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.

Spring 2007 (Vol. 2, No.2)

In This Issue

Getting to Know All About PERC

Created by an act of July 9, 1981 [P.L. 208, No. 66] of the Pennsylvania Legislature, the Public Employee Retirement Commission (PERC) was assigned two responsibilities concerning the legislative process:

(1) ***To monitor public retirement plans in the Commonwealth and to assure their actuarial viability through a review of any proposed legislative changes in those plans; and***

(2) ***To study the retirement needs of public employees in order to formulate principles, develop objectives and recommend legislation.***

Analysis of Proposed Legislation:

The Commission is required by Act 66 of 1981 to review all proposed legislation applicable to public employee pension systems and to attach actuarial notes to the proposed legislation within 20 legislative days of referral by either House of the General Assembly. In practice, the exigencies of the legislative process frequently require the Commission to respond in substantially less time than statutorily permitted. The actuarial notes and the accompanying policy analyses provide a reliable estimate of both the immediate and the long-range actuarial cost and effect of each proposal. The Commission also provides technical assistance to and conducts studies for the General Assembly and the Governor in conjunction with their consideration of public pension legislation.

Development of Public Pension Policy Research and Information:

The Commission formulates principles and objectives related to public employee pension policy and recommends legislation commensurate with that policy to the Governor and the General Assembly through the issuance of formal reports. The Commission also annually reviews the actuarial valuation reports of the two statewide pension systems, the State Employees' Retirement System and the Public School Employees' Retirement System, with the actuary and the plan administrators of each system.

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Getting to Know All About PERC
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In addition to those duties, the Commission has also been given substantial regulatory functions for more than 3,000 local government retirement systems in the State. Act 293 of 1972 requires the preparation and submission of periodic employee pension systems reports by all county governments. Act 205 of 1984, known as the General Municipal Pension Plan Funding Standard and Recovery Act, requires the submission of biennial employee pension system reports by all municipal governments and authorities, and empowers the Commission to monitor and enforce compliance with legislatively mandated actuarial funding standards, and to certify municipal pension cost data to effect the annual allocation of almost $200 million of state aid to municipalities.

The Commission also provides technical assistance to Pennsylvania municipal pension systems and private sector service providers. In the most recent reporting year for Act 205, the Commission contacted 4,600 municipal governments and authorities to determine the status of their pension plans. Based on these initial contacts, more than 3,000 municipal pension plan reports were filed and reviewed by the Commission for compliance with the mandates of Act 205, and the data contained therein was compiled, analyzed and published in the annual Status Report of Municipal Pension Plans.

NOTE: The long-time Director of PERC Mr. Anthony "Tony" Salamone will be retiring in June 2007 after a career of Commonwealth service, including 21 years with PERC. His many friends in the public pension world wish him well as he embarks upon his own retirement.

Become a Member of PAPERS

Participating Members (public employee retirement systems) and Associate Members (corporate sponsors) can apply online at **www.pa-pers.org** or contact:

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From the PAPERS Executive Director

The third annual PAPERS Forum is in the record books. I would like to thank the Central Dauphin High School Stage Band for their early morning performance. It started things off on a very pleasant note. I would also like to recognize Al Neubert and IMN for the great job they did producing the Forum.

This year's topics were both educational and stimulating. The format with panel discussions on critical issues in the morning and the dual track workshops on technical issues later in the day provided challenging material for people at all levels of experience. You can review the program agenda on the PAPERS website: www.pa-pers.org.

We had 50 pension plans and state agencies represented this year. That is almost double last year's participation. We also had 38 corporate partners represented. There were well over 200 attendees.

The discussion on the creation of a new statewide pension plan for all local governments was a hot topic that deserves a lot of attention in the coming months. No matter which side of the issue you are on it would serve you well to understand the ramifications to your budget and your authority to determine your benefit structure and funding levels. I strongly recommend that you speak with your state representatives to insure that you understand what they are trying to accomplish and what it will mean to you.

Take care and thank you for helping to make PAPERS an organization that will serve you and your peers well for the future. If each current member recruits one new plan next year we will have 100 members and twice as many experiences to share.

Jim Perry,
PAPERS Executive Director

Your Fiduciary Duties: The Five W's
(Who, What, Where, When and What Happens If You Violate Them)

By Jeffrey Clay, PAPERS Board Member and Executive Director of the Public School Employees' Retirement System (PSERS)

This is the second in a series of articles that will explore the fiduciary duties associated with the operation of public pension plans in the Commonwealth of Pennsylvania. In the first article, we noted that one of the key criteria for the proper operation of any pension plan, and especially a governmental pension plan, is the creation and understanding of the fiduciary relationship between the pension system's governing body (trustees), employees and agents, and the beneficiaries or members of the retirement system. This fiduciary relationship or obligation is encompassed in two cardinal principles:

1. *a duty of loyalty to the beneficiaries of the trust, i.e. the members of the pension plan; and*
2. *a duty of prudence in the management and administration of the pension plan.*

In today's article we will further define each of these duties.

<u>Duty of Loyalty:</u>

The duty of loyalty requires one in a fiduciary relationship to manage and operate the pension fund for the **sole and exclusive** benefit of its members. In essence, this duty establishes the expected standard of behavior of a trustee or other fiduciary operating the pension plan or any other trust. What is that standard? A standard of strict integrity that puts the interests of the members of the pension plan first and all other interests, particularly the fiduciary's own interest, last. In other words, a pension plan fiduciary must unconditionally sacrifice his or her own self-interest and the interests of all others to the interests and benefit of the members of the plan. This duty is succinctly stated in PSERS' operating statute as follows:

> *The members of the board, employees of the board, and agents thereof shall stand in a fiduciary relationship to the members of the system regarding the investments and disbursements of any of the moneys of the fund and* ***shall not profit either directly or indirectly*** *with respect thereto. (Emphasis added). Section 8521(e) of the Public School Employees' Retirement Code (PSERC), 24 Pa.C.S. §8521(e).*

Justice Benjamin Cardozo penned a more famous description of the duty of loyalty as follows:

> *Many forms of conduct permissible in a workaday world for those acting at arm's length are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the market place. Not honesty alone but the punctilio of honor the most sensitive is then the standard of behavior. As to this, there has developed a tradition that is unbending and inveterate. Uncompromising rigidity has been the attitude of courts of equity when petitioned to undermine the rule of undivided loyalty by the "disintegrating erosion" of particular exceptions. Only thus has the level of conduct for fiduciaries been kept to a level higher than that trodden by the crowd. Meinhard v. Salmon, 249 N.Y. 458, 464, 164 N.E. 545, 546 (1928).*

What was true then is still true now, as evidenced by the renewed focus and scrutiny of pension trustees' behavior in the area of gifts, travel, socially motivated divestment movements, etc. Bottom line: pension trustees/fiduciaries are expected at all times to exercise their duties with the highest level of integrity.

<u>Duty of Prudence:</u>

The duty of prudence requires the plan's trustees and staff to manage all aspects of the pension system, whether it is investments, benefits administration or internal administration, in a prudent manner. Generally the level or standard of prudence required is the conduct that a prudent person, or the more recent trend, a prudent expert or prudent investor, would exhibit in a similar situation. The classic statement of the duty of prudence is the prudent man or person standard articulated by the Supreme Court of Massachusetts in the famous case of *Harvard College v. Amory*, 26 Mass. (9 Pick.) 446 (1830):

All that can be required of a trustee to invest, is, that he shall conduct himself faithfully and exercise sound discretion. He is to observe how men of prudence, discretion and intelligence manage their own affairs, not in regard to speculation, but in regard to the permanent disposition of their funds, considering probable income, as well as the probable safety of the capital to be invested.

Unlike the duty of loyalty, which governs the motivation/values of the trustee, the duty of prudence focuses on the trustee's competence.

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Your Fiduciary Duties: The Five W's

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Further, while the duty of loyalty has remained somewhat inviolate, the standard of competence imposed by the duty of prudence has evolved to keep pace with the changing skills needed to operate increasingly more sophisticated trust funds, of which, public pension funds are the prime example. Thus as noted, the original prudent man or person standard has been gradually replaced by the prudent investor or prudent expert standard. An example of the former is found in PSERS' own operating statute as follows:

> *[T]he trustees shall have exclusive control and management of the said fund and full power to invest the same, in accordance with the provisions of this section, subject, however,* ***to the exercise of that degree of judgment, skill and care under the circumstances then prevailing which persons of prudence, discretion and intelligence who are familiar with such matters exercise in the management of their own affairs not in regard to speculation, but in regard to the permanent disposition of the fund, considering the probable income to be derived therefrom as well as the probable safety of their capital.*** *(Emphasis added). Section §8521(a) of the PSERC 24 Pa.C.S. §8521(a).*

Conclusion:

All of this sounds good, but the real question is what do both of these duties practically mean in the real world of managing a public pension plan? That discussion will start in the next article in this continuing series.

The Basics Of Corporate Governance

HEALTHY BOARDS

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

Whether you are evaluating companies for potential investment or you sit on the board of one such company, it is important to be aware of the characteristics and habits of a healthy board of directors.

The best boards constantly focus on the fact that they exist for the sole purpose of serving their shareholders. If the board is guided by that principle in exercising its roles and responsibilities, it is already on the right path.

There are, however, other ingredients to a sound and fully functional board. Taking these recommendations to heart promotes productivity, checks-and-balances, and vision:

Keep The Board Strategic: A good board entrusts other professionals with the day-to-day responsibilities while it focuses on the strategic direction of the company. The board must keep its collective eye on the bigger picture, developing a strategic plan and devising the best way to implement it. A board that lacks members with big ideas is doomed to waste resources and disappoint its shareholders.

Maintain Strong Committees: With the board engaging in big ticket thinking, the implementation of the board's decisions should be relegated to a solid committee structure. Properly mandated and functioning audit, nominating, and compensation committees, for example, go a long way in maximizing the performance of the board. The role and responsibilities of each committee should be fleshed out in writing, and steered by a board member serving as committee chair. Importantly, an appropriate chain of reporting should be in place to ensure that the committees are communicating with the board and remain fully accountable.

Evaluate The Board Members: Everyone works better when they know they are being routinely evaluated. As such, the performance of each individual board member should be evaluated routinely, with feedback provided by the other members.

Evaluate The Board As A Whole: In addition to assessing the performance of the individual board members, the overall performance of the board should be critiqued by the members. On a regular basis, the individual members must evaluate the direction that the company is headed and whether the board's decision-making is maximizing shareholder value. An important part of this process is the creation of specific plans to cure weaknesses, and devising measures to follow up on the areas in need of improvement.

Efficiently Orient New Members: The integration and orientation of new members is an often-neglected feature of board maintenance. New members are rotated in, but are frequently left without appropriate guidance as to what it means to serve as a board member. The board must establish and adhere to a system of orienting new members in such a way that they learn not only what issues the board currently faces, but also the process by which the board functions.

The U.S. Economic Outlook for 2007

By David H. Resler, *Managing Director and Chief Economist at Nomura Securities International, Inc.*

Overview

Long accustomed to leading the world economy, the US now finds its own economy in fragile state that will depend on healthy growth abroad to help it navigate safely past the housing downturn. Over the past ten years, real output in the US has expanded at an impressive 3.1% annual rate, compared with average growth of 2.8% in the United Kingdom, 2.2% in the "Euro-zone" (comprised of the 13 European countries using the Euro as its currency), or the feeble 1.1% growth rate in Japan. But the marked slowing of the US economy since the first quarter of 2006 has dramatically narrowed those growth differentials. Indeed, measured over the four quarters of 2007, the Euro-zone economies grew faster than the US for only the third time in the last 11 years. Of course, none of "mature" economies could match the stunning growth of China's 10.7% or India's 8.6%, both of which continue to benefit from an accelerating pace of modernization and industrialization. Looking ahead, the consensus foresees only slightly slower growth in these rapidly expanding economies. Strikingly, however, the same consensus projects a 2.3% rate of growth in 2007 for the US, the Euro-zone, and Japan, and slightly stronger 2.6% growth for the UK.

What it Means

Some have interpreted the narrowing of growth differentials between the US and other most advanced economies as a sign of the diminishing US role as the primary engine of world economic growth. Undoubtedly and inevitably, the <u>relative</u> importance of the US – and all the other advanced economies – has and will continue to decline as rapid growth across Asia raises living standards toward those of the West and Japan. But the convergence of expected growth for Europe, Japan, and the US for the year ahead hardly disproves the leading role of the US economy. Indeed, the modest acceleration of growth in Europe and Japan arguably reflects the normal historical lagged response to the much stronger growth in the US during the previous three years.

However, unless the current slowdown in the US degenerates into a full-fledged cyclical contraction – an outcome I deem possible but unlikely – other economies need not be destined to follow the US growth deceleration. The reason is that the current US economic growth slump reflects primarily a severe contraction in the housing sector that has, so far at least, left most of the rest of the economy unscathed. Netting out the contraction in residential investment, US real output grew at a 3.8% clip in 2006, even faster than the 3.6% growth in non-housing output in 2005. That's not to say, however, that the US housing slump will not have some adverse impact on growth overseas. In the increasingly interdependent global economy, the US imports more of nearly every type of good, including the household appliances and other durable goods that get installed in new homes. Thus, the adverse consequences of a housing recession is no longer borne exclusively by housing related domestic manufacturers. But the slower growth of US non-oil imports is likely to have only a small impact on growth abroad.

Meanwhile, the strengthening economic conditions in Europe and Japan has expanded the demand for US products in overseas markets. The value of US merchandise exports has grown at double digit rates for three straight years and has exceeded the growth in the value of non-oil imports for the past two years. Removing the effects of changing prices, "real" merchandise exports increased by 10.5% in 2006. Measured from fourth quarter to fourth quarter, merchandise exports grew more than three times as fast as goods imports. The narrowing real trade gap, contributed accounted for nearly 0.5% of the 3.1% increase in real GDP during the year. If the consensus growth projections for the rest of the world prove correct, this trend is likely to continue.

Ironically, the biggest threat to this rather sanguine outlook for world trade is the growing protectionist sentiments evident in the political rhetoric. Failure to authorize "fast-track" trade negotiations by the late June deadline would hinder – if not kill -- prospects for continuing the expansion of world trade just as it begins to generate palpable benefits for the US.

THINKING ABOUT DIVERSIFICATION

By Rex Holsapple & Ronnee Ades, Dow Jones Indexes

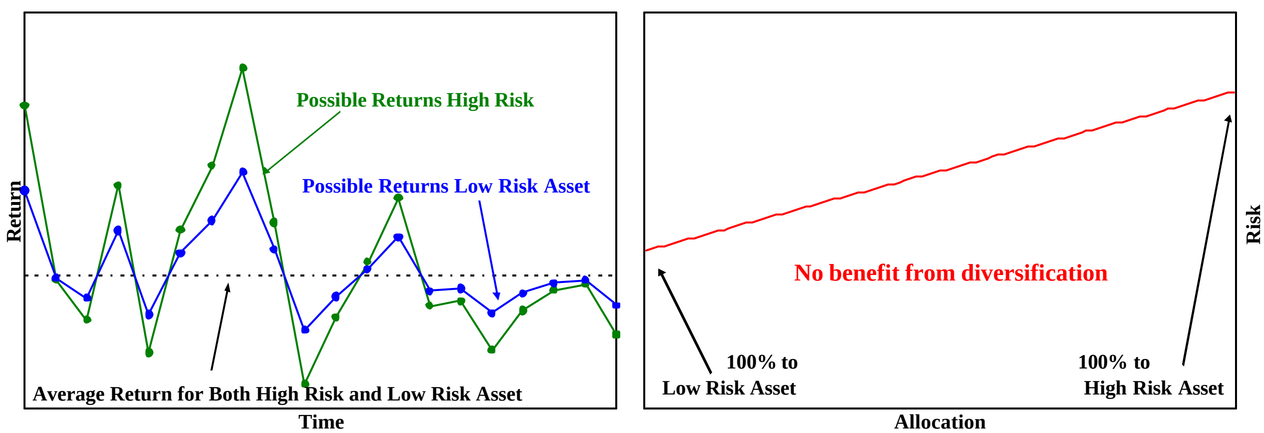
Diversification is one of the most important factors affecting the risk of an investment portfolio. Diversification reduces the risk of a portfolio without reducing its expected return. At the same time, investors should not expect diversification to increase return. The benefits of diversification are often misunderstood as demonstrated by remarks such as, "I don't want to invest in foreign stocks (or some other asset). They are too risky. I already have enough risk with my domestic stocks." "I added real estate (or some other asset) to my portfolio and it under performed. Diversification doesn't work."

How Diversification Works

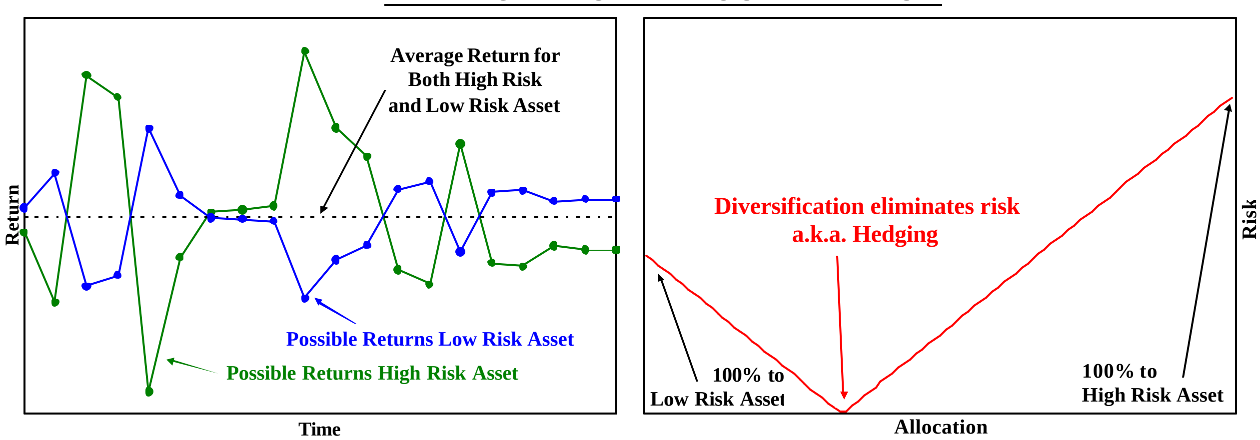
Suppose we have two assets to invest in. The average return is the same for both, but one is riskier than the other. In other words, over any period, we expect the high risk asset to deviate from its average more than low risk asset. If we start with a portfolio allocated 100% to the low risk asset and slowly add the high risk asset, it seems like the risk should go up. Except in unusual cases the risk actually goes down, at least for small allocations to the high risk asset.

The graphs below and on the next page illustrate how diversification achieves this result. There are three pairs of graphs. For each pair, the graph on the left, labeled "Possible Returns" shows the average return over the entire time period for the two assets (straight lines) and the return for each period that might have been achieved by assets having with the assumed characteristics (jagged lines). The graph on the right of each pair shows what happens to portfolio risk as we vary the asset allocation from 100% low risk asset to 100% high risk asset.

PERFECT POSITIVE CORRELATION



PERFECT NEGATIVE CORRELATION



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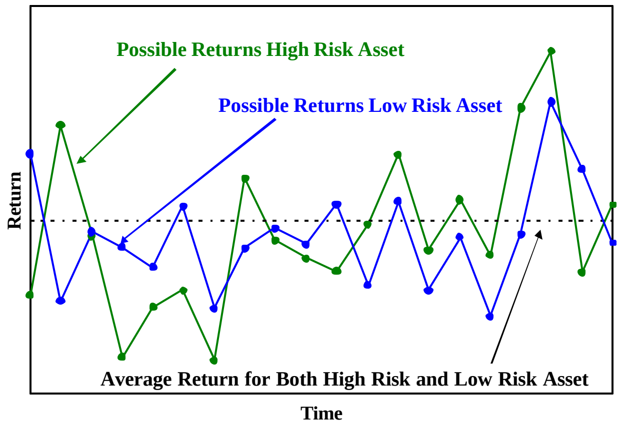
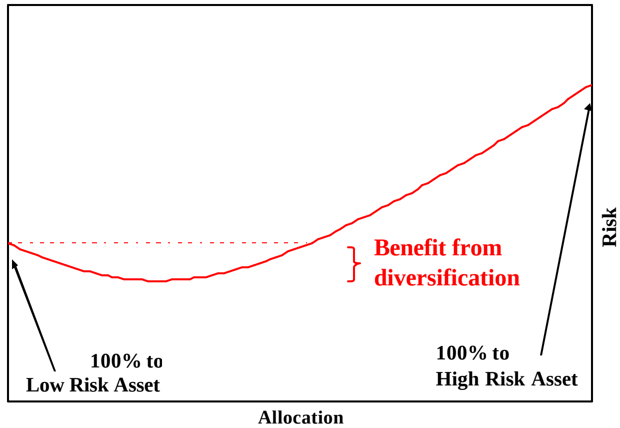
Thinking About Diversification *(continued from page 6)*

NON-PERFECT CORRELATION





PERFECT POSITIVE CORRELATION

In the first pair of graphs, there is a peculiar relationship between the returns of high risk and low risk assets. Every time the return of the high risk asset is above average, so is the return of the low risk asset. Every time the return of the high risk asset is below average, so is the low risk asset's. Every time the return of the high-risk asset is extreme, relative to its average return, so is the low risk asset's. This relationship is called perfect positive correlation. When the asset returns move in perfect positive correlation, the risk of the portfolio always goes up as we add the high risk asset. There is no diversification benefit when there is perfect positive correlation.

PERFECT NEGATIVE CORRELATION

Perfect positive correlation, where asset returns move together, rarely occurs for investment assets. Another unusual but instructive scenario is perfect negative correlation, illustrated by the second pair of graphs. Every time the return for the high risk asset is extreme, so is the return for the low risk asset. However, every time the return for the high risk asset is below average, the return for the low risk asset is above average. It is easy to understand that when the fluctuations in one asset offset the fluctuations in the other, there is some allocation where the fluctuations exactly cancel out. This leaves only the average return without any risk at all. (The exact allocation depends on various factors.) We might call this perfect diversification; it is more commonly called a hedge.

NON-PERFECT CORRELATION

Most investment assets have neither perfect positive nor perfect negative correlation. For most assets, when one is up, sometimes the other is up, and sometimes it is down. When one's return is extreme, sometimes the other's return is extreme, and sometimes it is not. This situation is illustrated by the third pair of graphs. When we do not have perfect correlation, adding a riskier asset to the portfolio reduces risk at first but eventually increases risk. (The allocation that minimizes this risk reduction depends on various factors.)

For assets with perfect positive correlation there is no benefit from diversification. For assets with perfect negative correlation, the benefit from diversification can completely eliminate risk. Most assets have correlations somewhere in between, and the benefit from diversification lies somewhere in between. Therefore, for most assets, adding some amount of the asset to a portfolio reduces risk. This risk reduction is the benefit of diversification.

Common Misunderstandings

"I don't want to invest in foreign stocks (or some other asset). They are too risky. I already have enough risk with my domestic stocks." - This investor is comparing the risk of a 100% allocation to domestic stocks to a 100% allocation to foreign stocks. That is not the relevant comparison. What is relevant is the risk of a portfolio holding some foreign stocks. Unless the investor believes the returns of foreign stocks have a perfect positive correlation with domestic stocks, a completely implausible belief, there is some allocation of foreign stocks that results in a lower risk.

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Thinking About Diversification

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"I added real estate (or some other asset) to my portfolio and it under performed. Diversification doesn't work." - Some investors, when they look at the results of diversification, compare the historical return of a diversified portfolio with that of an undiversified portfolio. If the historical return of the diversified portfolio was lower than that of the undiversified one, they conclude that diversification did not work.

The investor who observes lower returns and questions whether diversification works, is judging it by the wrong standard. Diversification is not supposed to increase returns; it is supposed to decrease risk. In fact, diversification works because it does not always deliver higher returns. Sometimes the return of real estate is higher than that of other assets; sometimes it is lower; and we cannot predict when. These are the return characteristics that enable diversification to lower risk.

Investors who do not understand diversification deny themselves opportunities to reduce the risk of their portfolios.

In the examples used to explain how diversification works, diversification reduced risk without reducing expected return. This was the result of using a contrived example where the average return of the two assets was the same. When the returns are not the same, it is more difficult to explain how diversification works. Nevertheless, in the real world, diversification generally reduces the risk of a portfolio without reducing its expected return. This is the fabled free lunch. Every prudent investor needs to understand diversification.

PAPERS

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. Simply 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.

Planning Ahead

PAPERS Forums have already been scheduled for 2008 and 2009!

Reserve these dates now – **April 21-23, 2008** and **April 15-17, 2009** - and plan to attend these conferences of public employee retirement systems in Harrisburg. PAPERS will be returning to the downtown Hilton Hotel for the conferences in both of these years. More details later.