



PENSION OBSERVER

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

Four Problems May Re-Price Credit Risk

By Gerhardt (Gary) P. Herbert, CFA

What keeps us up in the dark, and what we wish to share and expose to the sunlight, are concerns for: a) a potential slowing in the U.S. economy; b) continued systemic problems in Europe impacting higher quality sovereigns; and c) developing credit problems in China. Finally, the fourth and final indicator, a reduction in central bank reserves ex-China, has tended to forecast the onset of nearly every recession.

We are troubled by the potential for a more serious slowing of the U.S. economy or



even a double-dip recession. Recent leading indicators such as the Chicago Fed National Activity Index and the Economic Cycle Research Institute Growth Rate Index (Chart A, page 13)

highlight that these concerns may be well placed. Employment is recovering more slowly than expected and the housing market remains in a delicate state. As the government searches for ways to cut the deficit, an austerity-induced recession may take place, which would result in wider spreads.

While Greece will receive its next tranche of bailout money due to the passage of a severe austerity plan, the problems in Europe are still with us. In fact, the problems in

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De-Risking Portfolios Without De-Railing Potential Capital Gains

By Stephen Gelhaus, CFA, and Karen Beyer

Defined benefit plans have experienced a wild ride in pension funding levels since 2008. For many plan sponsors, the volatility in funded status, cash contributions and pension expenses — as well as the need for yield to support current beneficiary obligations — represent significant challenges that are likely to persist.

Given the outlook for continued low interest rates, below-trend economic growth and potentially lower investment returns, the demand for attractive, regular income is high. The narrowing of the gap between dividend and bond yields makes a strong case for an overall

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Why Dividends Now?

Today, a number of trends in the marketplace have converged to create a compelling case for equities with attractive yield and growing dividends.

• Dividends

have been an important driver of equity returns for more than 80 years. Since 1926, dividend income has contributed 43%* of the S&P 500's total return. Over the long term, dividend investing has the potential to provide equity-like returns with less volatility.

• For pension plans seeking to preserve the purchasing power of their financial assets and an alternative to low-yielding bonds, dividends can potentially provide a regular income stream that may grow over time and keep pace with inflation.

• Today's backdrop of appealing fundamentals (high levels of corporate cash and strong balance sheets) favors dividend strategies that invest in companies which have the potential to return a significant portion of this cash to investors.

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WASHINGTON OUTLOOK

National Umbrella Organization Coordinating the 'Kill Pensions' Movement

It's no surprise that pensions have come under fire in an increasingly alarming fashion this year. From California to Rhode Island, pension plans across the country were put under a microscope and were targeted for changes or even worse, elimination. While the economy and lack of fiscal responsibility are partially to blame for the increased scrutiny on pensions, they are merely secondary causes of the problem. Governments have been under tremendous pressure to balance budgets at a time when revenues are down. Lawmakers began looking at every program where they could make cuts and save money; no government program was safe. Personnel, health care and pensions represent the majority of cost in just about any budget. Pensions became an easy target due to cost and the allure of large amounts of money protected within pension portfolios.

While all of that is bad enough, there is more—a deeper, darker truth behind the increased scrutiny and attacks on public pensions. Interest groups nationwide are forming with

financial backing by some of the wealthiest individuals in the country. Seeming to spring out of nowhere, these groups have launched an all-out media campaign attacking public pensions and have caught many pension groups off guard.

One of the best examples of that is in Illinois where at least four anti-union organizations have sprung up to attack pensions. Groups such as Pension Fairness for Illinois, Illinois is Broke, and the Taxpayers United of Illinois, have recently launched websites and are raising funds to produce radio ads, flyers and rallies in attempts to turn public opinion against pensions and public employees. While some might think that legislators' agendas are behind these

groups, we find that it is a group of wealthy libertarians who are providing the funding. These are groups with traditional public support such as chambers of commerce but also include other organizations representing businesses and some "unofficial" support from libertarian and right-wing leaning organizations like the CATO institute and the Reason Foundation.

We recognize that the above organizations are in the same 'eliminate pensions' camp because of their strikingly similar literature and rhetoric that is posted on their respective websites; thus we draw a logical conclusion that these organizations in Illinois are working together toward the common goal of eliminating pensions altogether.

The kicker to all of this is that there is a national umbrella organization coordinating the 'kill pensions' movement that is also funded by wealthy individuals. The American Legislative Exchange Council (ALEC) is an organization with highly influential individuals that represent huge companies on their board—Wal-Mart, Centerpoint360, Bayer Corporation, Johnson and Johnson, AT&T, UPS, State Farm, Pfizer and Koch Companies are represented on this board. ALEC is not an organization to be treated lightly.

So what do we do in the face of this coming attack that is already ramping up? The answer is clear; we must stand

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PRESIDENT'S CORNER

By Eyna Canales-Zarate

We will not forget.

September 11, 2001 was a day that horrified America and the world. It has been ten years since the attacks on American soil... attacks that made this country come together like no other time in the recent past.

Commemorations were held across the United States to honor and remember those that gave their lives and those that continue to do the same today. "We will not forget." I still remember those words echoing at every turn during those terrible days after the attacks. Have some forgotten?

In ten years, what has changed? How did those men and women who proudly call themselves public servants and who risk and

How did those men and women who proudly call themselves public servants and who risk and lose their lives to save others become the new target in America? Why is it that in the past two years public pensions are at the crosshairs for elimination? What changed?

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What changed?

While one can argue that the United States economy is not in the same shape as it was prior to 9/11

and government budgets are under pressure, it is also true that during the 'good years' many government entities failed to make the necessary contributions to pension funds that were required. At the same time, public employees did *not* stop making their contributions. Public servants in Texas deserve better than to be considered the new villains.

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This is turning out to be quite a year for public pensions. Toward the beginning and middle point of the year, we all stood together as one and fought pending legislation that would have hurt pensions for the sake of satisfying budget balancing. We took to the State Capitol en masse and showed our elected officials that we are firmly behind all of our members and will continue to defend pensions against the barrage of misinformation and inaccurate data that has surfaced in the past year.

TEXPERS is committed to analyzing and countering misleading studies— issued by opposition groups such as the Texas Public Policy Foundation— while we provide the public with accurate facts to ensure that truth reaches all who wish to know it.

With the end of the legislative session and the conclusion of our 2011 Summer Forum in Irving, Texas, we are now pushing forward with plans to educate lawmakers and citizens about the real truth concerning pensions and how they work. Opposition groups would have you believe that pensions are cost-inefficient and fiscally irresponsible, and that 401(k) type plans are the only thing that is able to bring an end to the unfortunate budgeting situation the nation and Texas still face. In fact, those claims could not be farther from the truth.

TEXPERS, along with other organizations, has continuously published up-to-date studies clearly showing that pensions are more cost effective than 401(k)s and that switching to 401(k) type plans will ultimately cost more in the end.

While TEXPERS continues to educate the public, there are unsettling reports of major

financial backers that have been continuously funding opposition groups that would like to see pensions fall. Groups like the Greater

Houston Partnership have ties to several opposition groups while the GHP itself is discussing and making a push towards eliminating DB plans. Individuals like Bill King have been courting potential suitors to support his stance against public pensions: TEXPERS will be keeping a close eye on this and any other movement within the anti-pension world.

One thing is certain, the world of public pensions is and should be bracing for a war. In the coming months there will be statements, press releases and increased media attention on the viability of pensions and we can expect the casual citizen

to get easily caught up in the media firestorm that the anti-pension movement can create. To help keep a level head, there are multiple things one can look for to identify published misinformation— simple things such as verifying an alarming study's sources and dates of data collection can easily expose an

official-looking study as nothing more than false propaganda. In these economic times, dates and the relevance of statistical evidence are key, mainly because stats that may have been true in 2008 do not pertain to what is happening today. A favorite trick of groups like the CATO Institute and the TPPF is to use data from a prior economically down year and compare it to an "average year of economic growth" in order to deceptively imply that pensions are on the decline. So remember, check the dates of data collection because chances are that the gloom and doom that these charts convey are very much well outdated.

Another thing to watch for in studies is to check the sources of a study. More often than not, an opposition group's study will use information and sources that are in line with that group's thinking. For example, you will see the TPPF use work from CATO, Citizens Against Government Waste, the Pew foundation and the State Policy Network (SPN); all organizations that share the same overall line of thinking with the TPPF. So when you see a paper that cites "numerous sources" be aware that those "numerous sources" may not be as objective and neutral as one may think.

2011 is far from over and we here at TEXPERS anticipate that the battle over pensions will only get more intense. It is for this reason that we need all of you to stand together and help educate your fellow citizen about the subject of pensions. Whether it be your next door neighbor or just a stranger in the coffee shop: if you see or hear someone spewing facts that are simply wrong, take the time to educate them about what and who you represent.

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Corporate Dealmaking and Shareholders: Trust but Verify

By Marlon E. Kimpson

The market for mergers and acquisitions (M&A) is currently robust. Financing and credit markets have significantly improved as we emerge from the financial crisis while corporate and financial buyers have hordes of cash they seek to deploy.

Arguably, these factors are positive developments for our financial markets and our economy in general. However, with respect to acquisitions of publicly listed U.S. companies, investors should remain cautious about getting swept up in the M&A euphoria.

Pricewaterhouse-Coopers (PwC) attributes some of the increased deal volume to strong stock prices used as currency to make acquisitions, as well as historically unprecedented amounts of cash on corporate balance sheets. As of mid year, the available cash on S&P 500 company balance sheets exceeded \$1 trillion, and some estimate that total cash on corporate balance sheets exceeds \$2 trillion. Private equity buyers also have a considerable amount of cash on the sidelines, and those financial buyers deployed some \$70 billion on M&A through the first five months of 2011, according to PwC.


The ultimate price offered to shareholders in M&A transactions is equally as important as the process by which the board of directors of the target company agrees to the acquisition. No one knows the true value of a company more than

the directors and officers. These players possess information unknown to the market, and that information is often the focus of litigation surrounding the acquisition, so called "Deal Litigation." In certain circumstances, litigation is appropriate and can create significant value for the shareholders of the target company—either through enhanced disclosure of the negotiation process that enables shareholders to have better information prior to voting or through increased compensation for target company shareholders.



As of mid year, the available cash on S&P 500 company balance sheets exceeded \$1 trillion, and some estimate that total cash on corporate balance sheets exceeds \$2 trillion. Private equity buyers also have a considerable amount of cash on the sidelines, and those financial buyers deployed some \$70 billion on M&A through the first five months of 2011, according to PwC.

While our general economy appears to be having a difficult time getting into stride, factors suggest that the M&A market will continue to thrive. Shareholders must remain vigilant about their rights when their companies are going through mergers and acquisitions. As one Commander in Chief was fond of saying, "Trust, but verify." This is good advice for shareholders evaluating whether an announced deal provides adequate

financial consideration. 

Marlon Kimpson, is a member attorney with Motley Rice LLC, a plaintiff litigation firm, located in Charleston, SC.

- According to Bloomberg's Mergers & Acquisitions Legal Advisory Rankings report, there have been **3,747** deals announced in the United States through the second quarter of **2011**.
- The total volume of the deals announced during the same period is more than **\$420 billion** with an average deal size of **\$235.7 million** and average premiums of about **35 percent**.
- Globally, there were **13,075** deals announced valued at more than **\$1.2 trillion**. This represents a **33.62 percent** increase in deal volume during the same period in **2010**.

www.texpers.org

EXECUTIVE DIRECTOR'S REPORT

By Max L. Patterson

Many of you have heard about efforts from some individuals and groups to form an organization to take defined benefit plans away from public employees in Texas. As a response to that movement, representatives of numerous pension groups and other public employee organizations have joined arms to form Texans for Secure Retirement, a 501 (C) (4).

The board of directors for TSR include:

- John Lawson, Chairman (Executive Director, Houston Police Officers Pension System);
- Paul Brown, Secretary (Past President, TEXPERS);
- Eyna Canales-Zarate (President, TEXPERS);
- Todd Clark (Chairman, Houston Fire Fighters Relief & Retirement Fund);
- Peter Morin (Chairman, Austin Police Retirement System);
- George Tomasovic (Chairman, Dallas Police & Fire Pension System);
- Shawn Ury (Vice Chair, San Antonio Fire & Police Pension Fund); and
- Max Patterson, Executive Director (Executive Director, TEXPERS).

In addition to the board, TSR has formed an advisory committee to ensure that every statewide group that wants to participate will be able to do so.

TEXPERS has been working with TSR and has provided the necessary resources to assist in the formation of the organization.

The role that TEXPERS is playing is very similar to the role that Houston Fire Fighters Relief & Retirement Fund provided to TEXPERS when it began in 1989. At that time, HFRRF provided office space to

TEXPERS and other minimal services.

TEXPERS will continue to provide education and assistance to its members as it always has; whereas TSR has a single focus—to preserve defined benefit plans for public employees in Texas — thus will focus exclusively on overcoming efforts by anyone statewide who may be working to deprive public employees of their defined benefit plans.

TSR will be launching a website in the very near future. We encourage all

funds with a website to provide a link when the site becomes available. TSR will also be fundraising. As you all know, it takes money to run an effective communications program and to build an effective lobbying program. The lobbying program will be funded through the creation of a PAC; however TSR is

currently accepting donations to help in the day-to-day operations. You can send donations to TSR c/o TEXPERS, 1225 N. Loop W., Suite 909, Houston, TX 77008. Donations to the PAC will go to a separate account, and we will get that information out to you as soon as the account is established.

TEXPERS has recently highlighted the job firefighters have been doing around the state in battling wildfires. We also have recognized several pension fund boards for their investment performance and board training via ads in their local newspapers. TEXPERS will continue telling the positive stories about how local boards perform, the job that public employees do and other stories that don't always make the headlines. If you hear of a local story about public employees in your community, please let us know of it. We want to get these good stories out. For every negative story that gets in the headlines, we need to have five to ten positive stories.

We will keep you informed about TSR and its efforts. Let us know where we can help at the local level. And remember, we need to tackle this effort together.

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UPDATE: New Address

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Liquidity Management: The New Plan Governance Challenge

By Liz Tennican

A difficult portfolio management “balancing act” — with urgent governance implications — is challenging many of today’s leading pension plans.

The global financial and liquidity crises of 2007-08 demonstrated how critical it is to maintain an adequate share of assets in investments that can be readily converted to cash. Market conditions, though still volatile, have stabilized since then, but the liquidity issue



remains. Simultaneously, the needs and current funding status of both corporate and public pension funds demand not only full investment in their policy portfolios, but also the ability to nimbly

execute tactical trades to take advantage of shorter term opportunities.

For pension funds, reconciling the twin goals of achieving fund risk-return objectives and maintaining enough liquidity for both routine and unforeseen needs has risen to the level of a fundamental fund governance concern. Many sponsors now recognize that they need an entirely new approach in order to meet both goals with cost efficiency, flexibility and timeliness.

Underfunding Remains Prevalent

Across the pension plan community, the need for return is clear. Funding levels have improved since the credit crisis, but mismatches remain between fund assets and liabilities, and underfunding is prevalent. According to calculations based on average plan allocations, typical funded ratios for U.S. corporate pension plans are estimated to be around 85%, while U.S. public pension plan funded ratios are around 75%.

While wrestling with funding concerns, many pension plans also have attempted to respond to liquidity issues by increasing allocations to cash. The problem is that cash can adversely affect returns, impacting a plan’s ability to meet longer-term obligations. For a defined benefit plan, holding 2% of assets in cash is conservatively estimated to contribute 50 basis points of tracking error relative to plan targets.*

There are well established practices for “equitizing” cash balances. Fund managers today use futures, swaps, ETFs or some combination of the three to invest some of their transactional cash and cash reserves into positions that more closely approximate policy portfolio allocations but can be readily converted to cash.

Each approach presents some distinct disadvantages as well as benefits.

Futures are capital efficient — only a fraction of the underlying value is required for investment. They also have low transaction costs and trade on exchanges. However, the range of liquid futures can be limited and also entail management of margin requirements as well as the roll/expiry.

Swaps provide little to no tracking error and are capital efficient. Less advantageously, they involve cumbersome paperwork and carry counterparty risk that may be difficult to identify or quantify. Additional challenges can result from unwinding swap positions early, which can lead to potentially significant early termination costs.

ETFs are less capital efficient but trade on

exchange. They generally have low to moderate tracking error and no margin requirement, paperwork burden or set expiration or maturity date, but they do have a management fee. Importantly, ETFs have been shown to provide liquidity benefits during periods of relative illiquidity in capital markets. For example, when the average daily trading volume of corporate bonds fell precipitously in summer 2008, the average daily volume of the exchange traded iShares Investment Grade Corporate Bond ETF (LQD) increased dramatically, providing both price discovery and a source of liquidity for investors.

Developing an Integrated Solution

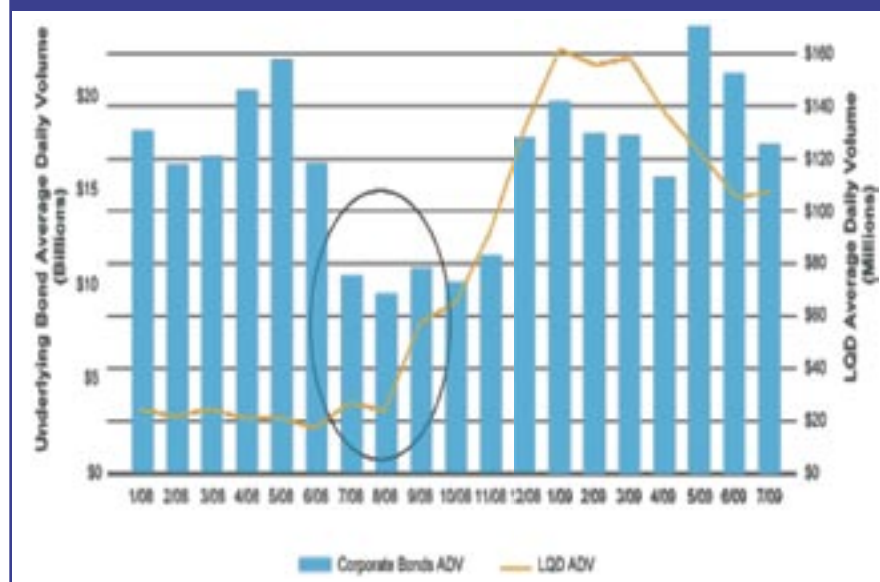
Each of these cash equitization tools is effective. But they all carry an additional burden for fund managers seeking an integrated, efficient beta solution. To equitize cash, the fund manager must purchase and manage a basket of these securities in order to approximate the asset-class mix of the policy portfolios. Buying and selling futures, swaps and/or ETFs could re-

quire investing in one or more proxies in each of

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Corporate Bond and ETF Volume (Monthly)



Sources: BlackRock, Federal Reserve Bank of New York, Bloomberg. There is no assurance that an active trading market for shares of an ETF will develop or be maintained.

Liquidity Management: The New Plan Governance Challenge

By Liz Tennican

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the categories of domestic equity, international equity, fixed income, private equity, real estate and hedge funds.

There is no question that maintaining such a liquidity strategy offers highly desirable benefits. But the logistics of managing all of those positions could be demanding and might require a significant diversion of resources from other management functions.

A new approach is required. The design and management of a liquidity portfolio represents a logical progression in the development of liquidity management practices — and a highly promising solution to the governance challenge that liquidity management now represents.

A strategy that is invested in exchange traded funds (ETFs) with allocations that correspond to a fully-invested policy portfolio would help enable pension plans to meet asset allocation targets while also offering exchange traded flexibility. The strategy puts the benefits of flexibility, transparency and transaction cost

efficiency offered by ETFs to work providing efficient policy beta exposure in a single trade.

This approach offers a highly targeted solution for pension plan sponsors. Institutional use of ETFs is, in fact, a trend already well established. In a Greenwich Associates study published in late 2010, 15 percent of large institutional funds in the U.S. reported using ETFs in their portfolio. According to Greenwich research released in May this year, one third of institutional funds plan to increase the share of portfolio assets they invest in ETFs over the next two years. This trend seems likely to accelerate, as institutional knowledge of innovative ETF-based portfolio solutions expands.

We are continuing to engage pension plans in a dialogue to identify liquidity needs, policy

portfolio targets, preferred investment structures and other critical dimensions of the liquidity/return issue. The goal is to maintain a simple, innovative response to the urgent need to balance liquidity and return; and, going forward, to identify other institutional portfolio challenges against which ETF-based solutions can be effectively applied. ➔

**Source: Morningstar, BlackRock based upon 98% index and 2% cash rebalanced to allocation annually as of 12/31/10*

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Liz Tennican is a Managing Director and head of institutional sales within the iShares business at BlackRock in San Francisco, CA.



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Should Secular Trends Cause One to Question Policy Asset Allocation?

By Mary Kathryn Campion, Ph.D., CFA, AIFA

YES! Remember, target asset allocation is a function of asset class selection as well as overall portfolio volatility. If asset markets become more volatile, a fiduciary must consider the overall portfolio volatility. If that 60/40 portfolio was designed (during the last bull market) to have a 17% volatility and now that 60/40 portfolio exceeds 25% volatility, you have a reason to implement risk management techniques.

A volatile secular bear market has some fiduciaries considering an adjustment to target asset allocations with a focus on fundamental risk management tools. Cyclical bear and cyclical bull markets are a reality; each one has a different set of expected returns, variances, and correlation matrices. You might ask how to do this without throwing out modern portfolio theory? In fact, MPT is specific on the issue of using multiple correlation matrices in the development of an optimized minimum variance portfolio.

Defined benefit plans must brace for the criticism that exists whenever capital market returns fail to deliver the actuarially required rate of return for long periods of time. An absolute total return mindset should incorporate multiple risk and return scenario analyses in order to maximize long run portfolio performance. Volatility management techniques should be used along with the common implementation of MPT to enhance long term realized total return for defined benefit plan portfolios. Hoping for better days is not a viable strategy.

Bear markets are generally more volatile and associated with higher correlation among asset classes. A relatively simple strategy is to manage actual total portfolio volatility. As overall portfolio volatility increases, hoard cash or hedge the market to ensure total portfolio volatility is within policy bands. Fiduciaries must challenge all capital market expected return, risk and correlation assumptions. We must manage these assumptions and expectations in both bear and

bull markets. The statistics will be different. Another interesting risk management technique is to identify changes in price to earnings relationships; shifts in this relationship can be used to identify changes in market cycles. We must attempt to recognize these changes in market cycles as early as possible, so we can minimize portfolio pain.


Changes in the price earnings ratio is as good a signal as any out there. Using simple historical returns, one can illustrate the components to equity market returns. As illustrated in the graphic below, the three primary components are earnings growth, dividend yield, and price/earnings changes. Earnings growth is closely related to economic growth, or GDP. Dividends are correlated to growth in corporate earnings and these payouts have been relatively constant throughout history. This graphic indicates the lion's share of long term stock market performance determined by earnings growth and dividend yield, based on data from 1926 -2009.* However, the component

most necessary for identification of the end of a market cycle is the price to earnings ratio (P/E).

Despite P/E's relatively meager determinant to long term equity market total returns, it has the distinction of being the primary driver of

equity volatility. The price impact on total return provided by the relationship between price and earnings can be extreme and is associated with the bear and bull market cycles. Secular stock market cycles are driven by changes in the price earnings relationship.

Many institutional investors continue to hope for the return of more normal returns. Some argue that "normal" might not be back for domestic equities. Since earnings growth is determined by economic growth, there is reason to adjust estimated future returns downward for many of the same reasons some developed nations, including Japan and Europe, have lower expected returns than other more emerging economies. Fiduciaries should be preparing to re-evaluate the expected return assumptions used in their asset allocation analyses. As expected global growth becomes redistributed, expected return and risk statistics must adjust too.

While you are at it, be sure to address the assumption in Markowitz's dissertation regarding the assumptions used in the optimization of an investment portfolio. Markowitz was explicit: one must have expected return, volatility, and correlation assumptions for different capital market and economic environments. Relatively simple mathematics will cause one optimized asset allocation for a pro-growth inflationary environment and another for a deflationary environment. Thus input assumptions must be derived very astutely. Prepare for the next bull market, while you adjust your asset allocation for the current bear market. Keep your eye on that P/E ratio. 

* Probable Outcomes Secular Market Insights, Ed Easterling, Cypress House, 2010.

Mary Kathryn Campion, Ph.D., CFA, AIFA, is President of Champion Capital Research in Houston, TX.

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P/E Change (0.9%)	Dividend Yield (4.4%)	Earnings Growth (4.7%)
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Advisor Profile: UBS

UBS Global Asset Management (UBS Global AM) is highly involved in the world of public pensions, and is an Associate Advisor to TEXPERS. We recently interviewed Shawn Lytle, Head of Americas and Group Managing Director at the firm.

UBS, the parent company of UBS Global AM, traces its origins through its predecessor firms back 150 years. However, today's UBS was formed through a merger between Union Bank of Switzerland and Swiss Bank Corporation in 1998. With offices in more than 50 countries, UBS is present in all major financial centers worldwide, with about 37% of its over 65,000 employees working in the Americas.



Shawn Lytle

UBS is one of the largest financial institutions in the world and is divided into three main businesses: Wealth Management, Investment Banking and Global Asset Management.

UBS Global AM has approximately 3,800 employees located in 25 countries. In the Americas, UBS Global AM's main offices are located in Chicago, Hartford, and New York City, and it has a regional presence in Dallas.

UBS Global AM's history in the US extends back more than three decades, to the early 1970s. It traces its roots in asset allocation and global investing to Brinson Partners; in hedge funds with O'Connor & Associates; and in real estate investments with Allegis Realty Investors.


UBS Global AM offers investment capabilities and styles across all major traditional and alternative asset classes throughout the world, and has invested assets of over \$600 billion as of June 30, 2011. In addition to its presence in the US, the firm is a leading fund house in Europe, and one of the largest fund of hedge funds and real estate investment managers in the world.

UBS Global AM has grown its overall profile steadily over time, providing service in the asset management industry as it has strived to help institutional clients find answers to the age-old retirement question. "The foundation of UBS Global Asset

Management's institutional business is in public and corporate defined benefit plans" notes Mr. Lytle. "We are huge believers in defined benefit (DB)."

As the investment landscape has evolved over the decades—from an emphasis on diversification and asset allocation in the 1980s, to a focus on international investing and global investments in the 1990s, to the current interest in risk management and alternatives today—so, too, has UBS Global AM's dialogue with clients. "Risk management is a big focus now," says Mr. Lytle. "We're trying to help maximize returns with as little volatility as possible when it comes to public and private pensions." When asked about the evolution of public pensions, Mr. Lytle remarks, "It's interesting to see how much pensions have changed. Back in 1981, most defined benefit plans consisted of domestic allocations. Today, global equities and global fixed income are key parts of the allocation mix."

When questioned about the DB and defined contribution (DC) issue now being debated in the media, Mr. Lytle reaffirms his earlier statement about being a huge believer in DB. "The whole debate should not be around DC rather than DB," he notes. "It really needs to be about finding ways to build upon this great foundation of DB plans. It's important to remember that DC plans were not designed to be retirement plans, so it's difficult for them to be a 'single solution' to retirement planning. They don't adequately address the primary issue facing participants, which is providing enough money to see a participant through retirement."

Mr. Lytle summarizes his views on the DB/DC debate this way: "We firmly believe defined benefit plans should be here to stay. When you think about retirement outcomes for participants and the potential impact on retirement security, defined benefit plans are, in our view, the best and most efficient way to ensure that security." 



"It's interesting to see how much pensions have changed. Back in 1981, most defined benefit plans consisted of domestic allocations. Today, global equities and global fixed income are key parts of the allocation mix."

—Shawn Lytle

Allocating to Real Assets: Environmental Strategies

By Steven A. Falci, CFA

A look across the return drivers of publicly traded environmental equity strategies provides an intuitive link to three areas of real asset investing — alternative energy to energy related commodities, agribusiness to agricultural commodities and water to infrastructure and inflation protected utilities. Environmental equity strategies can play a role in investor portfolios as a diversifying, liquid component of real assets while also providing a source of secular alpha to a global equity allocation.

Environmental Equities and Real Assets

Environmental equities provide unique exposure to natural resources that are increasingly under pressure from a growing world population. The supply demand imbalance for energy, food and water are the result of secular trends that are creating challenging conditions for their adequate provision and exerting upward pressure on prices. Increasing prices create both the protection that is desired from real assets and are the foundation of favorable long term fundamentals for investment in environmental equities:

- **Renewable Energy.** A combination of the supply demand imbalance for energy and the need to increasingly meet the demand for energy while reducing carbon emissions point to an increasing reliance on renewable energy and provide favorable secular conditions for renewable energy stocks to benefit from rising energy prices.
- **Agribusiness.** The increasing demand for food from a growing, more affluent global population combined with the limited supply of arable land for farming put secular pressure on agricultural commodity prices which creates favorable economics for companies across the agricultural supply chain.
- **Water.** Water is a finite resource for which there is no substitute. Meeting the demand for water globally will require the implementation of equitable pricing structures that encourage conservation as well as massive investment in infrastructure to ensure its adequate delivery. Booz Allen estimates that approximately \$22 trillion will need to be invested in water infrastructure by 2030. Additionally, water utilities have their rates closely tied to inflation.

The correlation of environmental equities to energy commodities, agricultural commodities and infrastructure has been significant in recent years. More importantly, the economic

relationships described above support this correlation, and substantiate this relationship going forward.

Considerations for Environmental Equities in a Real Asset Allocation

While we can establish that environmental equities have a link to real assets, it's important to understand their similarity and differences in relation to real assets. Environmental stocks are equities and will be linked to general equity market movements. History has shown that over the long run equities can outpace inflation, but during periods of rapidly increasing prices like the 1970s they have not performed well. However, while the beta component of environmental equities can link their returns to market movements, the alpha component can provide opportunities to add value through stock selection that identifies winners in addressing the challenges of resource scarcity.

Environmental equities provide certain advantages relative to private infrastructure and commodities funds:

- **Exposure to Water.** Water does not trade as

pure commodity and as such is absent from most natural resource funds.

- **Liquidity.** Publicly traded equities are not subject to lock-up periods.
- **Less leverage.** Publicly traded infrastructure stocks have less leverage which is beneficial during rising inflation.
- **Transparency.** Portfolio valuation is based on readily available market prices.
- **No roll risk.** The roll risk embedded in com-

modity futures could be a significant cost to investment in energy and agricultural commodities during periods of rapidly rising inflation.

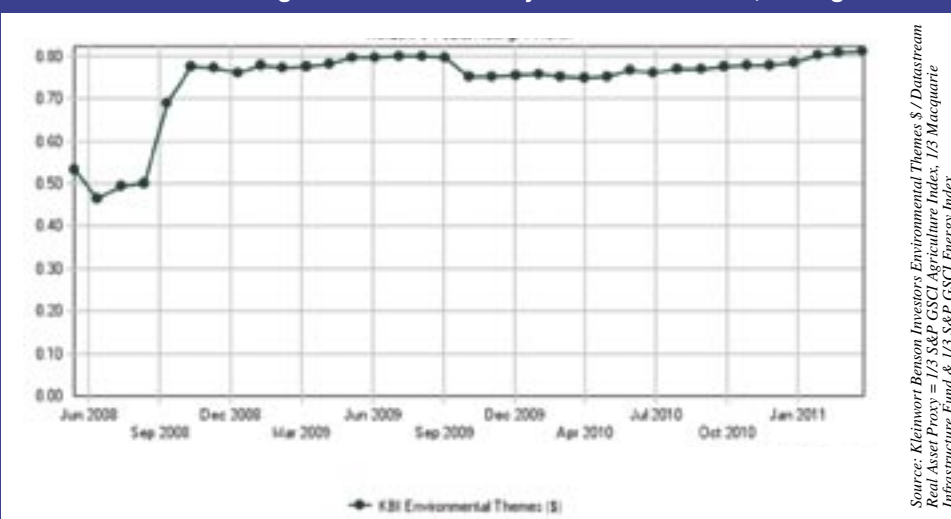
The relationship of environmental equities to rising commodity prices and investment infrastructure warrants their consideration as a unique, liquid and diversifying component of an allocation to real assets.

Environmental equities provide exposure to sectors, companies and regions that are poised to deliver growth for decades to come. As such, they provide investors with the protection they desire from real assets while also providing the opportunity to add alpha through specialist active management that identifies the winning sectors, technologies and companies. Moreover, in the current environment, they are attractively valued, providing investors with an opportunistic entry point. ➔

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Environmental equities provide exposure to sectors, companies and regions that are poised to deliver growth for decades to come.

Three Year Correlation Against Real Asset Proxy • Horizon: 3 Years, Rolling: 1 Month



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Four Problems May Re-Price Credit Risk

By Gerhardt (Gary) P. Herbert, CFA
(Continued from page 1)

Greece are simply the most severe of the sovereigns at this point. However, the fulcrum sovereign in Europe is Spain. Fittingly, a recent Citi Research piece compared the problems of Spain with Ireland across three important economic ratios: house prices to rent, construction investment as a percentage of GDP, and bank loans to the private non-financial sector as a percentage of GDP. The parallels are worrisome; should economic difficulties worsen in Spain, credit risk premiums will widen.

China has been the growth engine of the global economy. Their economy withstood the shock of the global financial crisis better than even the most pessimistic economists and analysts could have expected. As in the U.S., Chinese authorities expanded liquidity to minimize the developed market demand shock. Banking system balance sheets were inflated and domestic credit was expanded vigorously once the problem was recognized.

However, extending credit and making loans is relatively easy; making loans which are sound and have a high likelihood of repayment is more difficult. Our concern is that the dramatic inflation of banking system balance

Given the current level of spreads, the sovereign debt crisis in Europe, inflation in China, and the U.S.'s failure to address its budget deficit, investors should continue to upgrade the quality of their investments — moving from low single Bs to higher BBs — while reducing exposure to those business models that do not have the ability to pass through rising input costs.

sheets has at its core a host of troubled loans, particularly those made to local governments. These troubled loans, if severe enough, will require the banking system to seek governmental capital injections to stabilize balance sheets. Wary capital markets will re-price credit risk.

Another indicator is the state of U.S. dollar liquidity (chart B). According to GaveKal, today it appears to be harder for the foreign private sector to get

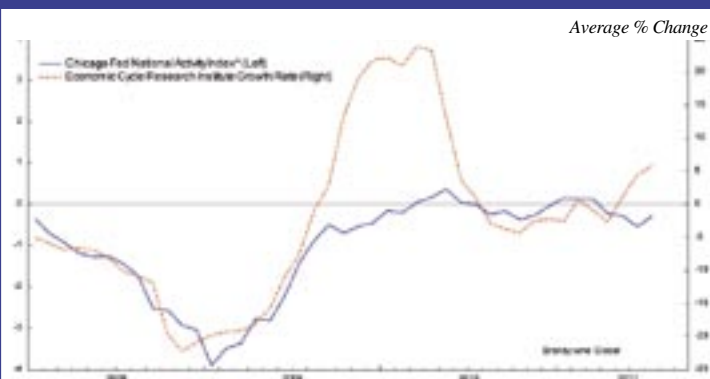
U.S. dollars. Given this lack of liquidity, it should have not come as a surprise that the Federal Reserve announced foreign central bank swap lines will stay open until the end of

2012. Yet, this strained liquidity will have the effect of making dollars more dear and reducing the velocity of money. In such an environment, we believe risk premiums will widen.

Given the current level of spreads, the sovereign debt crisis in Europe, inflation in China, and the U.S.'s failure to address its budget deficit, investors should continue to upgrade the quality of their investments — moving from low single Bs to higher BBs — while reducing exposure to those business models that do not have the ability to pass through rising input costs. We also believe that investors should seek to position themselves closer to the assets by moving up in the capital structure — toward first mortgage and senior secured securities — and increasing their covenant protection. In addition, we do recognize that should the global economy recover at a rapid pace, the aforementioned strategy will not keep pace with the global reach for risk assets that would ensue. 📌

Gerhardt (Gary) Herbert, CFA, is a portfolio manager on the High Yield team at Brandywine Global Investment Management LLC, located in Philadelphia, PA.

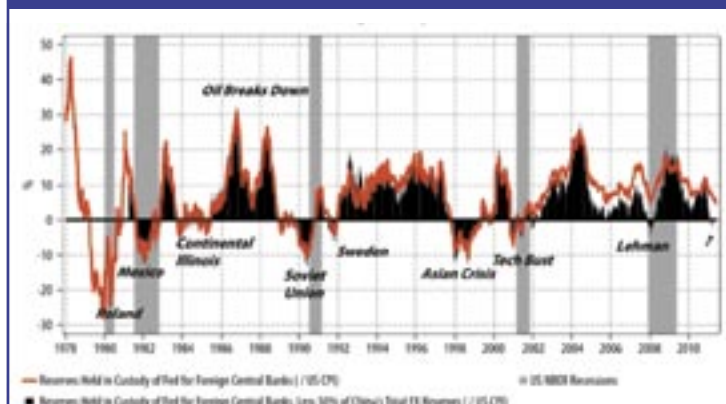
A. Chicago Fed National Activity Index
Economic Cycle Research Institute Growth Rate Index



* Shown as 3-month moving average
As of 07/31/2011

Source: Thompson DataStream, Brandywine Global Investment Management LLC

B. Growth of Central Bank Reserves Held at the Fed:
Total & Ex-China (9 Month % Change: Deflated by US CPI)



GaveKal

De-Risking Portfolios Without De-Railing Potential Capital Gains

By Stephen Gelhaus, CFA, and Karen Beyer
(Continued from page 1)


...an equity strategy focused on the likelihood of future dividends continuing can be a sound method to reduce the risk of volatility in a pension plan's overall investment portfolio, while preserving the opportunities for capital gains over the long term.

• Dividends offer a possible inflation hedge as growth in dividends has historically tracked inflation relatively well over periods greater than five years. **

• Demographic pressures for long-term income solutions due to increased life expectancy support the case for dividend-paying stocks today.

Outlook on risk

A strategy's focus on dividend-paying securities presents the risks of greater exposure to certain economic sectors rather than the broad equity market. Moreover, investment in common stocks does not assure dividend payments. Dividends are paid only when declared by the issuer's board of directors. The amount of any dividend may vary over time and there is no assurance they will be paid in the future. Dividend yield is one component of performance and should not be the only consideration for investment. An investment in the strategy is subject to market risk or the risk that stocks in the portfolio will decline in response to such factors as adverse company news or industry developments or a general economic decline. As with any investment strategy, possible loss of principal is also a risk.

It seems clear that an equity strategy focused on the likelihood of future dividends continuing can be a sound method to reduce the risk of volatility in a pension plan's overall investment portfolio, while preserving the opportunities for capital gains over the long term. 

*Source: Ned Davis Research, Inc. Copyright 2011. All rights reserved. Data as of 12/31/10. Return performance is based on equal-weighted geometric average of total return of all dividend-paying historical S&P 500 stocks, rebalanced annually. A stock is classified as dividend-paying if it paid a cash dividend at any time during the past 12 months. Other methods may produce different results.

**James Montier, *A Man From a Different Time*, August 2010, GMO LLC.

Stephen Gelhaus, CFA, is Senior Vice President and senior portfolio manager; Karen Beyer is Vice President and co-portfolio manager at GE Asset Management in Stamford, CT.

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Grand Hyatt Hotel • San Antonio, TX
August 4 - 6, 2013
Saturday, August 3 – CTT Course



25th Annual Conference

Renaissance Worthington Hotel
Fort Worth, TX
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2014 Summer Educational Forum

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President's Corner

By Eyna Canales-Zarate
(Continued from page 2)

When we think of all that has changed, let us remember what remains the same — that public servants continue to do the jobs they pledged to do for a salary *and* for a pension that was pledged to them at the time they were hired. Those pensions are a core component of their compensation package —not an option to be tossed aside at will.

It is incumbent upon us to remind those who have forgotten that *a promise made is a debt owed*; it is not in the spirit of Americans, especially not Texans, to renege on a promise that was made to people who have committed their working lives to serving the residents of the great state of Texas.

Please make a promise today to reach out to your legislators and remind them of the importance of supporting public servants in their communities by defending public pensions. If not you, who? If not now, when?

Let us not forget,
and let us not let others forget! 



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Washington Outlook

(Continued from page 2)

together, regionally and nationally, as one unified voice representing millions of U.S. pension plan members. Illinois has begun this process already by creating “We are One Illinois” as have other states across the country in preparation. National organizations like NCPERS and NASRA have already pledged their support, and groups like TEXPERS and CALPERS will continue to support and fight for pension rights. We must keep elected officials informed of our unwavering intention to preserve pension rights and approach those officials as representatives of a nationally united force of millions — we must reject the folly of assuming that each state’s particular problems are limited to that state alone: we are all in this together.

Finally, we must counteract the flood of misinformation pouring out from mushrooming anti-union organizations by aggressively providing the truthful facts to the public. We cannot stand idly by and hope that this troubling time merely passes; we must act now. 




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Lisa Ivie Miller Receives Austin Business Journal Award

Former Fire Fighters’ Pension Commissioner Lisa Ivie Miller (center) was named one of the Austin Business Journal’s 25 “Women of Influence” at a luncheon on July 14th. Joining her at the event were her family and friends, including former FFPC Commissioner Helen Johnson (left) and TEXPERS President Eyna Canalas-Zarate (right) who helped nominate Ms. Miller for the award. Ms. Miller is now the Director of Government Relations and Education for South Texas Money Management. 

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