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Safe? Secure? How Can a Plan Sponsor Know for Sure?

Unfortunately a crystal ball does not exist to provide absolute assurance as to the safety and security of any investment. Yet, even amid signs of a calming of the credit markets, plan sponsors continue to question the safety and security of their “safest holdings”; money market and stable value funds. Clearly the market turmoil over the last twelve months has raised considerable questions regarding all investments, in particular the investments in the often neglected, lower risk end of the investment spectrum. PEI’s clients are no exception; following the collapse of the global credit markets in September and October of 2008, all plan sponsors want to better understand the degree of safety associated with these asset classes.

It may seem a bit surprising the safest investments are coming under intense scrutiny. One such example is that the DOL’s ERISA Advisory Council plans to hold hearings on stable value products in late July. However, one only needs to evaluate a few funds to recognize that the investment style and holdings vary considerably from fund to fund. Proper evaluation goes beyond performance evaluation. The trade-off between risk and return is clearly evident in the way money market and stable value funds are structured and managed. Funds often show a clear preference to pursue either a conservative and safe investment philosophy, or exhibit a preference for yield generation through extended duration or lower credit quality. Money market holdings can run the gamut from Treasuries to asset-backed commercial paper to lower grade corporate credit. Stable value funds can hold illiquid and unrated securities such as private mortgages and structured notes. Understanding how a fund’s investment philosophy drives holdings is key to understanding the safety and security of a plan’s investments.

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While there is not a guarantee regarding the safety and security of any investment, there are certain good practices that plan sponsors can follow to develop a better understanding of the risk profile of the money market and stable value funds that are part of their plan.

A first step in evaluating the soundness of money market and stable value funds is to understand the investment philosophy of the fund. Does the fund have a preference for safer, lower yielding treasury and government guaranteed holdings, of shorter duration, or does the fund seek yield by extending the credit risk profile and the duration of the assets? PEI, as part of our fund evaluation, requests not only a snapshot of holdings, but also how they have changed over time. A review of the fund's holdings will provide an assessment of the liquidity and credit quality of the fund. In the current market environment, more than ever, these two key variables must be evaluated. With regards to credit quality, the fund should not be relying on ratings provided by the ratings agency, but rather have a team of internal credit analysts that are capable of understanding the credit structure of the holdings. Case in point: many funds that have recognized losses did not properly assess the risk associated with structured investment vehicle (SIV's) or asset-backed commercial paper (ABCP). A thorough credit analysis of structured vehicles should include an evaluation of credit support agreements that back the vehicle or conduit, the nature of the risk associated with the support organization, and the assets that serve as collateral for the vehicle.

A related telling sign with regards to the quality of fund management is the willingness of a fund to provide fiduciaries with detailed lists and descriptions of their holdings. Transparency and a willingness to objectively assess their investment in current market situations are paramount to a properly managed fund. Fiduciaries have begun to demand more transparency from money market and stable value funds, which has probably been the biggest eye-opener for fund companies as they have had to adjust to the current market environment. However, the better managed fund companies have always made open disclosure and transparency a priority.

Proper liquidity management is also a key part of the investment process of an appropriately managed fund. The fund's management should have an understanding of both the economic environment and its impact on their client base, and exhibit a willingness to make adjustments to the liquidity of the portfolio if necessary. Over the last 12 months, most money market and stable value funds increased liquidity levels, in the form of very short maturity or overnight cash in their portfolio. The better managed funds were ahead of the curve, and quickly adjusted their portfolios. In addition, fund management should have an understanding of the secondary market for the holdings, coupled with a sense of their investors and their reaction to market changes. This will allow the manager to adjust portfolio liquidity so as to minimize recognized losses to depressed asset values. As a related point, as funds increase their holdings in overnight or very short-term paper, proper repurchase agreement structure and collateralization is pertinent.

Operational controls and compliance procedures also must be scrutinized, especially as it applies to the management of a specific portfolio. Risk scenarios should be developed. Repurchase agreement procedures and securities lending practices must also be considered.

The factors outlined in the preceding paragraphs should be a part of an ongoing due diligence process for plan sponsors. While there is not a guarantee, evaluating a fund under this set of criteria will allow a plan sponsor to determine if their investment in a money market or stable value fund can put their mind at relative ease, or justify a search for a more appropriate replacement fund.

TIPS for Combating Inflation

As billions of dollars in government stimulus funds have been injected into the U.S. economy to battle the current recession, many economists have voiced concern over the implications of such measures, predicting high inflation for the future if the Federal Reserve does not reign in the money supply in a timely fashion.

For investors, the ripple effect of such government action and the long-term expectations for a rise in prices has made inflation risk a very real concern. Securities designed to offset a rise in prices are “TIPS” (Treasury Inflation Protected Securities). TIPS were first auctioned by the government in the late 1990’s and shortly thereafter TIPS (also known as Inflation-Protected Bonds) mutual funds were formed to professionally manage or track an index of these securities. These securities are structured similarly to typical debt securities, offering specified semiannual interest payments and a future delivery of principal. The coupon rates are usually lower than typical government securities. However, the security’s principal is directly indexed to the Consumer Price Index (CPI), or rate of inflation. As a result, an increase in prices will cause the security’s principal to rise as well. Therefore, both the principal and interest payments are adjusted to keep pace with inflation, protecting the real value of interest payments and principal. This is accomplished by calculating interest payments based on the stated coupon rate of the inflation-adjusted value. An investor will receive an inflation adjusted-principal, or the original principal payment (whichever is greater) upon maturity, as well as full interest payments based on this principal. These securities are also backed by the full faith and credit of the U.S. government.

Going forward, TIPS funds may serve as an effective investment option to add diversification and reduce inflation risk in a portfolio. These funds have grown in popularity due to:

Principal Protection: TIPS provides deflationary protection against the security’s principal. For example, even in a deflationary environment, the original principal value is guaranteed if held to maturity.

High Quality: TIPS funds invest almost entirely in government-backed securities, providing minimal default and credit risk. In addition, they offer a conservative, complementary fixed-income option in a participant’s portfolio.

Diversification: TIPS generally add good diversification to portfolios. For example, a rise in inflation generally has a dilutive effect on both conventional fixed income securities while TIPS complement the portfolio by appreciating in an inflationary environment. Additionally, TIPS are often less correlated with equities than many conventional fixed income securities.

Risk: While they can experience significant price volatility, TIPS are government securities and lack the volatility associated with the issuer and credit risk of conventional bonds, especially over a long-term time horizon.

Using Alpha and Beta in Investment Analysis

Beta is a measure of an asset's risk in relationship to the market or a specific index. This is the risk that is considered to be systematic, or non-diversifiable. It measures how an investment is expected to rise or fall compared to its benchmark. It is important to note that beta is a measure of co-movement, not volatility. The market benchmark will always have a beta value of 1. During periods of sustained market rallies, high beta funds would be expected to outperform the market. However, during periods of market corrections, it would be expected that these same funds would experience greater losses compared to their underlying index.

Consider the example in which two separate small cap value managers have varying betas compared to the Russell 2000 Value Index. Manager X has a beta of 1.4 compared to the Index, while Manager Y has a beta of 0.8. If over the next 12 months the Russell 2000 Value Index increased by 25%, it would be expected that Manager X would gain 35% (1.4 x 25) while Manager Y would gain 20% (25 x 0.8). However, over the next 12 months if the Index drops by 16% Manager X would be expected to lose 22.4% compared to an expected loss of only 12.8% from Manager Y.

Alpha measures a manager's performance compared to their benchmark when adjusting for risk using beta. A positive measure of alpha indicates that the manager outperformed their benchmark on a risk-adjusted basis, while a negative value represents underperformance. Alpha is calculated once the expected return of the investment has been determined using beta and the capital asset pricing model (CAPM). This model calculates the expected return on a portfolio by using the following equation:

$$\text{Expected Return} = \text{Risk-Free Rate} + \{ \text{Beta} * (\text{Benchmark Return} - \text{Risk-Free Rate}) \}$$

The actual return the manager achieved is then compared to this expected return to determine if the manager was able to outperform their benchmark. The difference between the two is the alpha.

$$\text{Alpha} = \text{Actual Return} - \text{Expected Return}$$

Using the example of Manager X and Manager Y once again, suppose that both managers achieved a return of 22% on their portfolios. During this period, the risk-free rate was 5% and the return on the Index was 20%. Using their betas that are listed above, each manager would have the following returns:

Expected Returns

$$\text{Manager X} = 5 + \{1.4 * (20-5)\} = 26\%$$

$$\text{Manager Y} = 5 + \{0.8 * (20-5)\} = 17\%$$

Actual Returns

$$\text{Manager X} = 22\%$$

$$\text{Manager Y} = 22\%$$

This illustrates that Manager X is expected to achieve a higher return due to the fact that they took on more risk (higher beta). However, this was not the case, as both managers achieved the same actual return. In this example, alpha can be calculated as follows:

$$\text{Manager X} = 22 - 26 = -4\%$$

$$\text{Manager Y} = 22 - 17 = +5\%$$

Therefore, with the use of alpha and beta, it can be determined that Manager Y was able to achieve a higher excess return on a risk-adjusted basis due to active management. Both statistics offer distinct purposes for fiduciaries. More generally, beta provides a gauge of risk relative to a benchmark while alpha allows for significantly more meaningful comparisons across investments than are implied by their returns alone as illustrated in the example above.

The Creation of the PPIP

The US Public-Private Investment Program Plan “PPIP” was created so that banks can voluntarily rid their balance sheet of their toxic assets. In the open market, these impaired assets have been sold by banks for 30 to 40 cents on the dollar over the 18 months preceding March of this year and banks had been unwilling to sell these assets for any less. As a result, the credit markets had been in a standstill, with adverse consequences for market participants. The PPIP program is a two-part program designed to help banks rid themselves of Legacy Assets, one involves Legacy Loans and the other involves Legacy Securities. The Legacy Loans program is designed to help banks remove loans from their balance sheets.

The program will provide FDIC guaranteed financing coupled with funds from the Treasury and private investors to purchase pools of these loans that will help banks deleverage.

As of July 8, 2009 the Legacy Loans program has been delayed indefinitely. If the program does take off, it will be using TARP capital and capital from private investors to generate additional purchasing power to buy Legacy Loans. The objectives are to maximize the impact of each taxpayer dollar by investing alongside with private investors (1-to-1) that have a partial FDIC backing. By investing alongside with private investors, the government is limiting the possibility that they are overpaying for these assets and both parties will have the opportunity to share in profitable returns.

While the Legacy Loans program deals with pools of loans, the Legacy Securities program deals directly with residential and commercial asset-backed securities and is designed to restore liquidity to the secondary credit markets. The Legacy Securities program is expected to be launched at the end of July. Only insured chartered banks will be allowed to sell assets through the program, but the exact details of this program have yet to be finalized. The program will work in a similar fashion as the Legacy Loans program; however, it will help banks rid themselves of unwanted securities instead of loans. Under this program, public and private capital will be employed and the financial leverage will be provided by the Federal Reserve instead of the FDIC.

Due to liquidity concerns, these Legacy Assets will most likely be held by closed fixed income funds, hedge funds and private equity. As of July 8, 2009, more than 100 funds had expressed interest in participating in the PPIP. Of these firms, 9 of them have been selected by the Treasury to operate funds that will buy these toxic assets. The list includes: BlackRock Inc; TCW Group; AllianceBernstein LP and its sub-advisers Greenfield Partners LLC and Rialto Capital Management LLC; Angelo, Gordon & Co. LP and GE Capital Real Estate; Invesco Ltd.; Marathon Asset Management LP; Oaktree Capital Management LP; RLJ Western Asset Management LP; and Wellington Management Co. LLP. Although most open-end mutual funds will not be able to invest in these assets, they are expected to benefit from this program since mortgage-backed and asset-backed securities should experience price increases as the credit market continues to thaw.

The recent announcement by the FASB to relax mark-to-market regulations may make banks less willing to part with their distressed assets and make them more inclined to hold them to maturity in hopes of realizing more value. As a result, the PPIP was originally expected to purchase \$1 trillion in Legacy Assets, but due to lack of interest and accelerating activity in the credit markets, it is now expected to purchase only \$50 billion, according to several reports. The PPIP has been 9 months in the making and there is no guarantee that the program will take off at all. There is a notion that just having this program as an option may help restore some confidence in the credit markets.

Endowments Reconsider Strategies

The sophisticated investment models utilized by the large endowments of Harvard, Yale, Stanford and Princeton have been the envy of most endowments for years. In fact, many smaller endowment managers have attempted to replicate these intricate portfolios (which invest in less liquid assets such as timberland, real estate, and private-equity) seeking to reap the rewards of both better returns and reduced volatility.

Unfortunately, during the recent broad downturn in the markets, these investments did not provide the diversification benefits that they had in the past, behaving much like their traditional equity counterparts. Furthermore, these investments lacked the liquidity of equities or bonds, causing some endowments to sell better performing investments or borrow to finance their obligations.

In addition, according to the Wall Street Journal, endowments with \$1 billion or less, which generally employ simpler, more traditional investment allocations, actually outperformed their larger, more sophisticated counterparts in recent periods.

Given these issues, many institutions have begun to reconsider their current investment approaches. Harvard University, Northeastern University and the University of Chicago have indicated that they intend to reduce their exposure to less liquid investments. In fact, according to the Northeastern University's faculty senate meeting in March, the university planned to liquidate up to 50% of its endowment in order to provide for endowment obligations moving forward.

What's New at PEI

One of PEI's Principals, Michael Sasso, was one of several defined contribution industry leaders who took part in a Pensions & Investments round table, discussing the future of defined contribution plans. An article on the round table was featured in the June 16, 2009 issue of Pension & Investments. Also of note, Greg McCarthy, Director of Research and Operations, was quoted in the April 20, 2009 issue of Pensions & Investments in an article titled "Southwest Pilots Seek the 'Golden Chalice' of DC Plans".

Underpinning our success has been our core philosophy – do everything in the best interest of the client. By being true to this tenet, we hope to continue to help our clients in achieving their investment objectives and meeting their responsibilities as fiduciaries, as well as to continue to grow as a firm.