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Investments

Ramifications of a US Credit Downgrade

The debt ceiling debate and rating agencies' warnings of a possible credit downgrade has been headline news for several weeks now. Most economists believe the likelihood of a default is low, however the possibility of a downgrade will still persist.

Of course, what happens in a downgrade is a big question mark. The longer end of the curve would rise, having implications across all economic sectors in the U.S. as well as globally. U.S. Treasuries are used as collateral for many types of global economic transactions, and may have carry over effects to other economies as downgrade would also raise funding levels around the world. It is possible that there is an opposite effect where global rates go down in the long run due to overall economic slowdown that results from the downgrade. With a government downgrade, private AAA rated U.S. entities (although few) could also be downgraded by S&P. While municipalities that are highly rated may not be automatically downgraded, to the extent they receive high levels of federal government money could have a negative impact on their ratings as well.

As far as where investors should go, there are not many alternatives. With turmoil in Europe, and possible spill over in the event of a U.S. downgrade, there are not many fixed income options unless global issues are resolved in a credible, long term way. A couple of organizations pointed to the fact that even with this concern in the market, investors are still buying treasuries as a flight to quality (albeit relative) given issues in Europe. It is unclear the impact this would have on emerging market debt. It is also unclear the impact on other funds in general, as many funds have limitation levels on credit ratings in their portfolio.



Investments

Ramifications of a US Credit Downgrade (cont.)

Liquidity could become an issue again, and the money market funds PEI spoke to recently have been increasing liquidity in the portfolio. It should also be noted that the liquidity comes primarily in the form of either short term treasury notes, or repo agreements collateralized with treasuries.

These are uncharted waters and PEI is taking the possibility of a credit downgrade very seriously. PEI has taken several steps in its portfolio monitoring process to identify any issues that may arise in clients' portfolios in the event of a credit downgrade.



Investments

European Debt Issues Elevate Money Market Concerns

Given the ongoing concerns about Greece and other fiscally troubled European nations, PEI reviewed European bank holdings in money market portfolios. Based on a review of a number of prime and liquidity money market funds, total European bank exposure ranged from 0% to almost 70% of the total money market portfolio. The total European bank exposure, as reported by the funds, included both direct and indirect exposure. Direct European bank exposure included instruments such as CD's, time deposits and notes issued by European banks. Meanwhile, indirect exposure included instruments such as repurchase agreements that have European bank counter party risks, even though they are secured by U.S. Treasuries or Agencies. Most of the European exposure is concentrated within stable countries such as France, Switzerland, Scandinavia, United Kingdom and Germany. The funds have zero to very limited exposure to Portugal, Italy, Ireland, Greece and Spain. Investments within these countries are typically below 1% of the fund, of duration less than 30 days, and are invested in banks with the high-

est credit ratings. However, it is equally important to note that stable European banks also have exposure to the less stable countries and it was beyond the scope of our review to determine, in the event of a major crisis, the ramifications that would filter down through bank balance sheets.

“...it is equally important to note that stable European banks also have exposure to the less stable countries.”

As an extra note of precaution, most funds commented that they have re-examined their credit exposure to European banks and modified their approved list, where appropriate. Many of the fund management companies continue to perform stress testing on their portfolios, a recommendation that came out of the most recent changes to Rule 2A-7, and evaluate multiple “worse case” scenarios. In addition, most funds have increased portfolio liquidity in the overnight to seven-day range in order to accommodate any redemption tied to a worsening of the crisis.



Due Diligence

408(b)(2) for DB Plans

The DOL recently pushed back the effective date of the 408(b)(2) regulation to April 12, 2012. The regulations require certain service providers to employee benefit plans to disclose detailed information to plan fiduciaries regarding services, and the direct and indirect compensation they receive in connection with those services. This regulation primarily focuses on the defined contribution market, but it is important to note this regulation affects all qualified plans, which includes approximately 49,000 defined benefit plans. While plan fiduciaries are not responsible for preparing and providing the applicable disclosures, they must adequately review and process the disclosures to satisfy their fiduciary obligations.

To provide some background on this regulation, section 408(b)(2) has been a part of ERISA since its inception. It is related to ERISA Section 406(a)(1)(c) which prohibits service providers from providing services for compensation because they are a “party in interest.” The purpose of Section 408(b)(2) was to create a conditional exemption that allowed service providers to receive compensation for services provided to a pension plan. The original three conditions the 408(b)(2) required were 1) the services must be necessary; 2) the contract/arrangement must be reasonable; and 3) the compensation must be reasonable. The recently released amendment to 408(b)(2) adds additional requirements to the second condition stating contracts must be reasonable. A written disclosure must be provided listing all services provided, indirect and direct compensation received, fiduciary status and any conflicts of interest.

This disclosure regulation is designed to provide fiduciaries with the information they need to satisfy their obligations under ERISA Section 404(a)(1) regarding the reasonableness of fees. However, disclosure alone will not enable pension plan sponsors to determine if their fee structure is reasonable based on their service requirements. Pension plan sponsors should consider a fee benchmarking study to better understand if their current fee structure is reasonable in the marketplace.



PEI News

PEI launched its new website, www.porteval.com. It is full of information about PEI and how it works to serve the best interest of its clients.

PEI expanded its suite of services to include a new Online Fiduciary Resource Center to store plan-related documents. The addition of this new service will increase our clients’ fiduciary protection.

PEI participated in the Verizon Wireless Corporate Classic Challenge in Morristown, NJ on July 14th. The event was an opportunity for the staff to enjoy an evening of fitness and fun. The funding raised from the event benefitted the Jersey Battered Women’s Service, Inc.



About

Portfolio Evaluations, Inc. is a privately-owned institutional investment consulting firm. Founded in 1992, PEI operates in an independent, non-affiliated capacity to provide advice, guidance, direction, and education to the fiduciaries of institutional investment programs. Our independence allows us to serve our clients in a manner that is free from influence from investment management firms, mutual fund companies, broker-dealers, insurance companies and other industry professionals.



Trend Outlook

Establishing A Successful Investment Committee

Establishing an investment committee is essential to create a structure to oversee your investment program. Building a clearly defined investment committee can create a roadmap to meet fiduciary duties.

The first step is to have the appropriate authority to form an investment committee through a board resolution or similar action to grant the committee its oversight responsibilities. After this is completed, a charter and investment policy statement should be developed.

A committee charter will define the roles and responsibilities of each member along with the purpose of the committee. The charter forms the basis for all committee operations. The role of each member can vary from simple ideas or recommendations, to making final decisions. It can determine the term limits for committee members and create procedures for replacing them.

Along with the Charter, the committee should have an Investment Policy Statement (IPS), which clearly defines the goals of the investment committee and operating guidelines. A well structured IPS will include a purpose statement as well as state an investment strategy (which will vary for pension plans, 401(k) plans, and endowments). The guidelines in the IPS for actions such as hiring and firing managers and/or monitoring service providers should also be very straightforward.

“...it is essential that once this process is completed the standards set forth in both the Charter and IPS are maintained.”

Organizations may have different philosophies as to what to include or not to include in the charter and IPS, but it is essential that, once this process is completed, the standards set forth in both the Charter and IPS are maintained. One way to accomplish this is through regular meetings with a clearly set agenda.

At meetings, each committee member should be prepared and actively participate in discussions and the decision making process. Minutes should be recorded during these meetings to create a paper trail of the fiduciary decision making process. These illustrate that a prudent process was followed in accordance with the charter and IPS.

The final step is to review, adapt and change the charter and IPS on an ongoing basis. New investment and/or regulatory developments may lead to updates or additions to the IPS and charter. Along with the evolution of plan documents, the committee members need to remain focused on their fiduciary duties and continue to educate themselves on their fiduciary duties. Having this structure in place will help a committee to do this and more effectively meet its fiduciary responsibilities.



PEI Calendar

PEI Principal, Attila Toth, will be a panelist at the 2011 PLANADVISOR National Conference on September 13, 2011. Attila will speak on the topic of “What’s the Right Standard.”



Trend Outlook

CIO Outsourcing for Endowments and Foundations

Institutional use of the outsourced Chief Investment Officer (CIO) model of endowment management is increasing as investment boards face more complex financial markets and investment vehicles. Moreover adding to the trend, investment committee members (typically volunteers) have limited time and such committees may only meet infrequently. In the outsourced CIO model, the institution hires a firm whose professionals effectively make all of the investment decisions.

However, not all institutions are sold on the idea. Many endowments are not willing to give up oversight and control. Additionally, per UPMIFA, if investment duties are delegated to third parties, such as an outsourced CIO, the committee must prudently select and monitor the party. If an endowment selects this model, the investment committees will not become obsolete, but rather will have to adjust their role and oversight functions.

For example, smaller institutions may choose to outsource if they have a small investment staff and want more professionals to work on their account. However, they must maintain appropriate oversight over the CIO pursuant to UPMIFA. There is not a simple answer about how much discretion should be given to an outsourced CIO or if this solution will work all situations. Understanding that each endowment is unique, at the core of all investment committees' tasks is how to manage the assets of an endowment to generate the best possible returns and fulfill the fiduciary duties assumed by the committee. Therefore, should an outsourced CIO be selected, the committee still has a fiduciary duty to prudently select and monitor them.



Did you know?

Our Process

Our fiduciary process has been consistently applied to our services since 1992. The process we use will lead to more prudent decisions, resulting in the achievement of a client's unique investment objectives and the improvement of our clients' fiduciary protection.

The four key steps used to achieve meet objectives and provide clients with fiduciary protection are:

Identify Needs → **Develop Approach** → **Implement Solutions** → **Monitor Results**



Archives

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Asset Class Insider

Investing in Real Estate

There are various ways to invest in commercial and residential real estate, either directly or indirectly. Real estate is considered a good means of portfolio diversification and a potential means for hedging against inflation. Yet, there are unique risks associated with investing in real estate which can affect the value.

These risks include fluctuations in the value of real estate and borrowing costs, changes in costs of operating various properties in a portfolio, as well as competitive pressures in a particular marketplace, especially where rental income is concerned. In addition, other economic conditions such as unemployment or inflation may have an indirect impact on the willingness of buyers in the real estate marketplace. Tax treatment of real estate may also impact prices and risk profiles. Finally, real estate can often be more difficult to value than other assets such as equities, as the buyer and seller determine the value when they reach an agreement on the asset's worth.

It is possible to invest directly in real estate investment trusts (REITs), as well as funds that make direct investments in real property assets. There are also mutual funds and private funds which may comprise a part of these assets. Indirect methods of gaining exposure to real estate include such examples as the ownership of mortgage-backed securities and equities of homebuilders and those who supply them with building materials.

As with many asset classes, finding the right entry point in the market will also prove to be paramount to the returns achieved. This asset class is a good way to diversify a portfolio, but it should be understood that there can often be a significant amount of risk.

This newsletter has been prepared exclusively for informational purposes. Every effort has been made to provide accurate and authoritative information in regards to the subject matter in this newsletter; however, accuracy and completeness cannot be guaranteed and is now warranted as such. Numerous sources were used in compiling the data for this newsletter. PEI does not assume responsibility for the accuracy or completeness of such information. The information contained in this newsletter is provided with the understanding that PEI is not engaged in rendering legal, accounting, or actuarial advice. If such advice is required, the services of a competent professional of this kind should be sought. The information contained in this newsletter does not constitute the recommendation of any advisement advisor or their services nor does PEI assume responsibility for the conduct of any investment manager.

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