

Summer 2014 (Vol. 9, No. 2)

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**Philadelphia Hosts PAPERS 8<sup>th</sup> Annual Fall Workshop**

**Wednesday, September 17 – Thursday, September 18, 2014**



**Looking Ahead to 2015**

**More PAPERS Networking & Educational Opportunities**

**11<sup>th</sup> PAPERS Forum**

**May 21-22, 2015**  
 (Thursday-Friday)  
 Harrisburg Hilton Hotel

**The Wyndham Philadelphia Historic District**  
 400 Arch Street, Philadelphia, PA

**The conference agenda appears inside on Pages 5-6.**

**Conference registrations are due to PAPERS by 9/1/2014. The application is available on-line and also on page 9.**

**If you need overnight lodging - The guaranteed group rate at the Wyndham Hotel (\$149 plus tax for double or king) will be available only for reservations made on or before 8/26/2014.....hurry, time is running out! See page 10.**

## From the PAPERS Executive Director

Welcome! And thank you for checking out our Newsletter.

Allow me to introduce myself, and our organization if you are not familiar with PAPERS. If you are, please bear with me as I share some news regarding the changes that are unfolding that I hope you will find of interest.

After 40+ years of working in the public sector, thirty of which was as Secretary of an agent multiple employer public pension system, I have assumed the position of Executive Director of PAPERS. It is an honor and responsibility I accepted with some trepidation. Having to follow in the footsteps of the organization's founder and first Executive Director Jim Perry is truly a daunting task. Jim has elected to slow down a bit and enjoy his retirement. Fortunately, Jim will be available for a few more months to help out with my transition.

And while I am easing into my new duties, I am sure you will find some changes being made to the organization; hopefully changes that you will like. Unfortunately, there may be some you may not. Please let me know about your "likes" and "dislikes." I goal is to serve the organization's mission and I will need everyone's help if we are to succeed in that effort. Lest we forget, PAPERS was founded to, in part, "...**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.**"

One of my goals as the new Executive Director is to continue to provide strong educational opportunities to you the trustees and staff of Pennsylvania's public employee pension plans. One step along this path is to host a two day workshop on September 17 & 18, in Historic Philadelphia. We are trying to make it both topical and educational and are very excited about the wide range of speakers and topics that are going to be addressed. Elsewhere in this newsletter you will find a tentative agenda and the details of the



workshop. Won't you please consider joining us?

A second effort at offering educational opportunities will be a renewed commitment to the PAPERS Public Pension Certified Professional (PPCP) program. Krista Rodgers is doing a great job getting the program up and running and we are looking forward to more trustees participate in the coming months. The third way in which we seek to offer educational opportunities is through our periodic webinars. These sessions can be interactive or if you missed the "original" presentation, they can be revisited by visiting our library at: <http://www.papers.org/newweb/library.html>.

And finally, look for changes in the format of our Newsletter in the coming editions. We want to be a little more topical, a bit more educational, and a tad more reader friendly.

Please let us know how we are doing and what we can do to better help you meet the needs of your plan members!

*Jim Allen*

James B. Allen  
PAPERS Executive Director

## PAPERS Staff

**James A. Perry** (through 8/14/2014)  
*Executive Director*

**James B. Allen** (beginning 8/15/2014)  
*Executive Director*

**Douglas A. Bonsall**  
*Director of Operations/Newsletter Editor*

**Krista Rogers**  
*Director of Education/Certification Program*

## Becoming a PAPERS Member is Easy

A current year PAPERS membership is required for attendance at the Spring Forum and/or Fall Workshop and to receive credits in the CPE and/or PPCP programs.

Public employee retirement systems (pension funds) can apply to become Participating Members; each Participating Membership includes one complimentary admission to both the Spring Forum and the Fall Workshop. Corporate providers of service to pension plans can apply to become Associate or Affiliate Members online at [www.pa-pers.org](http://www.pa-pers.org) or by contacting:

**PAPERS**  
**PO Box 61543**  
**Harrisburg, PA 17106-1543**

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## Three PAPERS Membership Categories

- **Participating** (\$95) - *Public employee retirement systems (pension funds)*
- **Associate** (\$1,000) - *Corporate providers of legal and investment services to pension plans*
- **Affiliate** (\$500) - *Corporate providers of other services, exclusive of legal and investment services, to pension funds.*

Corporate (Associate & Affiliate) Members also have the additional opportunity to become sponsors for PAPERS' two annual conferences – the Spring Forum and the Fall Workshop. Sponsors receive recognition in the printed and on-line materials produced for the conferences and also receive priority consideration to provide speakers and/or make presentations.

## PAPERS Board of Directors

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# PPCP Webinars



**By: Krista Rogers, PAPERs  
Board Member  
& Director of Education**

At the May 2014 Spring Forum PAPERs had its largest graduating group yet from the PPCP Program:

- **James Eckstein** – Butler County,
- **Dana Descavish** – Cambria County,
- **Miriam Miller** – Lycoming County, and
- **Melva Vogler** – Public School Employees' Retirement System.

Congratulations to these newly certified pension professionals!!

There were quite a few members that expressed interest in this program at the Spring Forum but have yet to enroll – NOW IS THE TIME! **If you join now and attend the Fall Workshop as well as participate in the webinars through the end of the year, you would have 11 credits toward your certification!**

The PPCP has been, or will be, hosting webinars covering topics such as *GASB 67 & 68 – Preparing For Change, Rosetta Stone: Investments, Is Certainty Worth Paying For.* Interest and attendance have been increasing and

I am looking for presenters for the winter months and into 2015. The webinars are tentatively scheduled for the third Wednesday of the month and each month except May, and September due to the Spring Forum and Fall Workshop. These webinars give members an opportunity to obtain credits toward the PPCP certification as well as gain pertinent information on topic relevant to Public Pension Professionals.

## Upcoming PAPERs Webinars

- August's webinar is schedule for the 20<sup>th</sup> – 10:30-11:30 with Scott Lothian from Schroder Investment Management presenting ***Is Certainty Worth Paying For?***. Scott joined Schrodgers in early 2013 as senior strategist, with responsibilities for developing and delivering client solutions as well as devising and authoring investment-led thought pieces.
- October 15th – topic yet to be determined – Andrew Abramowitz, Esq. - Spector Roseman Kodroff & Willis, P.C.
- November 19th – topic yet to be determined - Lisa Shalett (head of investment and portfolio solutions at Morgan Stanley)

I would encourage all members to look at enrolling in the PPCP program. and the webinars are a great opportunity to earn credits toward the certification. The PPCP Program is open to all trustees, mangers and administrative staff as well as service providers who offer services to public pension plans in Pennsylvania and are current members of PAPERs.

Please contact me with any questions on the program or if you have an interest in being a webinar presenter.

**Krista B. Rogers**  
**PAPERs Director of Education/Certification Program**  
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# 8<sup>th</sup> Annual Fall Workshop Program Agenda

Tentative as of 7/28/2014 – subject to change

The Wyndham Philadelphia Historic District  
400 Arch Street, Philadelphia, PA

## Wednesday, September 17<sup>th</sup>

9:00 a.m.- 5:00 p.m.	Conference Registration/Exhibits .....	Meeting Rooms Foyer
10:00 a.m.-11:15 a.m.	PAPERS Board/Corporate Advisory Committee Meeting .....	Adams Room
11:45 a.m.-12:30 p.m.	Opening Luncheon .....	Hancock Room

**All workshop sessions take place in the Franklin Room**

12:45 p.m.- 1:00 p.m.    **Opening Session**  
 Welcome ..... Jim Allen, *PAPERS Executive Director*  
*Public Pension Certified Professional Program* ..... Krista Rogers, *Coordinator*

1:00 p.m.- 1:45 p.m.    **Keynote Address: Economic Overview and Fed Policy Discussion**  
 Speaker ..... Ardy Lynn Wurtzel, *Federal Reserve Bank of Philadelphia*

*Ms. Wurtzel will review current national and regional economic conditions, current labor market conditions, current inflationary conditions and current monetary policy dynamics. She will also provide insight into the Fed's policy, monetary goals and policy tools.*

1:45 p.m.- 2:30 p.m.    **Multi Asset Investing: A Hollow Box or a Better Building Block?**  
 Speaker ..... Adam Farstrup, *Schroder Investment Management*

*Investors struggling with complex investment challenges have increasingly turned to multi-asset solutions. Multi-asset portfolios can allow greater focus on achieving specific investment outcomes in an unconstrained yet risk managed way. Multi-asset strategies can also allow for a more dynamic asset allocation process, which many plan sponsors would like to incorporate. We will explore the advantages of a research approach focused on risk premia rather than traditional asset class buckets that can lead to better outcomes and the role that some multi-asset strategies can play in an investor's portfolio.*

2:30 p.m.- 2:45 p.m.    **Beverage Break**

2:45 p.m.- 3:30 p.m.    **What to Expect from Fixed Income Going Forward**  
 Presenter ..... Paul A. Matlack, *Delaware Investments*

*Paul will present an economic and fixed income outlook including a review of bond market performance and factors affecting interest rates and bond market performance going forward. Given the recent market behavior, he should have plenty to discuss!*

3:30 p.m.- 4:15 p.m.    **Opportunities in Emerging and Frontier Markets**  
 Speaker ..... To be announced, *BNY Mellon*

4:15 p.m.- 5:00 p.m.    **Report of the Blue Ribbon Panel on Public Pension Plan Funding**  
 Speaker ..... Bob Stein  
*The Blue Ribbon Panel on Public Pension Funding of the Society of Actuaries*

# Fall Workshop Program Agenda *(continued)*

## September 17<sup>th</sup> *(continued)*

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6:00 p.m.- 8:00 p.m.    **Private Reception/Guided Tours**  
Philadelphia History Museum at the Atwater Kent, 15 South 7<sup>th</sup> Street

## Thursday September 18<sup>th</sup>

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7:30 a.m.–12:00 p.m.    **Conference Registration/Exhibits** ..... Meeting Rooms Foyer

7:45 a.m.- 8:15 a.m.    **Breakfast**..... Hancock Room

**All workshop sessions take place in the Franklin Room**

8:30 a.m.- 9:15 a.m.    ***What It Takes to be Named the Top Small Public Plan in the U.S.***  
Speakers..... Imogen Rose-Smith, *Institutional Investments Magazine*  
Representatives from *Pennsylvania Municipal Retirement System*  
Representatives from *Philadelphia Board of Pensions & Retirement*

*A discussion of what went into earning this recognition for both the Pennsylvania Municipal Retirement System and the Philadelphia Public Employee Pension Plan.*

9:15 a.m.-10:00 a.m.    ***Opportunities and Risks Involved with International Small Cap***  
Speaker .....Harold E. Sharon, *Lord Abnett & Co.*

*Learn why major consultants are calling the international small cap asset class an essential part of a well-diversified institutional portfolio. The \$4 trillion opportunity—twice the size of U.S. small caps—continues to be a relatively ignored investment strategy. Understand the performance characteristics, the flows, what drives them, and macroeconomic policies may disproportionately help them.*

10:00 a.m.-10:15 a.m.    **Beverage Break**

10:15 a.m.-11:00 a.m.    ***Investment in Commercial Real Estate: Approaches for Today's Market***  
Speaker .....Meredith Despina, *National Association of Real Estate Investment Trusts*

*As investors contemplate adding or increasing exposure to commercial real estate, they should know that REITs and publicly traded real estate securities offer meaningful advantages as a way of obtaining that exposure. Publicly traded REITs are a high utility asset in institutional investment providing investors with an investment in the real estate asset class; an efficient way to gain global real estate exposure; and when combined with private real estate investments, REITs can play an important risk management role*

11:00 a.m.-12:00 p.m.    ***Security Breaches: The Implications and Costs Involved with Them***  
Moderator..... Jim Allen, *PAPERS Executive Director*  
Panelists .....To be announced

*Our speakers will discuss and share experiences they have had and the lessons they learned after being victimized by data pirates or careless office practices.*

12:15 p.m.- 1:00 p.m.    **Closing Luncheon**..... Hancock Room

# Special Thanks to our 2014 Fall Workshop Sponsors

## LEAD SPONSOR



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National Association of Real Estate Investment Trusts<sup>®</sup>



**LORD ABBETT**

**Corporate sponsorships & speaker opportunities on the Fall Workshop agenda are still available for PAPERS' Associate and Affiliate Members.**  
Please contact PAPERS Executive Director Jim Perry for more information.  
([perryja1@comcast.net](mailto:perryja1@comcast.net))

## **PAPERS and its corporate sponsors**

cordially invites conference attendees and their families to join us on Wednesday, September 17, 2014 at the Philadelphia History Museum at the Atwater Kent for a private reception and tour during the 8<sup>th</sup> Annual PAPERS Fall Workshop.



PAPERS' guests will enjoy food and beverages served in the Main Gallery of this building that was the original home of the famed Franklin Institute. Today the Philadelphia History Museum at the Atwater Kent tells the story of more than three centuries of history of "The City of Brotherly Love".

**DATE: Wednesday, September 17, 2014**

**TIME: 6 p.m. to 8 p.m.**

**LOCATION: The Philadelphia History Museum at the Atwater Kent  
15 South 7<sup>th</sup> Street, Philadelphia, PA**  
*(about 4 blocks from the conference at the Wyndham)*

# Registration for 8<sup>th</sup> Annual PAPERS Fall Workshop

Sept. 17-18, 2014 at The Wyndham Philadelphia Historic District  
400 Arch Street in downtown Philadelphia, PA

## Conference Registration Deadline - September 1, 2014\*

Each individual attending must submit a separate registration form. Please check appropriate category:

- Pension Plan Representatives** – Current (2014) PAPERS Participating Membership required
  - First individual from pension plan – complimentary
  - Each additional individual - \$50
- Corporate Sponsors** - Current (2014) PAPERS Affiliate or Associate Membership required + sponsorship
  - Platinum Sponsors receive four (4) complimentary registrations
  - Gold or Silver Sponsors receive two (2) complimentary registration
- Service Provider Representatives** - *Firms providing investment management and legal services*  
Current (2014) PAPERS Associate Membership required
  - Each individual from organization - \$400
- Service Provider Representatives** - *Firms providing consulting services, exclusive of investment/legal*  
Current (2014) PAPERS Affiliate Membership required
  - Each individual from organization - \$200

Individual's name \_\_\_\_\_

Preferred name for name tag \_\_\_\_\_

Representing (name of pension plan or company) \_\_\_\_\_

Mailing address \_\_\_\_\_

City, State, Zip \_\_\_\_\_

Telephone number (\_\_\_\_\_) \_\_\_\_\_ - \_\_\_\_\_ E-mail address \_\_\_\_\_

Please indicate all Fall Workshop events that you plan to attend. This information is needed so arrangements for adequate seating & meals can be made.

### Wednesday, Sept. 17, 2014

- Lunch
- Afternoon sessions
- Cocktail reception @ Phila. History Museum

\_\_\_\_\_ Indicate number of *additional* guests  
attending reception with you

### Thursday, Sept. 18, 2014

- Breakfast
- Morning sessions
- Lunch

\_\_\_\_\_ **Check if interested in PPCP (Public Pension Certified Professional) Program**

**Full payment of any fees due must be included with this registration.**

You may pay the registration fee either by check or electronically through PayPal.

1. **To pay by check.** Please make check payable to: **PAPERS** and return with this application to:  
**PAPERS, P.O. Box 61543, Harrisburg, PA 17106-1543**
2. **To use PayPal.** Please access the PAPERS website ([www.pa-pers.org](http://www.pa-pers.org)) and click on "Fall Workshop". Select the appropriate type of registration from the drop down box and follow the directions to have PayPal transfer the applicable fees automatically from your bank account to PAPERS. In addition to PayPal payment, you must also submit this registration form. Your completed conference registration form may either be mailed to: **PAPERS, PO Box 61543, Harrisburg, PA 17106-1543** or scanned, saved and e-mailed to: **douglas.b@verizon.net**.

\*The PAPERS Fall Workshop group rate for overnight lodging of \$149 double or king plus tax at The Wyndham is guaranteed only for reservations made on or before 8/26/2014. To make hotel reservations, call 1-877-999-3223 (identifying yourself as being with the PAPERS Fall Workshop) **OR** reserve on-line at:

[http://www.wyndham.com/groupevents2014/47153\\_RETIREMENTSYSYSTEM/main.wnt](http://www.wyndham.com/groupevents2014/47153_RETIREMENTSYSYSTEM/main.wnt)

# 8<sup>th</sup> Annual PAPERS Fall W4orkshop

September 17-18, 2014

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

## The Wyndham Philadelphia Historic District 400 Arch Street, Philadelphia, PA

Conference Rate: \$149/double or king + tax

Conference Rate Guaranteed for Reservations **made on or before 8/26/2014**

For Reservations:

CALL 1-877-999-3223 OR RESERVE ON-LINE at:

[http://www.wyndham.com/groupevents2014/47153\\_RETIREMENTSYSYSTEM/main.wnt](http://www.wyndham.com/groupevents2014/47153_RETIREMENTSYSYSTEM/main.wnt)

## Driving Directions to the Wyndham Historic District

### I-95 Traveling North from Philadelphia International Airport

Follow I-95 North to Exit 22 (Exit is marked 676 West, Independence Hall and Callowhill Street). Follow the Callowhill Street Exit. Proceed two (2) lights to 4<sup>th</sup> Street and turn left. We are just past the third traffic light on the right hand side.

- **Shuttle Service from the Airport:** Lady Liberty can be picked up at the luggage claim area and then for return trip to the airport, the hotel bellmen can assist with arranging pick up times. Their phone number is 215-724-8888.
- **Public Transportation from the Airport:** SEPTA does have options available to get here. From the airport, they would take the R1 Airport Line from Terminal EF to Market East station. At Market East, they will transfer to the Market Frankford Blue Line East Bound. From this, they get off at 5<sup>th</sup> street and walk the two blocks to the hotel.
- **Taxi Service from the Airport**

### Traveling from the New Jersey Turnpike

Take Exit 4 off of the turnpike. Take Route 73 North to Route 38 West to Route 30 West. Once you are on Route 30 West, follow the signs to the Ben Franklin Bridge. When you are crossing the bridge, stay in your right hand lane. At the bottom of the bridge, take the first right hand turn. It is a very sharp turn, about 180 degrees. (You will end up being on a cobble stone road) Go to the stop sign at the bottom of the ramp and turn right. This street is 4<sup>th</sup> Street. Our driveway is just past the second light on the right hand side.

### Traveling from the Pennsylvania Turnpike

Follow 76 East to Exit 38, which will be marked Central Philadelphia, 676 East. This exit is on the left-hand side. You are currently Vine Street Expressway. Follow this to 8<sup>th</sup> Street exit and turn right. The next light that you come to is Race Street. Turn left onto Race Street. Follow Race Street for four traffic lights and turn right onto 4<sup>th</sup> Street. We are just past the first traffic light, on the right hand side.

### Traveling from New York on I-95 South

Exit off of I-95 South at Exit 22 the Route 76, Vine Street, Center City Exit. At the bottom of the ramp, stay to your left, this will take you onto 2<sup>nd</sup> Street. Take 2<sup>nd</sup> Street for two traffic lights and turn right. The street that you are turning onto is Arch Street. Take Arch Street for two, (2), blocks and turn left. The street that your turning onto 4<sup>th</sup> Street. We are the first driveway on your right hand side.

***Parking for conference attendees will be in the hotel's adjacent parking garage at a special conference rate of \$15 per day (for overnight guests) and \$10 per day (for commuters).***

# An Outcomes-Oriented Approach to Alternatives

By: Lisa Shalett, *Morgan Stanley Wealth Management*

## Introduction

Transformational forces are colliding in a way that necessitates a fresh approach to asset allocation guidance for alternative asset classes and strategies: the proliferation of lower-cost alternative investment formats; the normalization of interest rates; and the need to reintroduce alternatives to Financial Advisors and clients, many of whom in the past have been disillusioned by unfulfilled expectations, high fees, tax complexity and liquidity. In this new outcomes-based approach, we have a navigation framework that is intuitive and tests for suitability through alignment with basic portfolio goals. We also posit performance parameters that allow us to compare the trade-offs between alternative mutual funds/ETFs and private offerings and suggest benchmarks that provide clients with a way to measure success.

## Executive Summary

The Global Investment Committee (GIC) view has long been that properly selected alternative asset classes and investment strategies can add diversification, provide some measure of downside resilience and, thus, should be incorporated, when suitable, in investment portfolios. In this paper, we explore both lower-cost alternative investment formats and outline a fresh approach to asset allocation that incorporates them alongside traditional products.

The first principle of wealth management is to create and maintain portfolio diversification through effective asset allocation. The power of this principle lies in the role that compounding returns play in wealth accumulation and preservation. To that end, we manage risk in an effort to mitigate large portfolio drawdowns and minimize volatility. When we minimize volatility over the typical multiyear investment horizon, we increase the probability that we achieve our goals. Allocations of bonds and cash have been the primary risk-management tool in portfolios, but the end of a 30-year bull market for bonds — combined with the impending unwinding of historic central-bank intervention in markets and the likely rise in bond volatility — raises the question of how effective these traditional assets alone will be in managing risk during the next three to five years.

The GIC believes that, as investors navigate this historic period of interest rate normalization, alternatives will be an even more important tool for portfolio diversification. In the past, bringing alternative investments into portfolios was challenging, in large part because liquidity, tax efficiency, transparency and affordability resulted in complexity and, therefore, limited access. Now, through alternative mutual funds and alternative exchange-traded funds (ETFs), some of these barriers are falling. The GIC believes that this development is transformative for asset allocation and portfolio construction. Specifically, this development enables the transition from a pure accessibility-driven framework to a more precise, risk-management and suitability-driven approach from which even the most conservative investor with a basic stock-and-bond mix could benefit.

Easier access alone is not sufficient to attract investors. Client skepticism around alternatives is high, in part resulting from disappointing performance during the financial crisis. In addition, there has been confusion about how and when to use alternatives, given that they range from all flavors of hedge funds to private equity, real estate and commodities. Alternatives' lack of clear benchmarks, naming conventions and performance standards has further hindered their use.

In our view, new products and new packaging are not going to create better outcomes for clients. What is needed is a more robust, refined and disciplined approach to asset allocation and portfolio construction — one that includes categorizing products and strategies by clearly defined investment characteristics, performance metrics and benchmarks. This new framework acknowledges that alternatives is not a singular asset class to be allocated to but a collection of diverse strategies and asset types that can be used specifically as tools to aid portfolio construction. Finally, investors require a structured approach to navigating the sea of choices in a framework that better links potential solutions to their long-run goals. This paper attempts to establish such a construct for Financial Advisors and clients.

*(Continued on Page 12)*

# An Outcomes-Oriented Approach to Alternatives

(continued from Page 11)

For more information on this topic, go to the PAPERS e-library at <http://www.papers.org/newweb/library.html> to access a longer document submitted by the writer.

## Author:



**Lisa Shalett**

*Head of Investment & Portfolio Solutions Morgan Stanley Wealth Management*

Lisa Shalett is the Head of Investment & Portfolio Solutions for Morgan Stanley Wealth Management and a member of the Global Investment Committee and the Investment Products & Services Executive Committee. She works to develop portfolio solutions that leverage the firm's strategic and tactical asset allocation advice to meet client goals. In addition, Ms. Shalett is responsible for Morgan Stanley Wealth Management's thought leadership agenda and publishes white papers on topics of importance to practitioners and clients. Ms. Shalett earned an MBA at Harvard Business School and holds a dual degree in applied mathematics and economics from Brown University.

## Submitted By:

**Richard J. Hazzouri, CFA**

*First Vice President, Senior Institutional Consultant, Senior Investment Management Consultant*

Richard is a First Vice President and Senior Investment Management Consultant of The Hazzouri Group at Morgan Stanley. A graduate of Scranton Preparatory School, Richard earned a Bachelor of Science degree from Loyola College, Baltimore, Maryland. He is a holder of the Chartered Financial Analyst (CFA) designation and has completed the Accredited Investment Fiduciary (AIF) certification at the Center for Fiduciary Studies. Mr. Hazzouri is a member of the CFA Institute as well as the New York Society of Security Analysts. In addition, he serves on the Board of Directors of the Association of Professional Investment Consultants (APIC), an independent organization made up of Morgan Stanley Financial Advisors dedicated towards professionalism within the investment consulting industry.



**John McGeehan**

*Financial Advisor*

John is a financial advisor with The Hazzouri Group at Morgan Stanley. His responsibilities include discretionary portfolio management, tailored lending and investment manager due diligence. He holds the General Securities Representative license (Series 7) and the Uniform Combined State Law Examination (Series 66). John is a member of the Association of Professional Investment Consultants (APIC), an independent organization dedicated towards professionalism within the investment consulting industry. He currently serves on the Investment Solutions committee.

## Perspective

# Fossil Fuel Divestment: Too Narrow a Solution?

**SRI/Core Equity Team - Neuberger Berman**

*Arthur Moretti, CFA; Ingrid S. Dyott; Sajjad Ladiwala, CFA; Mamundi (MG) Subhas, CFA*

**The call for fossil fuel divestment has become increasingly powerful in the climate change debate. But even for those who support CO<sub>2</sub> emission reductions, is it a viable investment choice?**

At present, the scientific community almost universally recognizes the role of human pollutants in climate change. Increases in temperature have contributed to a rise in sea levels, the melting of glaciers and ocean acidification, which poses risks to marine ecosystems and species up and down the food chain. Extreme weather including hurricanes has increased in frequency and severity, while crop yields have been damaged, contributing to commodity price volatility.

(continued on Page 13)

# Fossil Fuel Divestment

(continued from Page 12)

To avoid a further, potentially catastrophic 2° C increase in global temperatures by 2050, many scientists argue that concentration of carbon dioxide (CO<sub>2</sub>) in our atmosphere must be capped at 450 parts per million, versus 400 parts per million today. By extension, this means dramatically curbing the world's carbon budget to 565 gigatonnes over the next 35 years—which is far less than current global reserves of coal, oil and gas.

## Missing Target: Consuming Industries

To reach this goal, proponents of fossil fuel divestment argue that investors should simply eliminate their exposure to fossil fuel providers. While we agree with the overall effort to reduce emissions, we believe that the divestment approach has a range of implications, most significantly in not addressing the CO<sub>2</sub> generation of energy-consuming industries—which represent about 80% of carbon emissions and almost 90% of equity market capitalization

In addition, divestment does not impact state-owned enterprises, which account for three-fourths of global oil and gas reserves, or consider the challenges associated with some alternative energy sources, such nuclear or hydroelectric.

## A Holistic View

Rather than simply exclude a roughly 12% chunk of the global investment universe, we believe that a more effective approach on climate change may be to seek investment opportunities across industries in businesses that are finding growth while delivering emission reductions in their operations and through their products. This could include a shift from coal to cleaner natural gas in electric generation—as well as encouraging “best practices” among both producers and users of fossil fuels. Overall, we believe such a strategy can be effective in promoting leadership in CO<sub>2</sub> reduction while maintaining a relatively open investment universe.

For investors, we believe that any policy choice on climate change needs to be made in light of overarching goals: Does it further carbon reduction? Does it have an impact on portfolio risk-return characteristics? Would it be better to integrate risks associated with climate into the investment process?

The proponents of fossil fuel divestment have done much to elevate the discussion on climate change and have highlighted important issues as to the need to assess and value carbon-exposed businesses. We have long considered the business risks associated with CO<sub>2</sub> exposed businesses. Lost in the discussion on divestment is how to become positioned for the new growth opportunities being enabled across industries in emission-reduction technologies and services. We believe that a well-researched bottom-up ESG investment process can effectively address the CO<sub>2</sub> challenge while avoiding some of the return trade-offs associated with a simple divestment strategy.

**This paper is adapted from *Energy, the Environment and the Investment Process*, a paper written by the Neuberger Berman SRI/Core Equity Team. For more information, please contact Neuberger Berman.**

<sup>1</sup> Source: CPD, 2013. Reflects percentage of companies reporting to the CDP.

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# IT'S THE ALPHA, STUPID

By: Susan Long McAndrews, Partner, US, Pantheon

**M**any years ago, when I began my career in private equity, one of the key features that all of us - consultants, managers and intermediaries - touted as a key benefit of this new "alternative asset" was its low correlation to other asset classes, particularly public equities. As a result, private equity made its way into many institutional asset allocations in the 1990s and early 2000s because of its presumed diversifying effect within portfolios. To some extent, that was correct; valuations of private equity investments were at that point generally held at cost until an actual realization event. Specifically, they were not adjusted up or down even in rising or falling equity markets. The theory was that illiquidity made private equity not only "alternative" but also uncorrelated.

Enter the dragon: fair market value accounting standards and a whopping global financial crisis. Starting in 2007 as managers were forced by new accounting standards to mark-to-market their investments - using public comparables, recent M&A events and other methodologies - it soon became apparent that private and public equity were indeed correlated - highly correlated in fact! Stir in a tumbling global equity market, and falling private equity valuations ensued. Thus, the ah-ha moment occurred - public equity and private equity are the same corporate assets subject to the same company-specific issues and macroeconomic trends. They are simply subject to a different ownership model! The historic lack of private equity valuation adjustments had created the false perception of uncorrelated returns, and with this new insight, private equity's ability to diversify was quickly discredited. As widely respected investor and Yale University endowment [CIO] David Swensen noted in 2009, "because of the strong fundamental links between private equity investments and marketable equities, private equity provides limited diversification to investors....Illiquidity masks the relationship between fundamental drivers of company value and

changes in market price, causing private equity's diversification power to appear artificially high."<sup>1</sup>

One might then ask: if private equity offers few diversification benefits, why should investors bother to include this illiquid asset class in their portfolios? To paraphrase a famous US presidential campaign theme, "It's the Alpha, stupid!". High quality private equity managers have demonstrated for over 30 years that they can generate excess returns on a risk adjusted basis. They do this by improving the operations and management of their portfolio companies. They optimize the alignment of management incentives. They introduce initiatives to grow revenues and optimize margins. They expand overseas and combine with competitors-...

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<sup>1</sup> Quote taken from: "Pioneering Portfolio Management: An Unconventional Approach to Institutional Investment" by David F Swensen.