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The Institutional Investment Landscape: Unsettling Realities

Louis R. Morrell, Vice President Investments & Treasurer, Wake Forest University

- Wake Forest are tactical investors – they are never in cash and move into most investible
- Since Lou has been at Wake Forest, their assets have grown from $407 M in their endowment in 1995 to $969 M in 2002
  - Markets are dynamic, investment management is static
  - Wake Forest's investing style/committee is very unique
  - They ranked in the 22nd quartile – beating 78% of other endowments
  - Their committee meetings are policy decision discussions; many members of the committee have not ever met their managers
  - They have had a large investment in private equity – Timberland; 14.85% return since 1980
- They move in and out of sector funds about two times a week and are heavily invested in defense and retail. Their positions here are due to the fact that they think about the environment, like national elections or war, and it's all in the market
- Investment strategy views:
  - Global mix
  - Balance of value and growth
  - Alternative investments
  - U.S. is the most opportune market
  - Influence of economic growth and federal policy is considered
  - The dollar is expected to lose relative value
  - Interest rates and inflation are expected to remain constrained
    - Currently, Wake Forest does not favor growth – there's no pricing power in the market
- Number of factors drive asset mix
  - Hedge funds, because they give you downside protection, not high returns
  - Real Estate, have a 10% target going forward; are a good part of every portfolio
  - Sector funds – Wake Forest has delivered 65% returns when the market was flat
- Strategic asset allocation – is their benchmark/target; however, they stray from it. Lou is evaluated against target.
- Forces that drive the market
  - Economic cycles

        - Bear markets – cyclical every 3 years
        - Slow economic growth currently
    - Investor action
        - Most defined contribution plans are disasters; investors entering areas such as bonds, late
    - Political consideration
        - Politicians do not want a recession
    - Corporate actions
        - Businessmen expanded output to take advantage of the opportunity of higher sales – sharply increasing the supply of goods
- Look at secular bear market
    - Law of supply and demand will always affect the market
    - Law of rational valuations
        - Greed and fear drive investors
- Risk management – you get it through diversification
    - Lou suggests you look at asset classes and ask, "Does is make sense?" Then, either eliminate or cut back your allocation and then move to alternatives such as Absolute Return Strategy.
- Inflation, supply and demand
    - China is a problem
        - Increased production of exports to U.S.
            - With sales declining in the U.S., corporations began to lower prices and a sort of cannibalization started as U.S. business fought for market share
        - The U.S. trade deficit with China jumped 20% last year
    - When the law of supply/demand comes back in balance, companies will get pricing power and inflation will go up
        - Inflation-linked bonds can help your portfolio

Corporate Governance and Ethics in a Post-Enron/WorldCom Environment
Honorable E. Norman Veasey, Chief Justice, Delaware Supreme Court

- Looking at the facets of change in the 21st century, it began with:
    - Y2K
    - Uncertainty in 2000 elections
    - 9/11
    - War on terrorism/Iraq
    - Corporate debacles
- Then the backlash came – lessons learned:
    - The need for "Standards of conduct for corporations"
    - Raised questions on Federalism

- Congress pulled together a "Regulation Report"
  - Corporations need to follow "best practices"
- State laws have internal governance and we are now seeing voluntary corporate codes of best practices

- Where to go from here:
  - Investment regulators and courts need to ensure corporate governance
  - Look at the laws in Delaware – why do so many companies incorporate in Delaware?
    - It's been a historic phenomenon: since 1897, 60% of the Fortune 500 companies have incorporated in Delaware
    - People go to Delaware because their laws benefit companies – the state's experience and speed of decisions are desirable
    - It's recently been questioned if this contributes to the company's value?
      - A study of 4,481 companies showed that the firms incorporated in Delaware were worth more and receive takeover bids more often
    - Also, there is no harm to shareholders by incorporating in Delaware
  - Investors have to be activists and force compliance, but courts have to wait until activists bring the issues to them
  - Pension fund directors – the director is in charge and needs to enforce the following:
    - Standard of Conduct
    - Standard of Liabilities
    - Best practices as directors include:
      - Independent director
      - Engaged in actual governance
      - Meet face-to-face frequently with Board
      - Limit the number of Boards on which they serve
      - Monitor rules/regulations
      - Look at disclosure documents
    - The Governance Committee needs to review the Board and ensure it is well structured and working well

How Consultants and Attorneys can Work Together to Protect the Pension Fund
Stanley Grossman, Pomerantz, Haudek, Block, Grossman & Gross LLP
Mary Morris, Kaplan, Fox & Kilsheimer LLP

- What Trustees' Duties Are?
  - To protect: they have to be counseled by an attorney on what it means to be a fiduciary

- Need to be educated – know enough to ask questions like, "why are we not in index funds?"
- Duty to be diversified
  - Fund should be monitored to ensure it's diversified and not too concentrated
- Should be informed of unusual trading in portfolio
- Monitor fund:
  - If an advisor is engaged on a Board, they must disclose other positions that are "conflicts of interest"
  - Don't get too comfortable with any one advisor – a robust corporate governance is crucial to help protect assets

- Pension plan boards
  - Issue is how to ensure they are independent directors – they need not have any "material tie" to the plan
  - For the NYSE, Sarbanes-Oxley defines "independent" as – you are not employed by and not a consultant for the plan
  - Need diversity on Boards – gender, race, age
  - Have written, published guidelines for shareholders to see

Risk Management in a Post Enron/WorldCom Environment
Harry Griffin, Trustee, San Antonio Fire & Police Pension Fund
Derek Young, Fidelity Investments

- Tools to manage risk:
  - Employ market neutral managers
  - Hire prime brokers to help
  - Software – use a system that alerts you when securities fall in/out of percent range
  - Custodial bank notifies plan when class action is filed
  - Use asset liability studies
- Rethinking traditional asset allocation
  - Swift reversal of asset class annualized returns
    - Cambridge US Private Equity Index: 10-years ending 12/99 = 18.49%
      2-years ending 12/01 = -1.50%
    - Russell 3000: 10-years ending 12/99 = 17.67%
      2-years ending 12/01 = -9.48%
  - Low interest rates are negatively impacting liabilities
    - American Academy of Actuaries July 2001 study finds "unusually low 30-year Treasuries increase liabilities about 12%
    - Ryan Labs study shows 2000 average plan's asset growth of -2.5% and liability growth of 25.96% combine for 28% decline in funding status
  - Economic cycle not ideal for unplanned contributions

    - New methodologies needed to protect plan's financial goals
- Is managing risk preferable to managing returns?
    - Annual returns of asset classes change dramatically
    - Greenwich Associates survey of 95 plans found that U.S. equities declined 11.6% and International equities declined 27.2% for 2001; 78% of the plans surveyed reported greater asset declines in 2001 compared to 2000
    - Annual standard deviations are more stable
- Dispersion of returns is greater than volatility for every asset class
    - For every asset class from 1989-2001, the dispersion of returns is greater than the dispersion of standard deviations
- What is risk budgeting?
    - Allocation of return volatility across portfolio components (asset classes, managers, and/or securities)
    - Goal = maximize return at targeted level of risk
    - Three basic steps
        - Set the appropriate level of risk
        - Develop a strategic allocation based on the risk target (assets)
        - Create a manager allocation consistent with asset class targets
            - The key is knowing how much risk to take
    - Recent survey of pensions plans found that 19% of plans are using risk budgeting and many others are considering it
- Primary research on strategic risk allocation
    - Choose asset classes
    - Calculate risk and return characteristics
    - Impose constraints
    - Formulate an efficient frontier
    - Determine the asset allocation
    - Rebalance using five different rebalancing methodologies
- Rebalancing methodologies and assumptions
    - No rebalancing – portfolio weights are set initially and not rebalanced during the study period
    - Annual rebalancing – portfolio weights are set initially and rebalanced at calendar year-end
    - Range rebalancing – the entire portfolio is rebalanced whenever any asset class drifts outside its strategic range
    - Risk rebalancing – (assume 9% target)
        - When the 1-year portfolio standard deviation (based on weekly returns) moves outside the target range (9% + -2%), make 5% reallocations using the S&P 500 and the Lehman Aggregate Bond Index as tactical asset classes.

        - Review the portfolio six months after the reallocation. If the portfolio standard deviation has not yet corrected, reallocate 5% again using the S&P 500 and the Lehman Aggregate Bond Index as tactical asset classes.
        - Range rebalancing is still applied; however, eliminate the range constraints for S&P 500 and the Lehman Aggregate Bond Index.
    - Risk rebalancing with 10% Lehman Aggregate base
        - Same as risk rebalancing, but if the Lehman Aggregate weight falls below 10%, elect to elevate diversification theory over risk budgeting and maintain the aggregate allocation at or near 10%
- Issue of risk budgeting: it's a fiduciary responsibility and risk budgeting becomes tactical
- Will risk budgeting change investment management?
    - Asset allocation
        - Active/passive mix
        - Market neutral strategies
        - Absolute return strategies
    - Manager selection
        - Performance attribution
        - Risk decomposition
        - Uncorrelated manager alpha
    - Portfolio construction
        - Security selection by marginal contribution to risk

Working with Consultants to Create a Management Team
Randall Kirkland, Asset Consulting Group

- Need to delineate roles and responsibilities
- Identify priorities
- Manage expectations
- Coordinate channels of communications
- Establish accountabilities
- Be proactive
- Plan sponsor and consultant interaction
    - Strategic – long-term plan
        - Board rotation and "oral history" of plan
        - How/why is the plan sponsor in this situation?
        - Identify key objectives – next 3-5 years; next 12 months; next quarterly review
    - Tactical – short-term plan
        - Project focus – manager search/educational workshops

        - Workshops are key to building chemistry between plan sponsors and consultants
    - Coordination of responsibilities
    - Consideration of potential issues, questions, objectives
    - Pre-meeting meeting
  - Plan for next Board meeting – near-term
    - Who's on watch list and why
    - Potential courses of action
    - Recommendations
    - Basic premise – no surprises
- Examples of coordinated efforts
  - Rebalancing and transitions
  - Manager modifications
  - Educational initiatives
- The Consultant Relationship with Board
  - Unbiased judgment
  - Source of perspective
  - Interpreter/translator
  - Educator
  - Reality check
  - Accelerator/brake
- Use Manager's Resources
  - Professional perspective on industry and portfolio
  - Research capabilities
  - Educational initiative with Board
  - Establish a "team mentality"

Richard Curtis, Ohio State Highway Patrol Retirement System

- Givens for their relationship with their consultant
  - Performance measurement
    - Measures how managers are doing with their plan assets; against their peers
    - Provide any warning the manager may blow up
    - Want consultant who does an analysis on managers all along, rather than after the fact (they blow up)
    - Would like to have
    - Want consultant to customize more information for their plan specifically rather than provide 75% of the report as standard material/general data that is given to all clients/plans
  - Asset allocation study

        - Study needs to be personalized to the plan – often times studies are 15% personalized and 85% "fluff"
        - Frequency – should match the strategy/needs since the studies are expensive
        - Format – replace 3rd party words such as "normally *plans* do this…" with "…*Ohio*…"
        - Give up to four alternatives, but say this is the one we think you should do – and include a disclaimer that you are not responsible
    - Fees and costs
        - Plans buy more product/analysis than they need
        - Consider asking your custodian to bid on performance measurement – could be less expensive
- Final thoughts:
    - We need consultants – they bring objectivity
    - Consultants need plan sponsors
    - Create a better team!

Russell Bjorkman, Florida State Board of Administration

- Board of trustee performs fund management – measure if the consultant brings value
    - Fund administration with discretion is the most difficult job
    - What to look for in a Consultant/Plan Sponsor relationship?
        - Thorough knowledge of:
            - Plan
            - Marketplace
            - Asset liability determinations
            - Asset allocation and benchmarking
- Consultant performance measurement – managers are sliced and diced; do consultants add value?
    - Yes, through asset allocation, manager selection, operating costs and fund performance

Hiring and Working with Consultants: A Candid Roundtable Discussion
Luke Howe, Chicago Park Employees' Annuity and Benefit Fund

- Plan uses Ennis Knupp – full service retainer; pay an annual fee for:
    - Research on products
    - Update on money managers
    - Investment policy review – three years/as needed
    - Asset allocation study
    - Attend meetings quarterly or more if needed (are local, in Chicago, so makes it much easier)

- Manager due diligence
- Not included in annual fee is "manager search" – this is billed separately when they complete a manager hire

Ralph Marsh, Houston Police Officers Pension System

- Use consultant as gatekeeper/screener for Alternative Investments/Private Equity
- In 1997, Houston Police took investment responsibility in-house
- They are pleased with their program being in-house
  - For manager searches, they narrow down the managers, complete interviews and then go to manager's offices to check their operations, systems, etc.

Stephen Carbone, New York City Fire Pension Fund

- The five funds in New York city use five different consultants
- The comptrollers office of New York sends out RFPs – each fund meets to discuss using their rating scale
- Believes performance measurement is becoming a commodity
- Risk management is a weak area for them where consultants can help
- How to judge a consultant:
  - Annual reviews
  - New ideas
  - Be responsive to needs
  - Keep fees reasonable

Fiduciary Responsibility, Financial Performance and Climate Change – How the Investment Community can Help Tackle Our Greatest Environmental Challenge
Roger Ballentine, Green Strategies

The Economic Value of Responding to Climate Change

- Climate change has a direct and significant financial relevance
- Businesses can mitigate risk and add value through climate-conscious management
- Investors/fiduciaries should evaluate these issues to reveal risk and value
- Climate change – the evidence is The Greenhouse Effect; the problem:
  - 8 of the 10 hottest years on record have occurred since 1990
  - The 1990s were the hottest decade in the last 1,000 years
  - Over the last century, sea level rose 4" to 8"; over the next century, sea level is likely to rise by two feet
  - Latest estimates are for average temperature increase over the next hundred years of 3 to 10 degrees
  - Last Ice Age (when Northeast was under 3,000 feet of ice) was 5 to 9 degrees cooler than today

- Climate change as a business issue: from activists to the Board room
  - It's no longer a "fringe" environmental issue
  - The WEF, World Economic Forum, called the GCC, Global Climate Change, the greatest challenge facing business in the 21st century
  - Increasing regulations worldwide – industrialized world (sans U.S.) implementing Kyoto Protocol (multinationals must respond)
- Climate change as a fiduciary issue: what's changed?
  - Domestic political measures are coming
  - The link between environmental and financial performance is more clear
  - Shareholders are taking notice, and there's an increasing demand for disclosure
  - Financial impacts:
    - Cash flow – increased operating costs (e.g., cost of energy); increased sales of environmentally favorable products
    - Cost of capital – worldwide, the cost of GCC performance is factored into interest rates and insurance premiums; U.S. credit rating agencies considering environmental performance
    - Market capitalization may be affected – failure to mitigate environmental risk can impact market cap (Halliburton and Dow lost 40% of market cap due to fears of retroactive asbestos litigation)
- Energy efficiency is key
  - More than a third of greenhouse gasses come from the production and use of electricity
  - Six large power plants are needed to power our TVs and VCRs when they are turned off
  - If households in California replaced four regular bulbs with CFLs, it would be the equivalent of building 17 new medium-size power plants
- Combine energy efficiency and energy management, which includes climate impact and fiduciary implications, and together it's the ability and decision to manage energy costs efficiently – the key to indicator of value
- Energy efficiency adds to value:
  - Increased productivity
  - Reduced costs
  - Decreased risk exposure
  - Improved corporate image
  - U.S. businesses waste $25 billion/year because of inefficient buildings
  - Investments in building energy efficiency can achieve a 35% to 50% reduction in energy consumption, with a 20% to 35% ROI, not counting productivity gains
- Corporate climate change policy actions
  - Reduce greenhouse gas emissions

    - Look at how changing market and regulatory conditions may benefit or penalize firm's products and services
- Corporate actions examples
    - Dupont – aggressive Greenhouse Gas mitigation program, a 60% reduction
    - Deutsche Telekom – saving $8 million DM annually from efficiency/emissions reductions
    - Alcoa – will reduce direct Greenhouse Gas emissions to 25% below 1999 levels by 2010
- Negative impact example – ExxonMobil
    - Claros Consulting report finds ExxonMobil is risking shareholder value by not moving more aggressively to mitigate political, legal, and PR exposure to Global Climate Change issues
    - Institutional Shareholder Services (ISS) recommended a vote for a proposal calling for ExxonMobil's Board to clarify renewable energy efforts because of long-term shareholder value concerns
- Conclusion: for investors, a new area of inquiry
    - For fiduciary reasons, investors should evaluate a company's climate change-related risk, vulnerability to impending regulation, proactive management actions and energy use
    - Firms (like Green Strategies) specialize in helping investors do this

Blaine Collison, U.S. EPA Energy Star Buildings Program

- Energy Star is the voluntary partnership between business, government, and others united in the pursuit of a common goal: to protect our environment for future generations by changing to energy-efficient practices today
- Energy Star is successful internationally
- Major retailers promoting Energy Star are: Sears, Circuit City, Best Buy
- Utilities are increasingly using the label: 30% of the U.S. is now served by Energy Star Utility partners
- Energy Star partners of the year include General Motors, Verizon and INOVA Health Systems
- Research objectives:
    - Determine whether or not superior energy management adds value for investors
        - If so, raise financial community awareness
    - Encourage investors to consider corporate energy efficiency performance and look for E*s (Energy Star)
- Research methodology
    - Develop models to evaluate energy performance
    - Analyze and rate companies
    - Analyze correlation between E*, energy performance, and financial performance

- What should you do?
  - If your organization manages or owns facilities, join Energy Star
  - If you manage someone else's investments:
    - Look for E* organizations as you evaluate your holdings
    - Demand good energy performance for the companies you track
    - Use energy performance metrics as a first indicator of good energy performance

Frank Dixon, Innovest Strategic Value Advisors

- Socially responsible investing in the U.S. – SRI
  - 14 of 18 SRI funds with over $100 million in assets earned top scores from Morningstar and/or Lipper Analytical Services in 2002
  - Morningstar gives 33.3% of SRI funds top scores versus 32.5% for all mutual funds
  - SRI assets grew by 3% in the first six months of 2002, while other assets under professional management fell by 10%
  - SRI assets total $2.3 trillion, up from $150 billion in 1995, representing nearly 12% of U.S. assets
- Changing viewpoint:
  - Traditional view: fiduciary responsibility to maximize returns precludes SRI
  - Most academic and business studies show a positive correlation between environmental and stock market performance – because environmental performance is an excellent proxy for management quality, which is a leading determination of stock market performance
  - Environment and social issues represent one of the most complex challenges facing management
- Implications for corporations and investors
  - Greater incorporation of externalities into prices through taxes, regulations, fees and other means
- Innovest Tracking Funds – adding an environmental screen to funds increased outperformance
- Obstacles to SRI
  - Belief that SRI funds underperform non-SRI funds
  - Belief that SRI is a style of investing (e.g., value, growth, etc.) rather than a discipline that can be applied to all styles
  - Belief that SRI may violate fiduciary responsibility by considering non-financial issues
  - Lack of analyst experience in assessing complex environmental and social issues
  - Some fiduciaries assume their investments already are socially-responsible
  - Belief that SRI must be adopted all at once, rather than phased in over time

    - Ambiguity about the definition and objectives of SRI
- Investor benefits of SRI
    - Reduces risk
    - Provides significant potential to increase returns
    - Best-in-class SRI approach shifts investments to better managed companies while maintaining sector diversity
    - Many foundations, endowments and HNW individuals give large amounts to benefit environmental and social causes
        - Greater benefits achieved through SRI since corporations are strongly influenced by the capital markets

Minimizing Market Impact and Managing Risk Through Effective Transition Management

Richard Clark, BNY Brokerage
Should You Hire a Transition Manager?

- What is transition management?
    - It's a vehicle – it is an efficient, cost-effective method for investors to allocate funds among asset classes, modify investment strategies and change investment manager rosters. Transition management includes:
        - Buying and selling of securities
        - Cost analysis and reporting
        - Administrative and organizational support
- When do transitions occur?
    - After asset allocation studies
    - After manager reviews
    - After corporate actions
- Why do you need professional transition management services?
    - Plans are experts at allocating assets and selecting managers to maximize investment returns
    - Limited resources to manage and implement transitions; outsource administrative burden
    - Transition managers are expert in cost and risk management
        - Reduces costs and risk associated with transition
- Transition costs
    - Commission – explicit; most obvious, yet often the smallest percentage of overall cost
    - Implicit cost
        - Bid-offer spread – difference between the bid and ask prices

        - Market impact – negative effect on prices from the very act of placing an order or executing a trade. In general, the more illiquid the asset, the higher the market impact.
        - Opportunity cost – risk that during the transition, prices move against the portfolio. The longer the trade takes to complete, the higher the opportunity cost.
            - Efforts to reduce market impact tend to magnify opportunity costs
    - Transition Management is very competitive – all managers do it well, so you need to go with who you trust
- Transition Risk
    - Operational risk – failure to coordinate activities among the many parties to a transition; systems error; human error
        - Miss transfer in-kind opportunities
        - Buy and sell securities in the wrong amounts
        - Miss funding dates
        - Failed trades
            - Missing a market rally, say of 3%, can affect your portfolio tremendously
- Transition Management Goals
    - Reduce costs and risks associated with a transition
        - Low commission rate
        - Maximize internal crosses/transfers in-kind
    - Implicit costs
        - Access major sources of liquidity – primary exchanges are the pre-eminent sources of liquidity
        - Broker flow crosses – possible if transition manager has a large trading operation
        - Look for pre-trade analysis – this data will dictate your course of action
        - Identify residual risk between target and legacy protfolis caused by differences in asset classes and index, sector, industry, country weightings
            - Integrated global trading system to monitor exposures
            - Use trading and hedging techniques to risk
            - Liquidity is the name of the game
- Qualities of a good Transition Manager:
    - Need precise discipline to implement
    - Works immediately with you to determine objective and priorities of transition
    - Designs a trading strategy that meets your goals while minimizing the implicit and explicit costs of trading
    - Implement a trading strategy by accessing multiple points of liquidity
    - Measures the outcome of the transition versus your objective, including measuring the quality of the executions

    - Eases the administrative burden on you and your investment managers while minimizing operational risk
- Life cycle of a portfolio transition
    - Old portfolios/new portfolios
    - Pre-trade analysis
    - Trading
    - Settlement
    - Post-trade analysis
    - Transitioned portfolios

What Role Do Index Funds and Index Related Products Play in the Current Asset Allocation Process?

Richard Spurgin, University of Massachusetts
John Prestbo, Dow Jones Global Indexes
Ryan Carrier, Standard & Poor's Index Services

Richard Spurgin, University of Massachusetts

- Owning foreign currencies = exporting capital
- Passive vs. Active
    - Active uses trends following the strategies
    - Passive has a negative correlation with equity markets and gives you better diversification of assets
    - Actively traded futures are up 15% in this down market
- Are plans better off hedging with an index or with specific currencies? There's really not a big difference between the two in returns.

John Prestbo, Dow Jones Global Indexes

- Indexes are traditionally used in asset allocation models
    - They help refine the return expectations of asset classes over time
    - ETF's, Exchange Traded Funds, are used as a proxy to indexes
- When defining the economic space, Dow Jones looks to determine:
    - Proper asset allocation
    - Consistent measures of standards are reached
    - S&P 500 and Russell models are not created with size in mind
        - Dow Jones defines large as top 70%; middle as top 20% and small as top 10%

Ryan Carrier, Standard & Poor's Index Services

- Alternative assets include hedge funds and commodities
    - S&P entered this area because there was not an index
- Hedge funds are good because:
    - They offer diversification characteristics

  - Risk-return benefits
  - Also – commodities work when the rest are failing
- Investible shares of S&P Hedge Fund index are available:
  - Daily liquidity
  - 11.3% return
  - 3% standard deviation
- Three styles of hedge fund indexes:
  - Arbitrage
  - Event Driven
  - Directional/Tactical
- To create the index, S&P narrows the universe from 3,500 to 275 to 50; process follows similar screens as the investment managers use
- 70% of the time, when bonds go down, commodities go up
- Commodities outperform when interest rates bounce back from lows

Fixed Income Strategies: How You Evaluate and Manage Risk
Michael Paternak, Goldman Sachs
Kurt Wright, GMAC Institutional Advisors
Robert Smith, Florida State Board of Administration

Michael Paternak, Goldman Sachs: A Changing Marketplace for Credit Risk
- Credit is strategic, not solely tactical
  - Historical empirical evidence has tended to support a tactical rather than strategic bias toward taking credit risk
    - Volatility of credit spreads offered little incentive to take a strategic view
    - Issuers seemed to benefit at the long term investors' expense (borrowers have benefited vs. managers and plan sponsors)
    - Most high profile active fixed income managers took market spread timing views rather than specific credit views
- Rolling excess returns from taking credit and liquidity risk are very volatile
- Big trends in bull, neutral and bear phases
- Histograms of excess returns encourage investors not to take B or CCC credit risk
- Investing in high yield: in recent months, rolling excess returns for high yield securities have rapidly descended
- Distribution of high yield excess returns:
  - As credit quality increases, excess returns range around a tighter band
  - As credit quality decreases, excess return distributions begin to look more random
- The current market cycle is following form:
  - Moving from BB to B quality total return leadership
  - Default losses are moderate

    - Refinancing and underwriting cycle ramping up
- Important differences emerging:
    - More risk capital available for distressed securities
    - Liquidity in secondary market very polarized
    - Fundamental credit differentiation spotty in a global context
    - OTC derivatives reveal demand for the market, but fear about specific issues
    - Credit-specific risk can be exploited in two directions: long and short
- Impact on high yield active management:
    - Many active managers have performed by avoiding specific risk, not embracing it
    - Tools to separate credit and liquidity factors are emerging
        - It will become apparent which active managers take credit risk effectively
- Credit provides another vehicle to diversify active risk
- Conclusions:
    - Historical record of managers and the market may be a surprisingly poor guide to the future
    - Taking credit risk strategically may pay
    - Credit risk styles will emerge
    - Active risk can be diversified by adding a credit component

Kurt Wright, GMAC Institutional Advisors

Why Commercial Mortgage Backed Securities?

- Stable, predictable monthly cash flow
- Fixed rate of return
- Strong credit characteristics
    - Reduced event risk due to loan diversification
    - Cushion from losses provided by subordinate classes
    - First mortgage liens securing the underlying loans
    - Investment grade CMBS have significant equity backing loans
- Call protection
- Liquidity
- Attractive vs. alternative fixed income investments
- CMBS market history:
    - The RTC utilized the securitization process/technology developed for single family mortgages to dispose of commercial mortgages in the early 1990's
    - This paved the way for private issuers to pick up where the RTC left off
    - Today, Wall Street, life insurance companies and portfolio lenders originate mortgages for securitization
- Depth of the CMBS market:
    - Cumulative outstanding issuance approaching $400 billion
    - Broader acceptance from investors, due to the size and transparency of the market

    - High degree of liquidity
- CMBS security:
    - Loss severity is limited due to security of first mortgage liens
    - Below investment grade classes incur losses of principal and interest prior to investment grade classes
    - Default frequency and loss severity further limited by borrower's equity in the property
- CMBS liquidity:
    - Investment grade CMBS have same day liquidity
    - During the credit collapse of 1998, AAA rated CMBS were found to have better liquidity than A rated corporate bonds
- CMBS spreads:
    - At historically attractive levels
    - On a risk adjusted basis, are high relative to alternative fixed income products
- CMBS vs. corporate bond spreads:
    - The corporate bond market has become more volatile due to weakening credit
    - While corporate spreads are attractive in a historical context, the potential reward may not justify the additional risk
    - CMBS spreads have held firm, evidencing the protection provided by the sector
- CMBS returns vs. fixed income alternatives
    - BBB rated CMBS have outperformed fixed income alternatives
    - Fixed income investors have begun to recognize the attractive fundamentals, structural and credit characteristics that CMBS posses
- CMBS correlations:
    - CMBS are not highly correlated with corporate bonds and alternative fixed income investments
    - Corporate bonds are suffering from credit weakness and residentials from prepayments, while CMBS benefit from superior credit characteristics and call protection
- GMAC Institutional Advisors believes that an inefficient, heterogeneous credit universe creates opportunity to outperform
    - Via intensive credit review, significant value can be added via asset selection
    - They also believe a significant percentage of CMBS should be strong performers, but a material percentage have potential for downgrade
- Conclusion: CMBS should have a material role in fixed income portfolios due to the following:
    - Superior credit performance
    - Superior spreads and risk-adjusted returns
    - Strong pre-payment protection
    - Market depth/liquidity

- Increasing market transparency

Robert Smith, Florida State Board of Administration

- There's been a significant shift in risk and excess return of investment grade corporate bonds since 1997
- During the period from 1988 to 1997, corporate bonds excess returns averaged 0.48%, while risk averaged 1.02%
  - Naïve assumption of the price of corporate risk:
    - (0.48/1.02) = .47 = Excess Return Ration (ERR)

Global Investments and Style Diversification: How Consultants Can Help You Gain Appropriate Overseas Exposure

Jonathan Passmore, GE Asset Management

The case for emerging markets, including positive structural reform; why outperformance will continue; and, emerging markets as a substitute for Japan

- Positive macro reform: % of MSCI benchmark with floating currencies has gone from <5% in 1989 to 89% in 2001
- Emerging market capital flows: direct investments have grown from <$20 B in 1990 to $120 B in 2002; while portfolio investments have only grown from <$5 B in 1990 to $20 B in 2002
- Outsourcing: a case study, GE China:
  - GE sourcing from China grew 37% from $95M in 1995 to $600 M in 2000
- Global competition is driving emerging markets, which means:
  - Quality is improving
  - Competitive advantages occur
  - Global market share
- Local companies – influence of independent management is greater
  - December 1995:
    - Independent management = 52%; government or family management = 48%
  - April 2002:
    - Independent management = 73%; government or family management = 27%
- Improving returns reflect the impact of reforms
  - Returns for emerging markets ROE vs. world ROE have moved closer together at an 8% return each as of June 2002
  - Relative performance – emerging markets are starting to outperform
  - Valuations are becoming compelling:
    - 2002: MSCI World P/E = 16x; MSCI EMF P/E = 9x
  - New driver includes domestic growth
    - Asian consumer lending increased

    - Mexico – outstanding credit; consumer to total loans is greater than total consumer loans
- Japan and emerging markets – leveraged plays to global growth, but they are heading in opposite directions
  - Japan and emerging markets have been highly correlated historically
  - Japan's macro picture continues to deteriorate vs. industrial Europe, Ex-Japan Asia, and USA
  - Japan's micro picture is equally unimpressive – ROE's consistently low
  - Bottom line is that Japan is being left behind in Asia; substituting emerging markets for Japan can enhance returns
  - By the end of 2004, ten emerging countries are joining the European Union