Rector McCollum. I look forward to working with all of you over the next two years. I would also like to recognize and thank those outgoing board members who gave of their time and served the public employees of Texas.

. . . delegates passed four resolutions dealing with the cost of health care, opposition to mandatory Social Security, opposition to terminating defined benefit plans, and a cooperation resolution with the State Pension Review Board and House Committee on Pension and Investments.

Barbara Chelette, Larry Reed and Billy Samuel have devoted their energy in support of TEXPERS and our members, and were instrumental in securing the rights and benefits of public employees. Once again this conference was well attended; the delegates passed four resolutions dealing with the cost of health care, opposition to mandatory Social Security, opposition to terminating defined benefit plans, and a cooperation resolution with the State Pension Review Board and House Committee on Pensions and Investments.

As many of you know from the last issue

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STATE CAPITOL REPORT

By Neal T. "Buddy" Jones

The Republican and Democratic primary elections were held on March 7, 2006. In what was a surprise to many, several veteran legislative incumbents were defeated in their own party's primary. In the Republican primary, four incumbents were defeated. Two of these incumbents, Kent Grusendorf and Elvira Reyna, chaired powerful committees in the Texas House of Representatives.

Grusendorf, Chairman of the House Public Education Committee, was defeated by Diane Patrick an Arlington, Texas, area educator. The Chairman of the House Local and Consent Calendar Committee, Elvira Reyna, was defeated by former Sunnyvale, Texas, Councilman Thomas Latham. Other Republican incumbents defeated were Carter Casteel, from New Braunfels, and Roy Blake, from Nacogdoches. San Angelo incumbent Scott Campbell was forced into a runoff and subsequently defeated in the April primary by Drew Darby.

In the March Democratic Primary one incumbent, Jesse Jones, was defeated. Former Dallas Councilwoman Barbara Mallory defeated this long-time Dallas legislator. Incumbents Richard Raymond and Al Edwards were forced into runoffs in April. Raymond, from Laredo, won handily in his runoff election. Al Edwards, a Houston Democratic legislator, was defeated in his re-election bid. Long time Senator Frank Madla was upset in his bid for re-election to the Texas Senate in the Democratic primary. He was defeated by House member Carlos Uresti. Madla, currently chairs the Senate Intergovernmental Relations Committee. This committee typically has all pension-related legislation referred to it. Senator Madla has been a long-time friend of the public pension community and will be missed.

It appears both Carole Keeton Strayhorn

and "Kinky" Freidman will get enough signatures (of people who did not vote in either the Democratic or Republic primaries) to be put on the General Election ballot in November. If they are qualified as Independent candidates, we will be assured of at least five people on the ballot running for Governor.

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In order to satisfy the Texas Supreme Court's ruling to fix an unconstitutional school finance system, Governor Rick Perry called the Texas Legislature into special session on April 17, 2006. He put into his call a request for legislation which will reform and raise business taxes in the state, legislation which will lower property taxes, and legislation which will appropriate money to the Texas public school system in order to satisfy the Texas Supreme Court ruling.

The Texas house had prompt hearings on these subjects and voted positively on five bills and sent them to the Senate. House Bill 1 dealt with public school finance and property tax reduction. Further property tax reduction was called for in House Bill 2. House Bill 3 incorporated the Sharp Tax Commission plan into a new far-reaching tax for Texas businesses. House Bill 4 called for truth in pricing for used autos so that a true sales tax can be assessed. Finally, House Bill 5 assessed a \$1.00 per pack tax on all cigarettes.

These five bills have been sent to the Senate. House Bill 3 has been passed and sent to the Governor for signature. The other four bills are being debated in Senate committees and the full Senate. The special session ended on May 16th.

The House Pensions and Investment Committee met on April 27 to discuss possible legislation for the Teachers Retirement System. The committee has not had any hearings on its interim charges.

In the Senate, Senator Madla's Intergovernmental Relations Committee has not posted any hearings thus far. Senator Madla plans to step down from his Senate seat after the current special session. We do not expect the Intergovernmental Relations Committee to meet until late this summer.

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

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Washington Outlook

By Matt Aukofer

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“We need to work together to honor that commitment and we should start by putting aside polarizing ideas that won’t work,” he added. “Private accounts that take money out of Social Security remain a bad idea that most Americans oppose. They drain money out of Social Security, cut benefits and pass the bill to future generations.”

Sen. Lindsey Graham (R-S.C.) said the report “proves that time is not on our side when it comes to reforming Social Security and Medicare.” He said he and many of his Republican colleagues have proposed several combinations of ideas that would lead to Social Security solvency. “Unfortunately, no member of the Democratic Party has come on board,” he said. “When it comes to Social Security and Medicare reform, the Democratic Party solution seems to be blame Republicans. It needs to end.”

Graham noted that the number of workers paying taxes to support Social Security dropped from 16-to-1 in 1950 to 3-to-1 today. Within a generation, there will be only 2

workers to support each retiree. “The consequences of ignoring the demographic time bomb facing Social Security are severe,” Graham added. “If we fail to modernize the system we will be forced to either raise payroll taxes 50 percent or cut benefits by one-third. The first choice poses a significant risk to the economy and the second devastates tens of millions of seniors. We can fix Social Security if we roll up our sleeves and get to work. To do nothing is political malpractice.”

In the 2006 Annual Report to Congress, the Trustees said:

- The projected point at which tax revenues will fall below program costs comes in 2017 — the same as the estimate in last year’s report.
- The projected point at which the Trust Funds will be exhausted comes in 2040 — one year earlier than the projection in last year’s report.
- The projected actuarial deficit over the 75-year long-range period is 2.02 percent of taxable payroll — up 0.09 percent from last year’s report.

• Over the 75-year period, the Trust Funds require additional revenue equivalent to \$4.6 trillion in today’s dollars to pay all scheduled benefits. This unfunded obligation is \$600 billion higher than the amount estimated last year.

• Income including interest to the combined Old-Age and Survivors, and Disability Insurance (OASDI) Trust Funds amounted to \$702 billion in 2005 — a \$44 billion increase from 2004.

John Berthoud, president of the National Taxpayers Union (NTU), pointed out that the combined liabilities of Social Security and Medicare will force either triple-digit tax increases or unsustainable borrowing. “Our nation simply can’t remain competitive in today’s global marketplace if we enact the tax increases some are proposing to keep our entitlement programs solvent. Fundamental reforms, not higher taxes, are the answer for our pending fiscal challenge.”

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Manager Searches: Practical Considerations

By Tim Sharpe and Tim Ng

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a history of consistent, superior performance within a prudent level of risk, and the quality of the firm's composite. Generally, investors should try to determine if the composite accurately reflects the performance of a firm's current staff and investment process.

Based on twenty-five years of experience, we have identified a set of ideal "best practices" and other practices that should raise concern or potential "red flags."

Best Practices:

1. Begin with the broadest possible initial universe of managers.
2. Firms considered should have long-term track records, preferably five or ten years. AIMR compliance and verification are pluses.
3. Screen for outperformance against both the proper style-specific benchmark and the appropriate broad asset class benchmark. For example, use both the R2000 growth and the R3000 indices for a domestic small-cap growth manager.



Tim Sharpe

4. Screen for consistency of returns using rolling time periods and batting averages.
5. Review up and down-capture ratios and cumulative returns.
6. Analyze risk-reward tradeoffs with

appropriate measures such as the Sharpe ratio (Professor William F. Sharpe, Stanford).

7. Separate manager skill from luck with measures such as information ratio.
8. Insist on independent, written, professional research. Consulting firms should be able to provide research on any manager you hire.
9. Ensure that your manager search is free from conflicts of interest.
10. Analyze correlation among current and proposed managers to ensure true diversification.

Red Flags:

1. Beware of searches that start with a universe constrained for reasons that are not valid. Some frequently heard constraints include "an acquaintance uses this manager" or "this manager attends our conference." An inability or unwillingness to perform searches

which include managers outside some pre-approved research universe should be of concern.

2. Be cautious in selecting managers with short-term track records, especially less than three years, unless a compelling case can be made regarding a longer related history with other similar products.
3. Be careful if only using time period specific rates of return, these can be very sensitive to the choice of period and endpoint.
4. If using a consultant, be sure they are free from potential conflicts and objective at all times in their professional recommendations.

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Tim Ng

5. Ensure that your portfolio is truly diversified (and doesn't just appear so) by analyzing the correlation of the manager structure.

Many plan sponsors and trustees turn to an investment consultant to search and recom-

mend appropriate managers. Experienced investment advisors have the proper search tools for their financial advisors to use, and dedicated research staff to perform initial and ongoing due-diligence. Consultants may be able to assist in negotiating lower fees with investment firms and help maintain an objective relationship between firms and trustees. They can also assist in the development and documentation of a prudent fiduciary process—one that can help avoid frequent pitfalls.


Tim Sharpe, CFA, CIMA, is Second Vice President—Wealth Management Senior Institutional Consultant; Tim Ng, CFA, is a Consulting Group Analyst. Both are with Citigroup Smith Barney in Houston, TX.

Washington Outlook

By Matt Aukofer

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Berthold asserted that these entitlement shortfalls are not as far off as some policymakers would like the public to believe. In the next nine years, Medicare Part A will run a combined deficit of \$112 billion, a fourfold increase from last year's projection. This reality has so far spurred little debate on Capitol Hill, a situation NTU's members hope to reverse. Ed Lorenzen, policy director of the Concord Coalition, said lawmakers and the media "erroneously focus on the solvency date as the primary indicator of Social Security's and Medicare's financial health." "But solvency is misleading. It's cash flow that matters. The existence of trust fund balances will not change the fact that these shortfalls will place tremendous pressures on the rest of the budget and the future taxpayer as well as the economy as a whole," Lorenzen said. "To redeem the bonds in the trust fund and cover the shortfall, Congress will have to cut spending on other programs, issue more debt, or raise taxes. Clearly, 'financially solvent' bears no relationship to 'fiscally sound.'"

The 2006 Trustees Report is available at www.socialsecurity.gov/OACT/TR/TR06 

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

MARK YOUR CALENDARS

Upcoming Conferences

TEXPERS Summer Educational Forum

August 20 & 21, 2006

San Antonio, TX

TEXPERS 18th Annual Conference

March 18 - 21, 2007; Austin, TX

Marriott at the Capitol

2007 Summer Educational Forum

August 19 - 20, 2007

San Antonio, TX

Westin Riverwalk

President's Corner

By Paul R. Brown

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of the Pension Observer, we went into this conference knowing that TEXPERS would be under the leadership of a new president. At the board meeting in conjunction with the March Conference I was elected to take over the position of President of TEXPERS. I would like to take this opportunity to thank the Board of Directors for their confidence in allowing me to serve and represent this outstanding organization. I would also like to personally thank Randy Stalnaker for his excellent leadership over the past four years. Randy has been an innovator and brought sound judgment to the board. We are fortunate that Randy will continue to serve on the board as an elected member representing the municipal pension systems.

As the new president of TEXPERS, I have hit the ground running. The board has hired a new executive director, Maxie Patterson, who will be on board as of May 22. Contracts are being negotiated to insure that business is as usual at the TEXPERS office. We are closely

following legal developments that affect our members in a case before the Texas Supreme Court. The Board has also responded to a request by a major newspaper in Texas in regards to an Open-Records request.

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Let me conclude by saying how much I look forward to working with everyone involved with TEXPERS. It is your support that allows us to continue with the TEXPERS mission. I encourage each of you to step-up, volunteer and be active.

I look forward to seeing you in San Antonio. 🗝️

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