



PENSION OBSERVER

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

Fundamental Indexing

By Carmen Campollo and Jason Hsu

Fundamental indexing is a recent development which the institutional investor who is seeking to complement or enhance current market cap-weighted investments may wish to investigate. Components of the FTSE RAFI 1000 Index, an index of US-based companies, are weighted using four fundamental factors: book value, cash dividends, sales and cash flow, all of which are a departure from the traditional market capitalization weighted indexes.

When might an index based on fundamentals make sense? There are many ways to

One reason a fundamental index like the FTSE RAFI may outperform in a bull market is that the index does not shy away from growth stocks.

measure the size of a company. While market capitalization itself is an objective number, it incorporates a strong component of investor sentiment about what a company is worth, and that value can vary over a wide range as market sentiment changes or companies' fundamentals change. The use of fundamental metrics addresses issues that can occur with capitalization weighting, namely the weighting of the most overvalued stocks and therefore

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Portable Alpha—How to Turn a Good Mousetrap into a Better one

By Peter Chiappinelli, CFA

Portable alpha is an intimidating phrase that seems to be all the buzz this year and may be worthy of your attention. It is a strategy that can represent an important alternative or complement to traditional approaches.

First, the Traditional Approaches

Professionals have typically managed investments—a U.S. large-cap equity mandate, for example—in one of three ways:

- Passive: Match the S&P 500 benchmark.
- Enhanced: Take on little active risk and hope for a little return.
- Traditional active: Take on more active risk and hope for more return.

A Very Good Mousetrap

Managers assume that the best way to beat the S&P 500 is to “fish” in the same pond as the S&P 500. To borrow the Greek, the *alpha* (excess returns) is assumed to come from the same source as the *beta* (benchmark).



Portable alpha challenges this assumption. It allows us to get our benchmark (beta) return from one source, and our excess return (alpha) from another. Here's a simple example of porting alpha onto the S&P

500, a common benchmark in pension plans.

U.S. small-cap stocks have historically been rich sources of excess return (alpha). Low coverage by securities analysts has often meant that managers with an “information advantage” can exploit this area. The numbers bear this out as you will see in Chart A shown on page 5. This chart shows the returns for the median small-cap manager taken from a large universe of active managers (five years ending 2003). The median manager, who we'll call Manager A, returned 11.99%,

annualized. Chart A shows two distinct components on her return. The bottom component is the return for the Russell 2000, the benchmark (beta), which returned 7.13% annualized. The top component is the excess return (alpha) for this manager, or 4.86%.

So, now we have the alpha. How do we make it “portable”? (See Chart B, page 5)

First, let's assume that we had hired small-cap Manager A and given her \$100M to invest.

Second, all we really want from Manager A is her excess return. Remember, our objective is to beat the S&P 500. We remove her benchmark (beta) component, while keeping the excess return (alpha) component by selling (sometimes called “shorting”) \$100M of Russell 2000 futures. All that's left is her excess return (alpha) of 4.86%.

Now that we have isolated the alpha, we can combine it with the beta we originally wanted, the S&P 500. We use the proceeds

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MARK YOUR CALENDARS!

TEXPERS SEVENTEENTH ANNUAL CONFERENCE

Sunday - Wednesday
March 12 - 15, 2006

Renaissance Dallas Richardson Hotel
900 East Lookout Drive
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\$141 Single or Double

TEXPERS Members-Only
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Register online: www.texpers.org

WASHINGTON OUTLOOK

By Matt Aukofer

Americans Optimistic About Retirement, But Not Social Security

A new global survey on retirement offers surprising insights on work, life, money and retirement from more than 6,900 people in 11 countries. For example, with record numbers of Baby Boomer Americans entering retirement, only one in five workers actually knows what his or her specific retirement income will be. And although Social Security is a significant income element for retirees, more than 90 percent of current workers view Social Security as “troubled” or “in crisis.”

The second annual survey by AXA Equitable, the principal life insurance subsidiary of AXA Group, a financial advice and wealth management firm, finds that American workers’ confidence in their retirement income may stem from observing their parents. Current U.S. retirees report on average \$4,243 in monthly income — the highest amount of any country in the study; nearly double the Canadians and well ahead of France, Japan and Germany.

...most American workers are concerned about the source of income in retirement, as 92 percent believe that the current Social Security program is in some degree of trouble.

Despite this confidence, most American workers are concerned about the source of income in retirement, as 92 percent believe that the current Social Security program is in some degree of trouble. Retired respondents agree, but to a lesser extent: 84 percent have lost faith in the program, even though 70 percent rely on Social Security and pension plans “heavily” for retirement income, according to the survey — the AXA Equitable Retirement Scope.

Consequently, nearly 65 percent of America’s working respondents plan to rely on their own retirement savings or income sources rather than Social Security or pensions, the survey finds. High

expectations for retirement income may influence U.S. workers’ hopes to continue working in retirement, as 63 percent of those surveyed desire to hold a paid job once retired. A total of 6,915 people between the ages of 25 and 75 were interviewed in Australia, Belgium, Canada, France, Germany, Hong Kong, Japan, Italy, Spain, the United Kingdom and the United States. The main sample from the U.S. included 848 people, 435 of whom were working and 413 were retired. In addition, AXA boosted sample sizes in Chicago, Detroit, Los Angeles, Miami and New York to gain specific information on these influential markets, but these additional respondents were not included in the main sample.

AXA contracted with research firm GFK Sofema, which managed the survey globally. Local firms fielded the questions in each country during August 2005. AC Nielsen conducted the survey by telephone in the U.S.

Key findings include:

- Americans lead the world in preparing for their retirement. Nearly 85 percent of working Americans have already started planning for retirement, leading all nations. On average, the American worker starts saving at age 30 and sets aside \$1,253 monthly for retirement, a figure that more than doubles retirement savings in all other surveyed nations. However, the median amount is \$463 monthly, also significantly more than the median amount in the other surveyed nations.
- Nearly half of retirees surveyed have invested in real estate. Home ownership

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PRESIDENT’S CORNER

By Randy Stalnaker

My term as president of TEXPERS expires at the Annual Conference in March. This was my second consecutive term, which is all that TEXPERS’ bylaws allow. Consequently, this column will be my last (and by my count, my 22nd column) and I would like to take this opportunity to use the insights gained during my years as president to comment on the challenges facing the organization.

TEXPERS faces challenges of two different types — those from without and those from within. The challenges from without (external challenges) are quite obvious and TEXPERS has a good track record of dealing with them.

TEXPERS has an important mission and thousands of Texas public employees are counting on us.

One upcoming external challenge our plan members face is the “freezing” of defined benefit plans. This strategy has become a popular cost saving method in the corporate sector and public plans will soon face pressure to follow suit. City councils and administrators across the state have already begun discussing this option. TEXPERS must be prepared to help its plan members deal with this threat to benefits that Texas public employees have worked very hard for many years to establish.

The challenges TEXPERS faces from within (internal challenges) are not as obvious and, in my opinion, TEXPERS has not done as well in dealing with them over the years.

TEXPERS needs active members, members willing to work to help the organization achieve its goals. TEXPERS has recently experienced a shortage of individuals willing to put forth the time and effort to make the organization work as well

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STATE CAPITOL REPORT

By Neal T. "Buddy" Jones

The election season is upon us and federal, state, and local candidates are busy seeking voters in the Democratic and Republican primaries. These primaries include five contested Congressional races, five contested Senate races and 53 contested House races.

In the Democratic Primary, two incumbent congressmen, Silvestre Reyes of El Paso and Henry Cuellar of Laredo face primary opponents. One Senator, Frank Madla, has a Democratic opponent and in the House eleven Democrats face primary opposition.

On the Republican side, three congressmen, Sam Johnson, Ron Paul and Tom DeLay have primary opponents. One Republican, Senator Bob Deuell, drew a primary opponent in the Senate. In the Texas House nineteen incumbents will face primary opposition.

On the statewide level, the Governor's race is shaping up to be a real horse race. Carole Keeton Strayhorn has announced she is running as an Independent rather than as a Republican. Richard "Kinky" Friedman, an Austin musician and cowboy philosopher, also announced his intention to run as an Independent. At least four other candidates have expressed an interest in running as an Independent.

If all the Independents get the required signatures to run for governor, the November ballot could have up to nine candidates. One Republican, one Democrat, one Libertarian and six Independents could all be vying in the General election for the governorship.

Since the Supreme Court recently ruled our state's public education tax system was unconstitutional there has been much speculation on how our legislative leaders will see

fit to fix the current system. Over the past few weeks, the Sharp Commission, a blue ribbon panel appointed by the governor and led by ex-comptroller John Sharp has been holding hearings across the state. They want to determine Texans' feelings on different proposed tax systems. Lt. Governor David Dewhurst has also appointed a key panel of senators to look at school finance and education reform.

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Both of these panels are expected to submit their reports and recommendations in early April. Governor Perry is expected to call the legislature back into session right after the April primary runoff election.

So far no interim hearings have been scheduled involving pension matters. Two members on the House Pensions and Investments Committee have primary opponents, Representative Mike Krusee and

Representative Dan Flynn. The Chairman of the Senate Intergovernmental Affairs Committee, Senator Frank Madla, faces a tough primary challenge from former House member Carlos Uresti. Many observers believe no interim hearings on pension matters will be scheduled until after the first primary in March.

The Pension Review Board met in Austin on January 26. This meeting had been scheduled in December but was postponed because of inclement weather.

Reports were given by representatives of several public pensions systems. Representatives from both the El Paso Fireman's and Policemen's Pension Fund and the City of El Paso testified on the status of fixing their unfunded liability problem. They testified no final solution had been reached but they were working on a final solution to the problem. Representatives from the Brownwood Firemen's Relief and Retirement Fund and the Houston Police Officer's System testified about the status of their respective funds.

It was announced from the floor the implementation of the new quarterly reporting system was being postponed. The Pension Review Board wanted more time to work with pension systems to make the report more reliable, more useful, and more apt to provide useful information to The Pension Review Board.

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

President's Corner

By Randy Stalnakar

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as it should. It is an organization of volunteers and unless enough of our members volunteer to work in TEXPERS' support, I am very concerned that the organization will become ineffective. If this were to happen, it would truly be a tragedy — TEXPERS has an important mission and thousands of Texas public employees are counting on us.

Please support the next TEXPERS president and each board member. Further, I encourage you to be active in working to help TEXPERS reach the level of excellence that our members deserve.

Lastly, I would like to extend deep appreciation to the TEXPERS staff. While serving as president, I have come to appreciate how hard they work and what a terrific job they do. Without them, TEXPERS would not be the widely respected and successful organization it is. 🍀

MARK YOUR CALENDARS

Upcoming Conferences

TEXPERS Summer Educational Forum

August 20 & 21, 2006

San Antonio, TX

TEXPERS Members-Only eligible to attend. See page 5.

TEXPERS 18th Annual Conference

March 18 - 21, 2007; Austin, TX

Washington Outlook

By Matt Aukofer
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is high among retirees in the U.S.; 91 percent own their homes and 15 percent own two.

- Nineteen percent of U.S. workers expect retirement income to be higher than their last salary, an optimism that trumps all other surveyed nations. Retirement income has increased for 20 percent of U.S. retirees, well above that of Australia and the UK, both tying for second, each with 14 percent of retirees experiencing similar good fortune.
- On average, people would like to retire before 60 years old but realize it's not likely to happen. Working people consider 55 the ideal age for retirement but don't expect to retire until 62; retirees would retire at age 59 if they could do it again. On average, Canadians and Americans retire earliest; nearly three out of four American retirees did so before age 65.
- Americans plan to spend their retirement savings, not pass it on to heirs. Sixty-four percent of working Americans expect to

spend their savings in retirement; only one-third expect to maintain savings and pass it on to surviving family members. French respondents were most generous with their inheritance — it's the only population in which more than half of workers plan to pass retirement savings on to heirs. Even more (71 percent) of French retirees are doing the same.

“Overall, our survey findings suggest that Americans are confident — but realistic — about the financial outlook for retirement,” Ken Gelman, vice president and director of market research for New York-based AXA Equitable, which represents AXA in the United States, said in a statement. “Respondents expressed a fair amount of optimism about their incomes and living standards in retirement, but they seem to understand that much preparation and planning are necessary to achieve these goals.” 🇺🇸

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

2006 Summer Forum: Fee Update

We are happy to report that the August 2006 TEXPERS Summer Educational Forum in San Antonio promises to be one of our best ever.

Once again you will access the best and the brightest investment minds, confer with colleagues and increase your knowledge and skills for the benefit of your fund.

On the update side, budgetary concerns dictate that TEXPERS initiate a fee of \$50 per attendee to slightly defray the increasing food expenses that go with presenting this comprehensive two-day educational event.

The TEXPERS Board of Directors has studied the issue extensively and voted unanimously to take this small but necessary step to help insure the continuing high quality of the educational offerings. TEXPERS fees are still among the lowest in the nation for similar events. For that, we may all be proud.

Sign up soon—August 20 is just around the corner. 🇺🇸

Portable Alpha

By Peter Chiappinelli

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from the sale of Russell 2000 futures to purchase S&P 500 futures.

We have just constructed a portable alpha program. The excess return (alpha) from Manager A has been “ported” to the benchmark (beta) that we originally wanted, the S&P 500. The net result is S&P 500 + 4.86%. The S&P 500 returned -0.57% annually during this time frame, so this portable alpha program would have turned a money loser into a winner. (Important note: this illustration assumed no transaction costs, which can run from 0.20% to 0.50%.)

One of the major problems with this approach is that Manager A’s alpha, while very

good on a five-year basis, looks much “lumpier” in shorter time frames. Even over three-year periods, Manager A’s alpha would be volatile. *But who says we need to rely upon a single manager or asset class?*

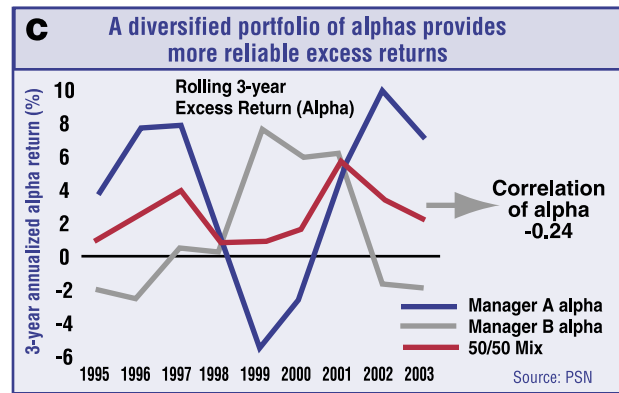
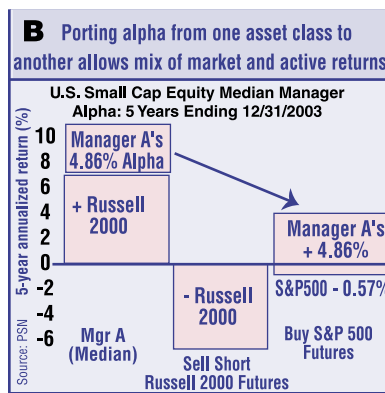
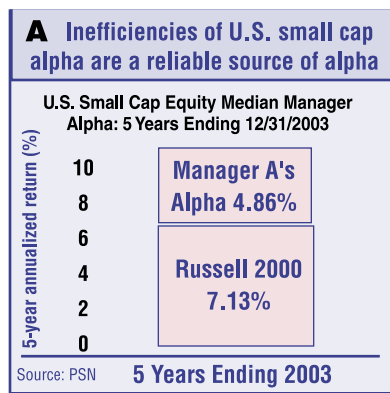
Non-U.S. stocks, as represented by the MSCI EAFE Index, have also been a rich source of excess returns (alpha). The median active manager, Manager B, added 3.18% over the MSCI EAFE Index over the exact same five-year time frame as before. Let’s assume that we perform a similar exercise as before and isolate his excess return

Now combine Manager A’s excess return

with Manager B’s, by splitting the mandate 50/50. (See Chart C.) Manager A’s rolling three-year alpha is lumpy, as is Manager B’s, but the combined portfolio has a very compelling profile.

Why should we stop at two? Analysis shows that combining eight to nine alpha sources into a diversified alpha-portfolio can create a more consistent alpha stream that can be ported onto a desired benchmark. If you believe that portable alpha is an innovative mousetrap, then clearly a diversified portable alpha-portfolio creates an even better one. 📌

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Fundamental Indexing

By Carmen Campollo and Jason Hsu
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concentration of assets in a small number of companies with very large market caps, and underweighting of undervalued or underpriced stocks.

The composition of a market cap-weighted index is objectively determined, rather than being a subjectively managed list.

The composition of a market cap-weighted index is objectively determined, rather than being a subjectively managed list. Fundamental measures are objective, and create indexes that are intended to more closely represent the true economic value of companies.

One reason a fundamental index like the FTSE RAFI may outperform in a bull market is that the index does not shy away from growth stocks. FTSE RAFI includes growth stocks that have demonstrated the ability to generate cash flows, sales, book

value and dividends. The growth stocks that are not included are stocks that have no history of generating cash flows, dividends, etc. In a bull market, the good growth stocks benefit just as much as the speculative ones. In addition, the Index gives increased representation to mid-cap and small cap companies not included in the S&P 500.

Analysis of the FTSE RAFI 1000 Index, an index of US-based companies, (by use of back testing including five years prior the Index December, 2005 launch) shows that there would have been a positive return of 34% over that five year period, compared to a (-8%) from the S&P 500 and (-4%) from the FTSE US All Cap index over the same period.

The FTSE RAFI Index Series, a series of 22 non-market cap weighted indices for the U.S. and international markets, was recently awarded the William F. Sharpe Indexing Achievement Award for the Most Innovative Benchmark Index for 2005. 🇺🇸

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