PAPERS

Pennsylvania Association of Public Employee Retirement Systems
PO Box 61543, Harrisburg, PA 17106-1543

Fall 2010 (Vol. 5, No. 3)

In This Issue

Save These Dates

May 24-25, 2011
(Tuesday-Wednesday)

7th Annual

PAPERS Forum

Crowne Plaza Hotel
23 South Second Street
Harrisburg, PA 17101

A current (2011) PAPERS membership is required for your pension plan or company to send its representatives. Each Participating (pension plan) Membership receives one free Forum registration. Registration will begin in March, 2011.

Corporate sponsorships and speaking opportunities are now available by contacting PAPERS' Executive Director.

CPPT Update

The availability of on-line courses for the PAPERS Certificate Program (Level 1 of the *Certified Public Pension Trustee* designation) announced in the last newsletter has been delayed. Look for more information about this program and the on-line courses in 2011.

SEC Concept Release on U.S. Proxy System

File Number: S7-14-10

Submitted by: Rosemary Kelly
Broadridge Financial Solutions/Member of PAPERS Corporate Advisory Committee

On Wednesday, July 14, 2010, the SEC published a Concept Release soliciting comment on various aspects of the U.S. proxy system. The Release is organized into general areas:

- The Current Proxy Distribution and Voting Process
- Accuracy, Transparency and Efficiency of the Voting Process
- Communications and Shareholder Participation
- Relationship Between Voting Power and Economic Interest

Questions posed in the Release cover over/under voting of shares, pre/post meeting record date position reconciliation, vote confirmation of, voting by institutional securities lenders, advance notice of meeting agenda, disclosure of voting by funds, proxy distribution fees, issuer communication with shareholders, means to facilitate retail investor participation, data-tagging of proxy related materials, proxy advisory firms, dual record dates, empty voting and related 'decoupling' issues.

The entire Concept Release can be viewed at: http://www.sec.gov/rules/concept/2010/34-62495.pdf.

The comment period deadline date was October 20, 2010, however the SEC will continue to accept comment letters.

INSTRUCTIONS FOR SUBMISSION OF COMMENTS

The SEC requests that you use only one method when submitting any comments:

Electronic comments:

- Use the SEC's Internet comment form, http://www.sec.gov/cgi-bin/ruling-comments?ruling=s7-14-10&rule_path=/comments/s7-14-10&file_num=S7-14-10&action=Show_Form&title=Concept%20Release%20on%20the%20U%2ES%2E%20Proxy%20System;
- Send an e-mail to rule-comments@sec.gov. Include File Number S7-14-10 on the subject line; or
- Use the Federal eRulemaking Initiative portal (http://www.regulations.gov). Follow the instructions for submitting comments.

Paper comments:

- Send paper comments, in triplicate, to:
  Elizabeth M. Murphy, Secretary
  Securities and Exchange Commission
  100 F Street, NE, Washington, DC 20549-0609.

For further information, please visit http://www.sec.gov/rules/submitcomments.htm.

From PAPERS' Executive Director

The following article appeared in the October 2010 issue of *TEXPERS Outlook* and is filled with important information for public pension funds. It is re-printed with permission by the Texas Association of Public Employee Retirement Systems.

GASB's Proposed Pension Accounting and Financial Disclosure Rules Come Under Fire

A large number of state and local government pension fund officials have responded to the Governmental Accounting Standards Board's (GASB) invitation for comments regarding its Preliminary Views (PV) on Statements 25 and 27, which relate to pension accounting and financial reporting by employers.

In a Sept. 17 letter to GASB, the fiduciaries, administrators and plan members of more than 80 public retirement systems focused on five primary issues raised by the PV:

- *The effect of "de-linking" accounting standards from pension funding;*
- *The requirement that employers place their unfunded pension liabilities on their basic financial statements;*
- *The proposed limitation on deferred recognition of investment gains and losses;*
- *Treatment of cost-sharing plans; and*
- *The proposed discount rate methodology*

The letter asks GASB to proceed with caution in making major modifications to Statements 25 and 27 because the current standards are so well established.

"Significant changes to this reporting model could result in confusion on the part of the user community and could disrupt the consistency of public pension reporting," the letter urges. "Such confusion and inconsistency could in turn reduce accountability and decision usefulness of public retirement system financial reporting."

In addition, eliminating the Annual Required Contribution (ARC) would diminish or eliminate incentives for policymakers and others not only to make proper financial decisions regarding their pension plans, but also to be held accountable for those decisions, the letter says.

The letter's authors also say that GASB's proposal to require a fund's net pension liability (NPL) to be included on the balance sheet would not be an improvement over existing standards. The new NPL would be dramatically larger in most cases than the number currently disclosed on the balance sheet, which would effectively "de-link" pension accounting from pension funding. This would create confusion over the "real" liability of the plan.

The authors believe Statements 25 and 27 in their present form have much to be commended and have served the financial community well.

The letter is available at http://www.nctr.org/pdf/PublicPlanResponseFinal.pdf. In addition, a summary of GASB's PV is available at: http://www.nctr.org/pdf/2010NL_NCTR3rdQtr 083110.pdf.

Meanwhile, the National Council on Teacher Retirement has prepared a "GASB Preliminary Views (PV) Employers Tool Kit" to help interested parties understand the basics of what GASB is proposing, and the consequences if the PV is adopted as the new standard.

It aims to simplify the complicated issues in the PV, while focusing on the elimination of the ARC and the inclusion of the NPL on balance sheets. It is available on the Web at: http://www.nctr.org/Federal%20Governmental%20Relations/GASB%20Toolkit.html.

***Jim Perry*, PAPERS Executive Director**

Become a Member of PAPERS

It's membership renewal time for 2011! Invoices to current PAPERS members will be issued on or about December 1st. Public employee retirement systems (pension funds) not already affiliated with PAPERS can apply to become Participating Members and corporate providers of services to pension plans can apply to become Associate or Affiliate Members online at **www.pa-pers.org** or by contacting:

PAPERS
PO Box 61543, Harrisburg, PA 17106-1543

James A. Perry, *Executive Director*
Phone: 717-545-3901; **E-mail:** perryja1@comcast.net
Douglas A. Bonsall, *Office Manager*
Phone: 717-921-1957; **E-mail:** douglas.b@verizon.net

PAPERS Fall Workshop

PAPERS 4th annual Fall Workshop was held Thursday, September 23, 2010, at The Desmond Great Valley Hotel & Conference Center in Malvern, PA. Just over 60 persons attended the one-day educational seminar, representing both public pension funds and companies providing services to those funds.

A copy of the Workshop's complete agenda, along with several of the presentations given by various speakers that day, may be found at: http://www.pa-pers.org/newweb/workshop.html.

Special thanks for the generous financial support of these PAPERS corporate (Associate & Affiliate) members, making it possible to provide free registration for representatives of public pension funds to attend the Fall Workshop.

- **Barroway Topaz Kessler Meltzer & Check, LLP**
  180 King of Prussia Road
  Radnor, PA 19087
- **BNY Mellon**
  BNY Mellon Center
  201 Washington Street
  Boston, MA 02108
- **Federated Investors**
  1101 Liberty Avenue
  Pittsburgh, PA 15222
- **Foster & Foster, Inc.**
  6290 Corporate Court C-201
  Fort Myers, Fl 33919
- **Intercontinental Capital Management**
  1270 Soldiers Field Road
  Boston, MA 02135
- **Lord, Abbett & Co.**
  90 Hudson Street, 6th Floor
  Jersey City, NJ 07302
- **Schroder Investment Management**
  875 Third Ave, 22nd Floor
  New York, NY 10022

The next PAPERS conference providing both educational and networking opportunities will be the 7th annual 2-day Forum, May 24-25, 2011, at the Crowne Plaza Hotel in downtown Harrisburg. Details will be forthcoming.

PAPERS Board of Directors

Brian Beader
County Commissioner, Mercer County, PA

Jeffrey Clay
Executive Director,
PA Public School Employees' Retirement System

Craig Ebersole
County Treasurer, Lancaster Co. Retirement

Cleveland Forrester
(Retired) Director of Finance, Borough of Chambersburg

Bernard Mengeringhausen
City Controller, City of Wilkes-Barre

Joauna Riley
City of Philadelphia, Board of Pensions & Retirement

Krista Rogers
Controller, Lycoming County

PAPERS Corporate Advisory Committee

Andy Abramowitz
Spector, Roseman & Kodroff, P.C.

Darren Check
Barroway Topaz Kessler Meltzer Check, LLP

Cheryl Daniels
Dow Jones Indexes

Steve Hanson
Lord, Abbett & Company

Rosemary Kelly
Broadridge Investor Services

Kathleen Smith
Renaissance Capital

PAPERS Staff

James A. Perry, *Executive Director*
E-mail: *perryja1@comcast.net*
***Phone :* 717-545-3901 (O) or 717-651-0792 (Cell)**

Douglas A. Bonsall *Newsletter Editor/Office Manager*
E-mail: *douglas.b@verizon.net*
***Phone:* 717-921-1957 (O) or 717-460-0723 (Cell)**

Overseas Without a Paddle:
The Erosion of Investor Protection Mechanisms Against Foreign Companies

By Andrew D. Abramowitz
Spector Roseman Kodroff & Willis, P.C. and
Member of PAPERS Corporate Advisory Committee

If you invest in the securities of overseas corporations – and if you are at all diversified, then multinational investment is practically unavoidable – you have been comforted by the fact that the managers of those companies have been accountable to you. If a foreign corporation defrauded investors, and either the fraudulent conduct occurred in substantial part in the U.S. or the fraud had an effect here, those investors had recourse even if the securities were purchased on a foreign exchange.

A series of decisions, beginning with a U.S. Supreme Court opinion from last June, has drastically sheared off the rights of U.S. investors to seek recourse for the fraudulent acts of foreign corporations. This has resulted in a handful of securities lawsuits – spearheaded by U.S. public pension funds – being tossed out.

In the highly anticipated decision in *Morrison v. National Australia Bank Ltd.*, the Supreme Court was faced with the issue of whether Section 10(b) of the federal securities laws – which allows investors to sue for false or misleading statements – applies to foreign plaintiffs suing both foreign and American defendants for conduct in connection with securities traded on a foreign exchange, commonly known as the "f cubed" situation. The Court ruled that U.S. securities laws should only apply to domestic purchases of securities. The focus, the Court held, should not be on where the fraudulent conduct took place, but rather, on whether there has been a purchase or sale of a security on a U.S. exchange. Foreign countries can regulate their own exchanges and transactions, the Court reasoned.

Since the *Morrison* opinion, lower courts have used that decision to dismiss the claims brought by U.S. investors, including public pension funds, against foreign companies. In so doing, courts appear to be focusing on where the stock purchases took place. If they took place abroad, the federal securities laws do not seem to reach the fraud.

For instance, in October, Swiss Reinsurance Company won the dismissal of claims brought by investors for the company's alleged failure to disclose the risk of a significant loss associated with credit-default swaps. The federal court in New York found that a U.S. investor who sues for purchases on a foreign exchange runs afoul of *Morrison*. Likewise, in September, the claims of U.S. investors against Societe Generale, which arose out of the French bank's exposure to subprime mortgage, were tossed out on the same basis. Similar results have hampered suits against Alstom and Credit Suisse. Public pension funds had taken on prominent roles in prosecuting many of these cases.

On the bright side, there appear to be murmurs of support for legislation in Congress that would eviscerate the ruling. But unless and until that time comes, U.S. investors should be mindful of the fact that a purchase of a security on a foreign exchange gravely reduces the chances of that company's being held accountable for fraud in a U.S. court.

SRKW
SPECTOR ROSEMAN
KODROFF & WILLIS PC

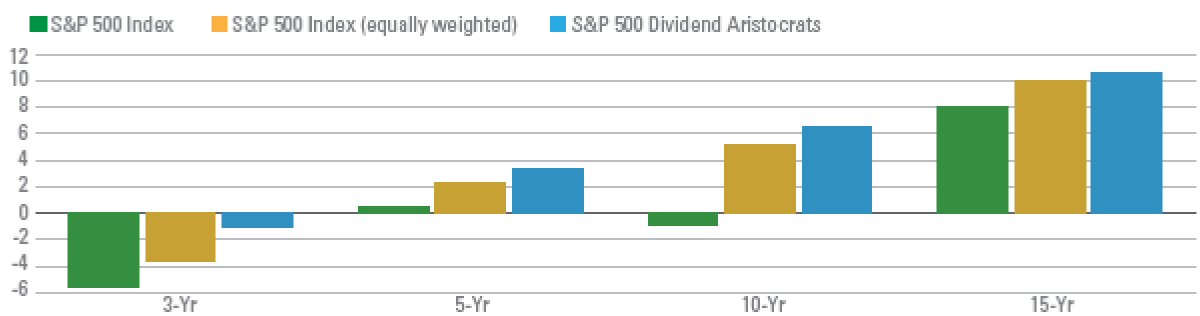
Dividends: Worth a closer look

Compelling yields
Many stocks today offer compelling dividend yields relative to Treasuries — some say the best advantage since the 1950s. In fact, as of 9/30/10, the S&P 500 dividend yield is 2.03%, with the 3-month T-bill yielding 0.16%, 2-year T-notes yielding 0.42% and 5-year T-notes yielding 1.27%. What's more, cash on corporate balance sheets is at high levels rarely seen — in other words, many companies are in good financial shape to increase dividend payouts and respond to arising growth opportunities.

Turning to dividend-paying stocks during times of economic uncertainty is not a new concept. However, it's one that seems especially relevant now, with the dividend yields of many stocks providing a relatively attractive alternative to the historically low yields delivered by bonds.

A long-term track record of higher returns and lower risk
Companies with a long history of growing dividends have produced a favorable risk/reward profile over time, holding up better on the downside and producing better results on the upside as well. As evidenced in the illustration below, the S&P 500 Dividend Aristocrats Index (companies in the S&P 500 Index that have increased the dividend payout for at least 25 consecutive years) have provided higher returns with less risk than the S&P 500.

Average annual total returns and risk as of 12/31/09



Standard deviation as of 12/31/09 (%)			
	S&P 500 Index	S&P 500 Index (equally weighted)	S&P 500 Dividend Aristocrats
3-Year	15.26	24.91	19.36
5-Year	13.07	20.02	15.39
10-Year	15.21	19.04	14.76
15-Year	14.99	17.60	14.27

Dividend-paying stocks offer many potential benefits for investors. Hersh Cohen, Chief Investment Officer and Senior Portfolio Manager, ClearBridge Advisors sees many reasons to look closer at dividends as an investment opportunity:

Dividends: Worth a closer look

• **A signal of quality:** Consistent dividend growth can be confirmation of a firm's "quality" status, as it shows the company's ability to consistently increase cash flow over time.

"When we look at our companies, we see many of them in the best financial shape in decades. Cash on corporate balance sheets is at levels rarely seen. Dividends have been raised, often sharply, for many. Coming out of the worst recession of our lives, we cannot help but believe that these high-quality companies offer the best values in the financial spectrum."

• **A source of income:** In today's current economic environment, where bond yields are at historic lows, stock dividend yields can be relatively more compel-ling, especially for stocks with low price-to-earnings (P/E) ratios.

"We believe it will take longer than is generally expected to return to 'normal,' and prefer to take our risks in more established companies that have come through this debacle in superior shape. When we are asked how to get more income with no risk, we reply that it is impossible. However, by stepping up to great companies, one can possibly get better returns with some risk. We like the trade-off."

• **A cushion from volatility:** Compared to the overall market, dividend-paying stocks have a history of lower volatility, which means they can provide stability to an equity portfolio.

"Clearly, stocks have inherent risks and volatility, but sometimes the risk/reward pendulum favors stocks. We can buy a variety of stocks with current dividend yields that we believe can grow over time, well above the risk-free rate of return. That is a rare occurrence, one we have not seen since the 1950s."

Take a closer look

There are many reasons to take a closer look at dividend-paying stocks — as a cushion from volatility, for income — just to name a couple — but also consider that dividends, reinvested and compounded over time, have provided a significant contribution to total return. For example, with dividends reinvested, the S&P 500 produced a cumulative total return of 393.4% during the 20-year period August 31, 1990 through August 31, 2010. Excluding dividends, price appreciation in the S&P 500 for the same time period was just 225.3% — a difference of $16,810 on an original $10,000 investment.

Making the most of the "dividend opportunity" requires stock selection expertise and active portfolio management.

• **A growing option for retirement:** Dividend-paying stocks can help to provide income needed in retirement.

"All investors, regardless of their age or financial goals, need investments that produce income. Income can also enhance your portfolio's total return potential and help to temper volatility. And with a population of nearly 80 million baby boomers starting to retire, this need for income will become even stronger. With longer life expectancies and the potential for rising inflation, income-seeking investors will need to make sure their money continues to grow."

Important information

The views expressed are those of Hersh Cohen as of September 14, 2010 and are subject to change based on market and other conditions. These views may differ from the views of other portfolio managers or the firm as a whole, and they are not intended to be a forecast of future events, a guarantee of future results, or investment advice. The information contained should not be used as the sole basis to make any investment decision. The statistics have been obtained from sources believed to be reliable, but the accuracy and completeness of this information cannot be guaranteed.

For more information about how you can access the experience and investment solutions that ClearBridge Advisors offers, please contact Andy Goldsmith or Sean Oakes at 1.800.691.6960, or visit us at www.ClearBridgeAdvisors.com

Emerging Market Equities

NEUBERGER | BERMAN

Conrad Saldanha, Portfolio Manager for the Neuberger Berman Emerging Market Equities Strategy, recently published a white paper entitled ***Does Economic Growth in Emerging Markets Drive Equity Returns?*** In this paper, Conrad discusses the commonly held notion that economic growth is a proxy for stock market returns.

While not always determinative, at the very least, economic growth generally provides an underpinning to a country's equity market. Companies operating in a weak or contracting economy may face obstacles to earnings growth, making valuation changes and price appreciation more difficult. Conversely, companies operating in a rapidly expanding economy may enjoy a tailwind.

While Conrad believes emerging market equities and economies have the potential to outperform moving forward, he believes that using gross domestic product (GDP) growth rates as a proxy for stock market behavior may be overly simplistic. Even though GDP growth in emerging markets has been accompanied by strong stock market returns since the late 1990's, the highest GDP growth countries have not always produced the highest stock market returns. The impact of GDP growth on stock market performance varies with each country and is influenced by other factors.

In order to understand stock market performance better, Conrad disaggregates U.S. dollar price returns (excluding dividends) and isolates the factors that he believes are the key drivers of performance. Through his own research, he demonstrates that the impact of changes in profitability (which affects EPS growth) and changes in valuation levels have a much larger impact on stock market returns than GDP growth. Through real world examples, Conrad further supports his thesis by showing that the size of the domestic economy and stock market structure affect stock market returns.

In this paper, Conrad also touches upon how certain types of broad market exposure may not always be representative of the local economy due to skewing caused by factors such as sector representation and market structure. Conrad ultimately believes that a bottom-up fundamental approach focusing on domestically-oriented companies may provide more attractive total return and diversification potential. He believes this approach is better at evaluating investments since it takes into consideration multiple factors including valuation and profitability metrics.

If you are interested in obtaining a copy of this paper, please feel free to contact your Neuberger Berman relationship manager or visit www.nb.com.

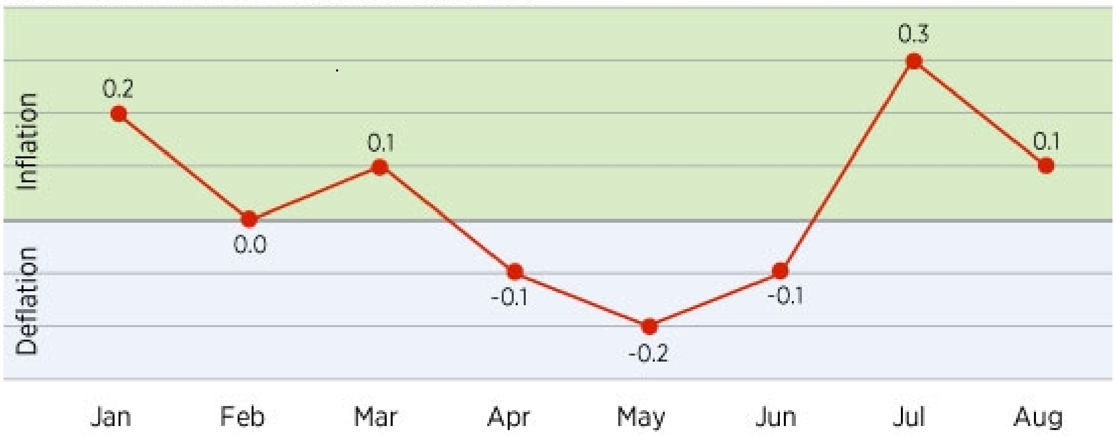
Inflation or Deflation? Managing the Risk with Absolute Return

By: Raman Srivastava, Putnam Investments
October 05, 2010

Early in 2010, as the economic recovery gathered steam and government debt mounted, investors became worried about possible inflation. While inflation seemed like a reasonable concern in the first few months of 2010, growth soon was derailed by the impact of Europe's sovereign debt crisis. In the second quarter, U.S. GDP growth fell to 1.7%, compared with 3.7% in the first quarter. The Consumer Price Index fell for three straight months before rising again in July.

Fears of inflation gave way to the reality of weaker prices in the second quarter

U.S. Consumer Price Index, Jan–Aug 2010



Source: U.S. Bureau of Labor Statistics.

Recently, concerns about *deflation* have emerged because of signs of further economic weakness. What does price uncertainty mean for portfolio strategy? As absolute return investors, we enjoy the flexibility to adjust to this tug-of-war between inflationary and deflationary forces, and we can employ modern investment tools to seek to manage risk. By comparison, more traditional funds with broad exposure to either stock or bond markets might be more vulnerable to shifting sentiments.

For example, a traditional bond fund with interest-rate sensitivity can be hurt when the market fears inflation, while an absolute return fund can use Treasury futures contracts to hedge out interest-rate risk. And a traditional stock fund can be set back by a deflationary outlook, which can often depress lending and economic activity. By contrast, an absolute return strategy has flexibility to avoid equities or to use index put options to hedge against the risk of downside volatility.

Currently, the economy is seeing price stability, which may last, given the economy's feeble growth rate, or which could shift in either direction — toward inflation or deflation. Absolute return strategies have investment tools to use in all scenarios to pursue their positive return targets while seeking less volatility than the markets.

New Data Uncovers Hidden Truths About the IPO Market

Since the internet bubble, investment advisors and academics alike have cautioned investors to avoid the IPO market, insisting that IPOs underperform in the long run and ultimately coining the phrase "IPOs are a loser's game." Despite the advice of these experts, an average of $130 billion is raised each year in the IPO market.

Renaissance Capital has written a White Paper that discredits the notion that "IPOs are a loser's game" with new data that shows IPOs in fact outperform. Further, it examines how and why the IPO market attracts such a significant amount of capital despite forewarnings. The White Paper also explains the benefits of incorporating IPOs into the asset allocation strategy and shows that if structured properly, IPOs can add superior risk-adjusted returns to a portfolio. An abstract of the paper follows below. For a copy of the full report, please contact Renaissance Capital at mhase@renaissancecapital.com or visit the PAPERS library.

Investment Experts and Academics Advise Against Investing in IPOs

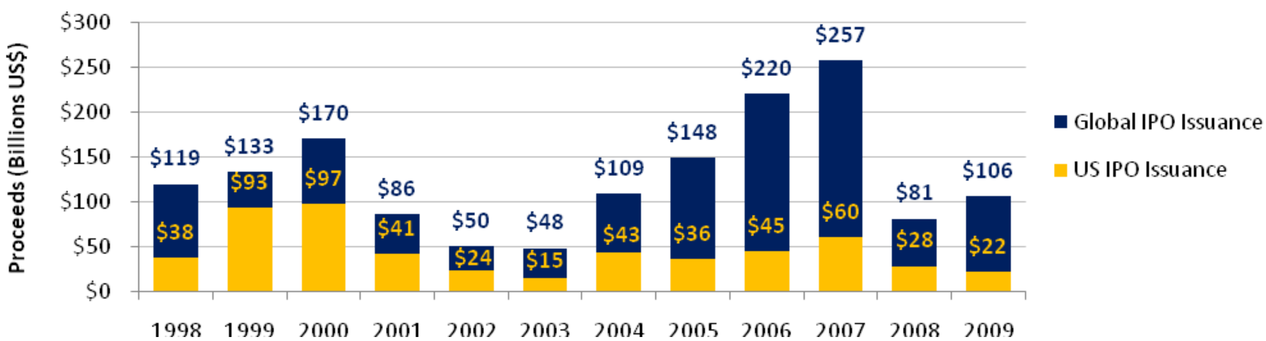
Over the years, investment experts and leading academics have told investors to avoid the IPO market. Some of this advice arises from an overreaction to stock market bubble periods, when investors chased unprofitable internet companies whose IPOs flew off the shelf, reaching valuation heights beyond realistic growth assumptions. After these periods, investment advisors seemed prudent in advising their customers to avoid IPOs.

This once correct call has since been hardened to the point where many advisors still encourage investors to avoid IPOs under all circumstances. Despite the admonitions of the experts, knowledgeable investors consider the IPO market to be an attractive sector. When it comes to IPOs, we suggest that investors ignore what the experts say, and follow the smart money.

1. Billions of Dollars are Poured into the IPO Market Globally Each Year

Exhibit 1

Global Investors Purchase an Average $130 Billion IPOs per Year
U.S. Investors Purchase an Average of $45 Billion IPOs per Year



Source: Renaissance Capital. Includes IPOs with deal size of US$100mm or greater.

(continued on page 10)

2. Active Managers and Hedge Funds Buy IPOs to Generate Alpha

Exhibit 2

How Active Managers Use IPOs to Generate Alpha

Conclusion

Similar to all asset classes such as commodities, fixed income and real estate, the IPO class of equities will have its excesses and it will have its attractive periods. We have constructed an index that is truly comparable to other indices that can measure these periods. IPOs are an economically significant category of equities that can produce superior risk-adjusted returns, and contribute unique returns to a portfolio. This is especially true during periods when the excesses have been squeezed out of the market and only the fundamentally strong and most attractively-valued companies are able to go public. Active managers and hedge funds know this, which is why they are active in the IPO market. Avoiding the IPO market during these periods means missing superior risk-adjusted returns.

About Renaissance Capital - Renaissance Capital, founded in 1991 and headquartered in Greenwich, CT, is the global leader in providing fundamental and quantitative institutional IPO research. The Firm maintains the FTSE Renaissance IPO Composite Index Series (Bloomberg symbols: IPOS, IPOST, IPOSC, IPOAPX, IPOHKT), the definitive benchmark of IPO activity and performance. Renaissance Capital also provides IPO-focused investment management services as the advisor to the IPO Plus Fund (symbol: IPOSX), the first mutual fund to focus solely on investing in IPOs, and through separately managed institutional accounts. For more information visit our website www.RenaissanceCapital.com or call 203-622-2978.

Understanding ETF Talk

RevenueShares™ REVENUE WEIGHTED INDEXES

"By Vincent T. Lowry, Chairman of the RevenueShares™ Trust"

Vince is the founder and CEO of VTL Associates and also serves as the firm's Chief Investment Consultant. He is responsible for leading the firm's investment consulting team, which currently advises institutional investment portfolios with total assets of approximately $20 billion. Vince has specialized in effectively serving the investment needs of institutional clients since 1989.

There is no shortage of ETF talk. It could be a "talking head" breathlessly reporting ETF assets are expected to grow to $1 Trillion by 2011. It could be a talking baby pitching commission-free ETF trades in brokerage accounts. It could be a consultant talking about how more pension plans are using ETFs because they can be traded without contracts.

Often, such talk assumes that ETF education has kept pace with ETF popularity and, as a result, basic introductions are no longer necessary. Many financial professionals smile and nod, even if they aren't completely sure how or why ETFs have become one of the fastest growing investment vehicles in today's market. After all, they've probably heard that ETFs were created way back in 1992 more often than they've heard that ETF assets didn't actually top $100 Billion until 2002. Since then, ETF growth has erupted with such intensity that it's easy to understand why many in the industry have never been properly introduced.1

(continued on page 11)

Understanding ETF Talk ***(continued from page 10)***

This article is a prime example. The term "ETF" has already appeared twelve times, but it has been defined zero times. It's never too late, so, let's start at the very beginning. The acronym ETF stands for exchange traded fund. Said another way, **ETFs** are simply **funds** that are **traded** on an **exchange**. ETFs are often compared to mutual funds because both are single investments that can provide diversified exposure to hundreds or even thousands of underlying stocks. There are, however, some very important differences between ETFs and mutual funds.

> **Trading Flexibility** – Unlike mutual funds, which are only priced at market close, ETFs are priced every fifteen seconds. *This is critical to investors who like to know a fund's price at the time of purchase.*
>
> **Transparency** – Unlike mutual funds, ETFs are required to publish full portfolio holdings daily. *This is important to investors who need to know exactly which securities they are investing (or not investing) in.*
>
> **Low Cost –** Since they are passively managed, ETFs typically incur lower management fees than mutual funds. ETFs trade like stocks and, as a result, buys and sells can be subject to commissions and other related trading costs*, but an ETF's management fees are embedded in the NAV of the fund; therefore, those fees do not constitute an ongoing liability to (or contract with) an investment manager.*

Although the benefits listed above can be compelling, invalid assumptions still prevent many "would-be" investors from incorporating ETFs into their investment strategies. One of the most common myths is the idea that an ETF's trading volume determines its liquidity. This is simply not the case. **The liquidity of an ETF, which tracks an index, is determined by the liquidity of the underlying stocks making up that index.** For example, an ETF tracking the S&P 500® will reflect the liquidity of those 500 individual securities. Therefore, an investor who doesn't have concerns about the liquidity of the stocks in the S&P 500® shouldn't have concerns about the liquidity of an ETF that tracks the S&P 500®.

While the relationship (or lack of a relationship) between volume and liquidity can be confusing to those not familiar with ETFs, it can also be the key to unlocking new levels of diversification. **Picture an ETF that tracks the S&P 500® ETF as a basket containing fractional pieces of 500 stocks.** In traditional indexes, the relative size of each stock piece is proportional to the size of each company's market capitalization ("cap"). Since cap is a stock's market price multiplied by the number of shares outstanding, the largest allocations in a cap-weighted basket are inherently the most expensive stocks. Investors may be drawn to the diversification and liquidity of the overall basket, but turned off by the idea that the largest components of their investment tend to be stocks with high price-to-sales (P/S) ratios.

At one time, investors would have been forced to decide if the diversification and liquidity of a cap-weighted index outweighed its bias towards expensive stocks. This is no longer the case. Today, the structure of ETFs allows for passive, indexed investing based on other fundamental economic factors (instead of market value). Investors who value the P/S ratio might opt to invest in a revenue-weighted version of the S&P 500®. **The revenue-weighted basket contains pieces of the same 500 stocks as a cap-weighted S&P 500® index.** This type of investment ranks companies by how much they sell rather than how much they cost without sacrificing diversification or liquidity. *It is important to note that diversification <u>can</u> be affected by indexes based on certain fundamental factors. For example, since not all companies pay dividends, a dividend-weighted version of the S&P 500® does not provide the same diversified exposure as the original index (since it excludes companies that do not pay dividends).*

Revenues and dividends are just two of many factors ETF providers use as alternatives or complements to cap-weighted indexing. According to the Investment Company Institute (ICI), 897 ETFs were available in the U.S. as of September 29, 2010. Hopefully, this article will be a useful companion to the sound bites of ETF "talkers" and allow you to make more informed decisions about which of those ETFs are best suited to meet the needs of your constituents.

ROCK MAPLE FUNDS

Why Hedge Fund of Funds Now?

In a private wealth and institutional investment environments, investing in the hedge fund space (Hedge Fund of Funds in particular) should be addressed in the larger context of traditional portfolio management and wealth maximization and not in isolation.

Fund of Hedge Funds (FOF) are not a substitute for either a bond or an equity portfolio but rather a complementary "asset" class. Including FOF in a 60/40 mix has historically improved the risk/adjusted return profile of such portfolios, particularly for low risk tolerance investors (Exhibit A). FOF should not be viewed as a "tactical" but rather as a "strategic" exposure in a "60/40" traditional mix mainly as a result of the "liquidity" profile associated with FOF. Therefore, when including a FOF allocation in a traditional portfolio, the objective is to size the exposure in such a way that the periodic rebalancing of the portfolio does not affect the FOF benefits.

Exhibit A:

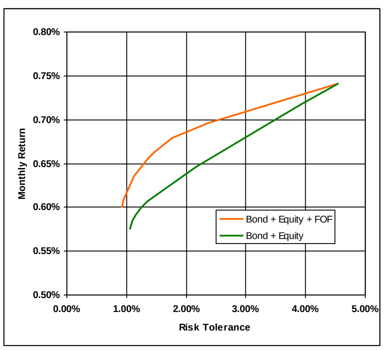
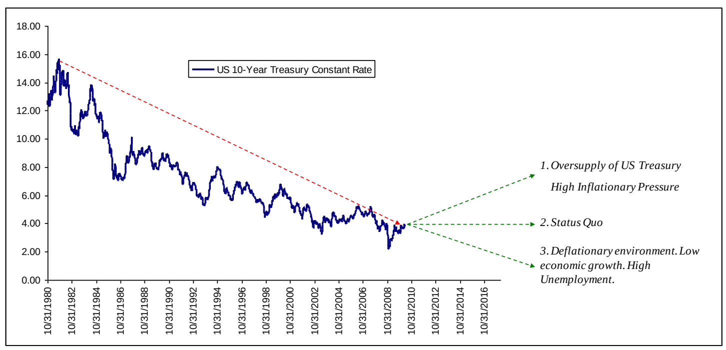


Exhibit B:



Going forward, exposure to FOF within traditional portfolios with defined return targets will be even more critical. The rationale is that the US bond market has gone through an almost 30 year bull run that took 10-year Treasury yields from 15.6% in 1981 to 3.2% in 2010 resulting in a historically steep yield curve. The financial crisis of 2008 continued this trend as the Fed lowered short term rates to close to 0% to maintain liquidity in the system while buying US Treasuries to keep the longer end of the yield curve low to support the housing market. During the same period, the sharp increase in government spending has created a huge national debt that needs to be financed and runs the risk of increasing further as more debt might be needed just to finance the deficit (Exhibit B).

This period of historically low interest rates won't last if the US economy regains momentum. Under this scenario, the Federal Reserve will raise short term rates to keep inflation under control thus making it even more expensive for the US to finance its debt. During economic recovery, portfolio managers tend to redeploy their capital into equities away from their fixed income allocation. This has the effect of adding further upward pressure to rates.

Within this environment, the inclusion of FOF represents a strategic allocation to an asset class that exhibits uncorrelated return characteristics to the traditional 60/40 mix and, as a result, further enhances the portfolio's risk adjusted return while increasing its performance consistency. The challenge of course, is to find the FOF that uses the same disciplined portfolio construction and risk management process that has been the backbone of traditional modern portfolio theory. They do exist, but finding them and knowing what to look for when you do, will be the subject of another article.

We’ve Got the Whole World in Our Hands: Evolution of Global Investing

By: Danielle Fischer, an Associate Director with UBS Global Asset Management, Chicago, IL

Investors have not entirely captured the global investable marketplace in their portfolios, in terms of both geography and market capitalization. Initially, many investors were satisfied with their domestic equity returns and had disproportionately large allocations to the US versus its share of world GDP (“home-bias”). Starting in the 1970s, and in the decades that followed, the world became more accessible and liquid. Investors increasingly sought to increase their total return with the diversified source provided through international developed markets. Today, investors are also beginning to incorporate emerging markets and international small cap companies into their overall global equity investment allocations. While progress has been made, investors may continue to expand their equity allocations and seek higher total returns by taking advantage of the entire global market capitalization.

		1987	1999	2008	2015 (est)
United States	GDP share of world total	23%	24%	21%	18%
	Average Fund Sponsor Allocation	48%	49%	38%	?
International	GDP share of world total	77%	76%	79%	82%
	Average Fund Sponsor Allocation	1%	14%	14%	?
Emerging Markets	GDP share of world total	37%	37%	45%	52%

Note: Gross domestic product based on purchasing-power-parity (PPP) share of world total
Average Fund Sponsor Allocation assumes 60% equity allocation in domestic balanced portfolio
International represents all developed and emerging/developing markets, ex-United States
Source: International Monetary Fund, World Economic Outlook Database, Callan Total Fund Sponsor Database

The gap between historical equity asset allocations and what was investable globally should not be necessarily attributed to the investor, but perhaps to the evolution of benchmarks. As benchmarks evolved to match trends in global investing, they became better representations of the global equity market capitalization. So, as investors began to consider developed international investing in the 1970s, the MSCI World Index gained traction. At that time the “world,” as defined by the index, represented only 60% of the world’s market capitalization in 20 developed countries and the US[1].

As it became more practical to adopt emerging markets as part of the global investable marketplace, the MSCI ACWI Index became the global index of choice. This expanded the widely accepted view of the world to 23 developed market countries and 25 emerging market countries. In the last decade, investors have begun to explore more deeply for total return and have examined the capitalization spectrum more closely. Subsequently, in 2008, the MSCI ACWI IMI Index was developed to capture global small cap companies (roughly 13%). Additionally, it maintained exposure to emerging market countries (nearly 45% of the world’s GDP) and, in total, the index represents roughly 99% of the global marketplace[2].

Ultimately, the benefit to the broadest definition of global investing has its basis in a fundamental tenet of modern financial theory – lack of constraints. Ultimately, the largest possible opportunity set allows skilled investment managers to formulate a portfolio of their highest conviction level. Allowing investment managers to work in the unconstrained landscape on which portfolio management theory is based allows them to seek the highest possible total returns for clients. As the world’s economies become increasingly inextricably linked and access to developing markets increases, both from a geographic and a size perspective, it is important for investors to expand their concept of global investing. Adding areas of high potential growth, such as emerging markets and international small caps, to one’s view of the investable world may prove very helpful, particularly in times of potentially low returns from traditional, developed markets.

---

[1] MSCI Barra, *Globalization of Equity Policy Portfolios.*
[2] Ibid.

IMPORTANT DISCLAIMER: PAPERS does not support the market value of liabilities approach but is publishing this article, feeling it is important for readers to have an opportunity to be exposed to both sides of the argument.

The Imperative: Evaluate Financial Position, Consider Unique Circumstances
Public Pension Plans in Search of a $3 Trillion Solution

Public pension plans face a challenge: surmounting a $3 trillion funding shortfall. Many may be unsure of where to begin in tackling this colossal deficit. At Yanni Partners, a Division of GBS Investment Consulting, LLC, we suggest careful measurement of each plan's financial position, and close integration of investment strategies with the unique plan's distinctive characteristics.

We believe that the industry's current accounting and funding standards are causing public plans to grossly understate their liabilities. GASB 25 and the Actuarial Standards of Practice (ASOP) stipulate that public plans should base their discount rates on projected investment returns. However, many experts counter that the discount rate should reflect the risks of the liability, not the assets. For example, Brown and Wilcox write: "Finance theory is unambiguous in that the discount rate used to value future pension obligations should reflect the riskiness of the liabilities." [i]

Some suggest that the U.S. Treasury yield curve should serve as the basis for the discount rate.[ii] Private, single-employer pension plans value liabilities based on this rationale, but use a high-quality corporate yield curve. Yet municipalities have taxing powers. The apparent strength of public plans supports the idea of using high-quality, fixed-income yields for discount rates.

If public plans would discount liabilities using high-quality, fixed-income yields, their liabilities and contributions would skyrocket. In fact, Novy-Marx and Rauh estimated that state plans' unfunded liabilities would increase from $1.0-3.2 trillion using U.S. Treasury yields.[iii]

Compared to private plans, public plans invest more heavily in equities[iv] (generally 60-80%).[v] Public plans have a perverse incentive to invest in equities because they can report an immediate improvement in funded status simply by raising the equity allocation. A higher equity allocation provides a plan the rationale to raise its investment return assumption, as equities have a higher long-term expected return. But better performance from an increase in the fund's equity allocation is not always a given.

The GASB appears to have acknowledged the validity of discounting certain liabilities based on high-quality, fixed-income yields. In its June 16, 2010, statement of preliminary views on pension accounting, the GASB proposed a discount rate based on high-quality municipal bond yields to value unfunded liabilities.

A key principle of investment management involves structuring a portfolio based on its plan's unique needs and circumstances. However, we evaluated 2009 public plans' survey data from the Center for Retirement Research at Boston College,[vi] – and found no relationship at all between investment strategy and plan characteristics (such as funded ratio and age of participants).

As institutional investment consultants, we must acknowledge the challenges that plans are facing. Taking steps to value liabilities using market interest rates – and linking investment strategies to plan characteristics – is the first step in starting the journey toward recovery.

(continued on page 15)

[i] Brown, Jeffrey R. and David W. Wilcox. May 2009. "Discounting State and Local Pension Liabilities." Public Pension Finance Symposium, Society of Actuaries.

[ii] Novy-Marx, Robert and Joshua D. Rauh, December 18, 2009, "Public Pension Promises: How Big Are They and What Are They Worth?"

[iii] Novy-Marx, Robert and Joshua D. Rauh, Fall 2009, "The Liabilities and Risks of State-Sponsored Pension Plans," Journal of Economic Perspectives, Volume 23, Number 4, 191-210

[iv] http://crr.bc.edu/images/stories/Briefs/slp_4.pdf?phpMyAdmin=43ac483c4de9t51d9eb41

[v] http://crr.bc.edu/frequently_requested_data/state_and_local_pension_data_4.html

[vi] http://crr.bc.edu/frequently_requested_data/state_and_local_pension_data_4.html