PAPERS PENNSYLVANIA ASSOCIATION OF PUBLIC EMPLOYEES RETIREMENT SYSTEMS

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The mission of the Pennsylvania Association of Public Employee Retirement Systems (PAPERS) shall be to encourage and facilitate the education of its membership in all matters related to their duties as fiduciaries overseeing the assets of the pension funds with which they have been entrusted. It will be PAPERS' primary purpose to conduct an annual educational forum that provides the basis for improved financial and operational performance of the public employee retirement systems in the State. PAPERS will function as a central resource for educational purposes and act as a networking agent for all public plan staff and board members.

Summer 2008 (Vol. 3, No.3)

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If you're interested in overnight lodging for the Fall Workshop

The Desmond Great Valley Hotel & Conference Center

One Liberty Blvd.
Malvern, PA 19355

Single or double rate $144 (suite upgrades available upon request)

Guestroom rates subject to 6% PA state Occupancy Tax and 2% Chester County Occupancy Tax.

For Reservations

Call toll-free:
1-800-575-1776

E-mail:
reservations@desmondgv.com

Looking Ahead...

The 5th annual PAPERS Forum will be held April 15-17, 2009, at the Hilton Hotel in downtown Harrisburg.

From the PAPERS Executive Director

Join us Sept. 23rd for the 2nd annual PAPERS Fall Workshop

Our focus this summer is on the production of our fall workshop at the Desmond Great Valley Hotel & Conference Center in Malvern, PA, just west of Philadelphia. We have put together an agenda that addresses most of the major issues facing public pension plans. Please see pages 2-3 for the details of this exciting agenda.

The fall workshop gives Participating Members, especially those in the eastern part of the state, an opportunity to meet with their plan sponsor peers and with Associate Member firms that provide investment, actuarial and legal services to the pension community. Best of all, there is no cost for any number of representatives from Participating Member plans to attend this one day educational event.

Beth Almeida from the National Institute on Retirement Security will discuss the importance of maintaining defined benefit pension plans. Chris Probyn with State Street Global Advisors will provide insight on the current economic environment and share what he sees in his crystal ball for the near future. We will also have three panels that will discuss actuarial issues, administrative concerns and legal issues affecting local plans.

On the investment front we will look at asset allocation, alternative investment strategies, and the problems and opportunities associated with dislocation in the mortgage and credit markets. We will also take a look at global warming and its potential implications for investment markets.

The success of the fall workshop and of PAPERS as an organization is dependent on your participation and support. I look forward to seeing you at the PAPERS fall workshop on September 23rd. You'll find the workshop reservation form just waiting for you to complete on page 4.

Jim Perry,
PAPERS Executive Director

PAPERS FALL WORKSHOP AGENDA
Tuesday, September 23, 2008 – 7:00 am–4:30 pm

The Desmond Great Valley Hotel & Conference Center in Malvern, PA

7:00 am – 8:00 am.......**Registration and Continental Breakfast**

8:00 am - 8:05 am........**Welcome to Fall Workshop** - **Jim Perry, Executive Director of PAPERS**

8:05 am - 8:35 am........**What Pensions Mean to You?**
Presenter: ***Beth Almeida*** *– National Institute for Retirement Security*
Beth will talk about the importance of maintaining Defined Benefit Pension Plans.

8:35 am - 9:15 am........**Economic Outlook**.
Presenter: ***Chris Probyn****, Chief Economist – State Street Global Advisors*
Chris will discuss the state of the economy and look at what we should expect in the near future. He will also take a look at the financial policies of the U.S. Presidential candidates in an effort to see what impact they may have on the economy going forward.

9:15 am - 10:30 am......**Issues Facing Local Pennsylvania Public Pension Plans**
Moderator: ***Alan Randzin****, Treasurer Chester County*
Panelists: ***Craig Ebersole****, Treasurer Lancaster County*
Bernie Mengeringhausen*, Controller Wilkes-Barre*
Robert Mettley*, Controller Lebanon County*
The panelists will discuss issues they have had to deal with in operating a Public Pension Plan in their political subdivision.

10:30 am -10:45 am.....**Refreshment Break**

10:45 am - 11:30 am....**Asset Allocation Trends**
Presenters: ***James Allen,*** *Secretary of PA Municipal Retirement System (PMRS)*
Rich Dahab*, Dahab Associates*
Panelists will discuss the Asset Allocation study recently completed for PMRS and talk about asset allocation in general in the current environment.

(Agenda continued on page 3)

PAPERS FALL WORKSHOP AGENDA

(continued from page 2)

11:30 am - 12:30 pm....**Alternative Investment Strategies**

Moderator: ***Seth Yablonovitz****, Ashford Consulting Group*

Additional panelist(s) to be announced

This panel will explore newer alternative strategies developed to deal with the current market environment and to help Plan Sponsors attain their actuarial targets.

12:30 pm - 1:00 pm......**Lunch**

1:00 pm - 1:45 pm........**What You Should Know about DROPs, COLAs & Pension Schemes**

Panelists: ***Greg Stump*** *- EFI Actuaries*

James L. McAneny*, Executive Director of Pubic Employee Retirement Commission (PERC)*

Benefit changes and special programs (e.g. DROPs, early retirement windows) are frequently discussed and analyzed, but how can the true cost of a change in your pension or retiree healthcare benefits program be determined?

- *Benefit changes and costs/savings*
- *Actual versus estimated costs*
- *Pitfalls and unintended consequences*

1:45 pm - 2:30 pm........**Taking Advantage of the Dislocation in the Credit and MBS Markets**

Moderator: ***PSERS or SERS Staff***

Presenter: ***Vesta Marks*** *- Utendahl Capital Management*

Speakers will explore opportunities that are developing for investors as a result of the recent turmoil in the credit and mortgage markets

2:30 pm – 2:45 pm.......**Refreshment Break**

2:45 pm - 3:30 pm........**How Global Warming will Affect Global Markets**

Moderator: ***Jeff Clay,*** *Executive Director, Public School Employees' Retirement System*

Panelists: ***Kevin Bourne****, Managing Director - HSBC Bank*

Joaquim de Lima*, Director - HSBC Bank*

Presenters will discuss the impact that global warming may have on the Financial Markets and Global Investment practices.

3:30 pm - 4:30 pm........**Legal Issues Affecting Local Retirement Systems**

Moderator - ***Joauna Riley****, City of Philadelphia Board of Pensions & Retirement*

Additional panelist(s) to be announced

Panelists will discuss legal issues they have had to deal with in the course of their daily routine in the public pension arena.

Announcing the:

2nd Annual PAPERS Fall Workshop

Tuesday, September 23, 2008

7:00 am – 4:30 pm

Continental breakfast and lunch included

The Desmond Great Valley Hotel & Conference Center

One Liberty Blvd., Malvern, PA 19355

Continuing its mission to facilitate education for persons affiliated with Pennsylvania's public pension plans, PAPERS is pleased to announce plans for this one-day educational workshop. All PAPERS Associate and Participating Members are encouraged to attend; PAPERS membership is required for registration. Free admission for all representatives of Participating Member systems; no limit on the number of individuals who may attend. The workshop registration fee for Associate Members is $500 per representative.

Registration for September 23, 2008 PAPERS Workshop

Please check appropriate category:

- ❑ ***Participating Members*** **–** No registration fee for any person(s) from your retirement system
- ❑ ***Associate Members*** **–** $500/person registration fee

Individual's name

Representing (company or system name) ______________________________

Mailing address ______________________________

City, State, Zip ______________________________

Telephone number ____________________ **E-mail address** ____________________

Complete, detach at dotted line and return no later than Sept. 12, 2008, with full payment due.

Make checks payable to: ***PAPERS*** **Mail to:** ***PAPERS, PO Box 6817, Harrisburg, PA 17112***

Meet These Distinguished Workshop Speakers

(NOTE: Biographical information and photos not available at press time for all speakers at the 2008 PAPERS fall workshop.)

Beth Almeida is the Executive Director of the National Institute on Retirement Security (NIRS). NIRS is a non-profit research institute based in Washington, established to promote informed policy making in the retirement arena by fostering a deep understanding of the value of pension plans to employers, employees, and the economy as a whole. NIRS conducts research, education, and outreach programs that are national in scope.

Before joining NIRS, Beth served as assistant director for strategic resources and as senior economist with the International Association of Machinists and Aerospace Workers (IAM) where she was instrumental in transitioning some 40,000 airline employees out of terminating or freezing pensions into the IAM's multi-employer defined benefit pension plan. She has authored numerous economic and pension publications and is a frequent speaker at domestic and international conferences. Beth earned a bachelor's degree in international business from Lehigh University and a master's degree in economics from the University of Massachusetts Amherst. She sits on the Executive Board of the Labor and Employment Relations Association and on the Advisory Board of the Center for Retirement Research's initiative on state and local government pensions at Boston College.

Kevin Bourne is a Managing Director and Global Head of Equities at HSBC Bank plc in London. He joined HSBC in September 2004 and is responsible for several of the firm's product teams – including Program, Algorithmic, Direct-Market Access Trading, Index and Optimisation products. Prior to joining HSBC, Kevin was at Citigroup for seven years, managing the electronic trading business in Europe. In 1995 he joined Fidelity Brokerage International Head of Institutional Electronic Trading. Prior to this, Kevin spent 10 years on the buyside in business development. Before joining the investment industry, Kevin spent 6 years with the British Army as an Intelligence Operator with the Airborne Forces having enlisted as a professional soldier at the tender age of 16.

Joaquim de Lima is the Director/Global Head of Equity Derivative & Quantitative Research for HSBC Bank plc London, United Kingdom.

- Holds a PhD in Solid State Physics from the University of Edinburgh
- Has an MBA degree from the University of Edinburgh
- Began his career in the city developing quantitative futures trading models
- Has over 12 years experience in the area of quantitative and equity derivatives research
- Currently the Head of Equity Derivative & Quantitative Research at HSBC which includes responsibility for the index creation group

Appointed member of the Advisory Committee for Dow Jones STOXX Indices. The STOXX Limited Advisory Committee is responsible for advising the Supervisory Board on the composition, accuracy, transparency and methodology of its indices and is composed of leading third party professionals from the financial services sector

- Appointed member of the S&P Global Index Advisory Committee
- Guest Speaker of the UNFCCC - address issues related to investment and financial flows in climate change investing
- Working in partnership with the UNFCCC

Seth Yablonovitz (Partner, Ashford Consulting Group) joined the Ashford Consulting Group after graduating with a Masters in Finance from the Wharton School in 2006. He received his undergraduate degree from Penn State University in 1994 where he was elected Phi Beta Kappa and graduated from the University Scholars Program. Seth is now a partner with the Ashford Consulting Group, focusing his time on asset allocation and alternative investing. Prior to business school, Seth ran long/short equity portfolios for nearly ten years, where he developed and implemented investment strategies focused on both fundamental and technical analysis.

Fall Workshop Speakers *(continued)*

Gregory M. Stump is a Fellow of the Society of Actuaries, an Enrolled Actuary under ERISA, a Fellow of the Conference of Consulting Actuaries, and a Member of the American Academy of Actuaries. He is Vice President of EFI Actuaries. After graduating from Indiana University of Pennsylvania (IUP), Greg enjoyed several years of teaching mathematics and computer science before becoming interested in actuarial consulting. Greg has worked with many pension and post-retirement healthcare plans, both public and private, throughout the United States. He is continually involved in furthering the education of the public pension community by frequently speaking at national and regional conferences. He has served as a member of the PAPERS Advisory Board since 2006. Greg's special areas of expertise include stochastic forecasting as well as funding and contribution policy analysis. As a consultant with EFI Actuaries, Greg provides actuarial consulting exclusively to public sector and governmental pension and retiree healthcare plans, including some of the largest and most complex systems in the country.

Special Thanks to our Fall Workshop Sponsors

- **EFI Actuaries**
  Suite 325, 1001 Connecticut Ave. NW
  Washington DC 20036
- **GE Asset Management Inc.**
  3002 Summer St., PO Box 7900
  Stamford, CT 06904
- **HSBC Bank**
  Level 4, 8 Canada Square
  London E145HQ, UK
- **State Street Global Advisors**
  State Street Financial Center
  One Lincoln St, 33rd Floor
  Boston, MA 02100-2900
- **Turner Investment Partners**
  30 Broad Street
  New York, NY 10004
- **Utendahl Capital Management**
  30 Broad Street
  New York, NY 10004
- **Vanguard**
  100 Vanguard Blvd., M-32
  Malvern, PA 19355

Free Service Available to PAPERS Members

PAPERS Participating Members (retirement systems and fund administrators) can get one-year free access to *Public Pensions Online*. This is yet another important reason to become a PAPERS member. Go to www.publicpensionsonline.com/member/papers.html and fill out the requested information (name, email, retirement board, etc.). Once the application is submitted, an account will be activated and you will receive an email with your personal login information.

FIDUCIARY DUTY AND THE USE OF ACTIVE MANAGEMENT

*by Rex W. Holsapple**

For trustees to use active managers, they must answer "yes" to both of the following questions.

Do good active managers exist?

Can we identify the good ones in advance?

A fiduciary has a duty to use care, skill, and diligence when answering these two questions. It is not sufficient to simply observe that some active managers have beaten the market in the past. Fiduciaries need to be familiar with the pertinent theoretical arguments and actual evidence.

The stakes are high. If trustees answer both questions yes but they are wrong, transaction costs and management fees will reduce their return in the long term by 1% per annum or more. Compounded over the 20+ year time horizon for pension investments, this is the difference between having a fully funded plan and being under funded by 25% or more.

<u>There is a convincing theoretical argument that most active managers of publicly traded securities under perform corresponding index funds in the long run.</u>

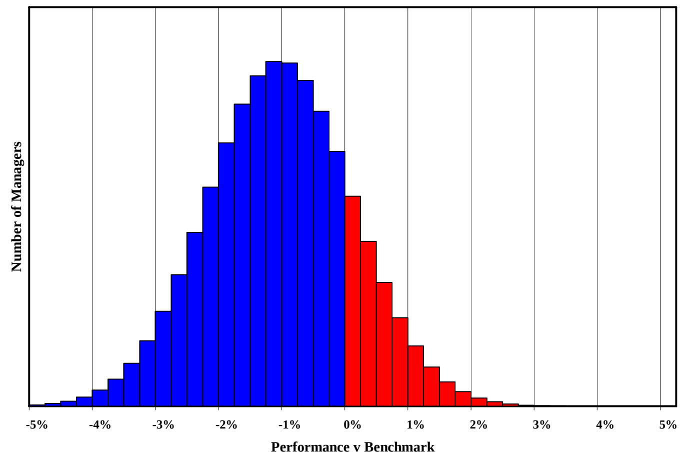
There are two kinds of investment portfolios. One kind tries to achieve a return higher than the return of the market for its asset class. These are called actively managed portfolios. The other kind tries to achieve a return equal to that of the market for its asset class. These are called passively managed portfolio or index funds. (I ignore the philosophical possibility that there are a meaningful number of investors who are trying to achieve a return lower than the market's.)

The return of the entire market or asset class is equal to the average of all the securities or portfolios in it. This means the market return is equal to the average of the return of the active portfolios and the return of the index funds. We know that the return of the index funds is equal to the return of the market. This means that the return of the active portfolios, as a group, must also equal the return of the market. However, we have not said anything about costs yet. Index funds have extremely low transaction costs and management fees. Most active portfolios incur significant transaction costs and charge significant fees. Therefore, after costs, active managers, as a group, must under perform index funds.

It is important to understand that this conclusion does not depend on any esoteric economic theory, such as the efficient market hypothesis. It is based only on the grade school arithmetic used to calculate averages. It is a convincing argument; every reasonable investor must agree with it. (For a more complete discussion see "The Arithmetic of Active Management" by William F. Sharpe. This paper is brief and easy to read. It can be found at www.stanford.edu/~wfsharpe/art/active/active.htm.)

<u>There is substantial actual evidence that most active managers under perform in the long run.</u>

There have been numerous studies of the historical performance of active managers. The graph below illustrates the track records of managers over long time periods, i.e. ten years or more.



Depending on which study you look at, only 15% to 25% of managers have over performed an index with comparable style. Sharpe's Arithmetic does not say that all active managers under perform, but it does say that most do. The studies summarized by this graph provide substantial evidence that this is the case.

<u>There are some theoretical arguments that all active managers under perform in the long run.</u>

Many investors believe that the market for publicly traded securities is efficient. In an efficient market, the market value of a security is the best available estimate of its true value. This implies that no investor can beat the market in the long run. It does not mean that the markets are perfect. It does mean that they are close enough that the cost of trying to beat the market, i.e. the cost of active management, negates any superior knowledge an active manager may have about the true value of a security.

When you buy a stock because you think it is under valued, you are buying it from someone who thinks it is over valued. Certainly, there are ignorant sellers who have no real idea of the value of a security, but you are not buying from a particular seller chosen especially for ignorance. If they make a completely honest assessment, most investors would conclude that they cannot be confident they know more about a security than their counterparty to a trade.

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FIDUCIARY DUTY AND THE USE OF ACTIVE MANAGEMENT

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Furthermore, you are buying at a price determined by the market, not by an individual seller. When someone decides what a security is worth, some of his analysis is probably correct, and some is probably incorrect. The market provides a mechanism for averaging out all these analyses. The incorrect analyses that conclude the price is too high are offset by the incorrect analyses that conclude the price is too low. All that is left is the price based on correct analysis. (For a more thorough discussion see The Wisdom of Crowds, a book by James Surowiecki.)

If you are the first one to hear and analyze a piece of new and relevant information, your new estimate of the value of a security may be better that the market's existing estimate. However, information moves very rapidly and thoroughly. Unless you are an insider, it is likely that other people are also aware of the information and that the current market price reflects it.

Not all reasonable people will find the arguments for market efficiency convincing. However, reasonable people should find them at least plausible.

There is some actual evidence that all active managers under perform in the long run.

Many people believe that the earlier graph is clear evidence that markets are not efficient and that some managers can beat the market in the long run. This is an overly simplistic interpretation of the graph. Surprisingly, the same graph provides some evidence that all active managers will under perform in the long run.

Suppose you give an active manager an assignment to invest in only one stock. If the manager picks the stock at random, he has a 50/50 chance of picking a good stock, i.e. one that over performs the market. An actual portfolio is simply an aggregation of many of these one stock portfolios. Therefore, any actual portfolio has a 50/50 chance of beating the market, before costs. (Again, this is based on arithmetic, not the efficient market hypothesis.) In other words, an active manager has a 50/50 chance of being lucky. Over longer periods of time, transaction costs and manager fees will drag performance down, and we would expect the random stock pickers to under perform. Nevertheless, for a few of them, we should expect their selections to be lucky enough that they will still over perform, even over ten years or more.

We can calculate what the graph would look like if all active managers were simply picking stocks randomly. Surprisingly, it would look very much like the graph we actually see. In other words, we would expect something like 15% to 25% of all active managers to beat the market over 10 to 20 years, net of fees, even if they are all making their buy and sell decisions by tossing a coin. After all, if we have a lot of people tossing coins, we should expect a few of them to be lucky enough to toss twenty heads in a row.

Therefore, the graph is not necessarily evidence that some managers beat the market because they are skillful. It may simply be evidence that some managers are lucky. If a manager's performance is due to luck, eventually his luck will run out and costs will drag him under. Furthermore, there is no way for a trustee to distinguish between managers that will be lucky and managers that will not.

Making the Active versus Passive decision:

Do good active managers exist? Can we identify the good ones in advance? The theory and the evidence do not give unequivocal answers. Knowledgeable fiduciaries can and do disagree on the answers. Nevertheless, using index funds is a natural and prudent way to invest in publicly traded securities. Considering the stakes, those who use active management have the burden of explaining why they answer "yes" to the two questions.

***ABOUT THE AUTHOR:**

Rex Holsapple *is currently the Managing Director of Sandy River Investment Consulting, LLC. He has served as the chief investment officer for the Maine State Retirement System, the Nebraska Investment Council, and for the benefit plans of Phillips Petroleum Company (now ConocoPhillips).*