PAPERS

Pennsylvania Association of Public Employee Retirement Systems
PO Box 61543, Harrisburg, PA 17106-1543

Summer 2009 (Vol. 4, No.2)

In This Issue

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

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Monroeville, PA

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New Address

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PAPERS Fall Workshop, Sept. 23rd

Pension Fund Trustees & Staff Can Attend Workshop FREE

In these uncertain economic times the PAPERS Board feels it is especially important for pension fund trustees and staff to have access to high quality training to help them with their duties. In recognition of the severe budget constraints that most local governments are facing, the PAPERS Board is offering **complimentary registration** for the Fall Workshop to all public pension trustees and staff.

This summer PAPERS staff and Board are working hard on the production of our Fall Workshop which will be held on September 23rd at the Holiday Inn in Monroeville, PA, just east of Pittsburgh. We have put together an agenda that addresses the basic skills trustees must master to fulfill their fiduciary duty to the members of their Plan. Please see pages 2-3 for the details of this year's agenda.

The 3rd Annual PAPERS Fall Workshop provides an opportunity for you to participate in an excellent series of educational workshops. In addition it gives you a chance to meet with your plan sponsor peers and with professionals who provide consulting, investment, actuarial and legal services to the pension community. Best of all, there is **no cost** for any public pension trustee or staff member who wishes to attend this one day educational event. To qualify you must submit a registration form so that we will be able to plan for the proper number of attendees.

The success of the fall workshop and of PAPERS as an organization is dependent on your participation and support. I look forward to seeing you at the PAPERS fall workshop on September 23rd. You'll find the workshop reservation form waiting for you to complete on page 13.

Jim Perry**,**
PAPERS Executive Director

PAPERS FALL WORKSHOP AGENDA

(subject to change)

Wednesday, September 23, 2009

7:00 a.m. – 5:00 p.m.

Holiday Inn, Monroeville, PA

7:00 a.m. – 8:15 a.m. .... **Registration and Continental Breakfast**

8:20 a.m. - 8:30 a.m. .... **Welcome to the PAPERS Fall Workshop**

Jim Perry, Executive Director PAPERS

8:30 a.m. - 9:15 a.m. .... **Keynote Speaker**

Dan Onorato, Allegheny County Executive (see page 5)

9:15 a.m. - 10:15 a.m. ...... **Trustee Panel on Issues Facing Local Pennsylvania Pension Plans**

Moderator: **Michael Shone** - Peirce Park Group

Panelists: **Cassimir Kwitowski**, Controller City of Erie
Ed Cernic, Controller Cambria County
Michael Namie, Controller Washington County
Mark Flaherty, Controller Allegheny County

The panelists will discuss issues they are dealing with in operating a Public Pension Plan in their political subdivision. The audience is encouraged to participate actively in this workshop.

10:15 a.m. - 10:30 a.m. .... **Refreshment Break**

10:30 a.m. - 11:15 a.m. .... **Understanding the Fiduciary Duty of a Public Fund Trustee**

Presenter: **Jeffrey B. Clay Esq.,** Exec. Director Public School Retirement System

Jeff will discuss the basics of fiduciary duties and identify some of the potential pitfalls of trustees who ignore their duties.

11:15 a.m. - 12:00 p.m....... **Things Every Trustee Should Know**

Presenter: **Mark Meyer, Nomura Asset Management**

Mark will discuss the basics that every trustee needs to know to make informed decisions at pension board Meetings

12:00 p.m. - 12:45 p.m..... **Lunch**

12:45 pm - 1:45 pm.......... **Asset Allocation from a Trustee's Perspective**

Moderator: To be announced

Presenters: **Stacy Marino,** Portfolio Manager State Street Global Advisors
Erik Gosule, Portfolio Manager D.E. Shaw

This panel will explore asset allocation from a Trustee's perspective in light of the current market environment.

1:45 p.m. - 2:30 p.m......... **A Discussion of the Status of Pennsylvania Local Pension Plan Funding and a Look at Proposed State legislation Being Developed to Deal with Some of These Issues**

Presenters: **James Allen,** Secretary PA Municipal Retirement System
Bill Asay, CEBS/President Mockenhaupt Benefits Group

This session will deal with the funded status of public plans in Pennsylvania and the proposed state legislation designed to deal with severely underfunded plans.

2:30 p.m. - 3:15 p.m......... **Solving the Mystery Surrounding the Calculation of Pension Liabilities and Actuarial Contribution Rates**

Presenter: **Jason Fine,** Consulting Actuary The Hay Group

The presenter will explore the various methods of calculating liabilities and employer contribution rates for public pension plans in Pennsylvania.

3:15 p.m. – 3:30 p.m........ **Refreshment Break**

3:30 p.m. - 4:15 p.m......... **The Rewards and Risks from Securities Lending**

Presenter: Tom Daniels, CFA.Managing Director BNY Mellon Asset Servicing

This session will help attendees understand what securities lending is, how revenue is generated, the risks of participating in any lending program and certain tools to monitor or manage those risks. Attendees will also be taught how revenue can be influenced based on the clients' risk tolerance, portfolio objectives and the type of assets enrolled.

4:15 p.m. - 5:00 p.m........ **State Pension Subsidies - How Are They Calculated and Where Are They Going**

Presenter: Staff from PA Auditor General's office

Staff from the Auditor General's office will discuss the calculation of pension subsidies for local government pension plans and talk about the future of these payments.

Continuing Professional Education (CPE) Credits

If you are interested in receiving an official certification of your attendance at the Fall Workshop sessions for CPE credits, please stop by the registration table in the lobby and ask for an attendance record form. When you are ready to leave, a PAPERS representative will certify your attendance by signing the form and return it to you for submission to your professional organization so credits can be issued.

Meet Our Distinguished Keynote Speaker

Dan Onorato, *Allegheny County (PA) Executive*

Dan Onorato is a life-long resident of Allegheny County. He grew up on Pittsburgh's North Side and attended North Catholic High School. In 1983, Onorato graduated from Penn State University with a bachelor's degree in accounting. Onorato worked for several years as a Certified Public Accountant before continuing his education at the University of Pittsburgh School of Law, where he earned a juris doctorate in 1989. Onorato practiced as a private attorney until 1991, when he decided to leave the private sector and enter public service.

Onorato was elected to Pittsburgh City Council in 1991 and re-elected in 1995. In 1999, he successfully ran for Allegheny County Controller and spent four years being a watchdog against wasteful spending and fraud. In 2003, Onorato launched a successful campaign for the Office of County Executive, and he was overwhelmingly re-elected to that office in 2007.

Onorato has brought a fresh approach to Allegheny County government. His background as a CPA and attorney give him the strong management skills and fiscal discipline with which he effectively governs Pennsylvania's second largest county.

Upon taking office, Onorato immediately began reducing expenditures and streamlining County government. He has reduced the County's payroll by 626 positions, which saves taxpayers more than $31 million annually. Onorato was also the primary advocate of Row Office reform, which has reduced the size and cost of County government by abolishing six elected offices.

In keeping with his commitment to fiscal responsibility and smaller government, Onorato has embraced opportunities to consolidate services and eliminate duplicate functions between Allegheny County, the City of Pittsburgh and other municipalities. He also successfully fought for a fundamental change to the County's property assessment system, which prevents dramatic swings in property values and eliminates backdoor property tax increases. Onorato has held the line on property taxes in every budget since becoming County Executive.

Onorato focuses on three areas that are critical to Allegheny County's future success: economic development at and around Pittsburgh International Airport; the reclamation and redevelopment of thousands of acres of brownfields and old industrial sites; and the creation and expansion of high-tech businesses and jobs resulting from university research and development. Onorato is also focusing public and private efforts to address 20 years of deferred maintenance at the County's nine parks, which encompass more than 12,000 acres.

Since taking office in 2004, Onorato has secured more than $1.2 billion in state support for a wide range of economic development, capital construction and regional transportation projects that span the County.

While presenting the County Executive with a check for $2.8 million for 19 recreation and conservation projects throughout Allegheny County, Pennsylvania's Secretary of Conservation & Natural Resources called Onorato "the smartest and hardest working county executive in Pennsylvania."

In an interview with the *Pittsburgh Post-Gazette*, Pennsylvania Governor Ed Rendell said "Dan Onorato is an incredibly effective executive, and he's a rising star."

Onorato and his wife, Shelly, reside in the Brighton Heights neighborhood of Pittsburgh with their children Kate, Emily and Danny.

Special Thanks to our Fall Workshop Sponsors

The generous financial support of these PAPERS Associate Members makes it possible to provide free registration for representatives of public pension funds to attend the Fall Workshop.

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Administration's Plan Includes Many Components Aimed at Investor Protection

Submitted by Rosemary Kelly, PAPERS Corporate Advisory Committee & Vice President Broadridge

Excerpted from the Council of Institutional Investors' weekly newsletter, the *Corporate Governance Alert*. For more information about the Council, see www.cii.org.

The Obama administration on June 17 released a sweeping regulatory reform plan to increase federal oversight of financial firms and strengthen investor protections in the U.S. capital markets. The Council welcomed the administration's efforts to extend the federal regulatory umbrella to cover all aspects of financial services. In a press release, the Council also praised the administration's plans to tighten oversight of credit rating agencies and to allow shareowners to cast annual non-binding annual votes on executive compensation packages.

The comprehensive overhaul is outlined in an 89-page paper, "Financial Regulatory Reform, A New Foundation: Rebuilding Financial Supervision and Regulation." The paper, executive summary and fact sheets can be found on the Treasury's Web site http://www.treas.gov/news/index1.html.

The broad outlines of the plan have been widely reported. Other key elements that could affect Council members include:

A realignment of federal agencies' oversight responsibilities:

- The Federal Reserve would be solely responsible for supervising financial firms that are found to pose a threat to financial stability based on their size, leverage and interconnectedness to the financial system.
- The SEC's Supervised Investment Bank Holding Company program would be eliminated and the Fed would assume oversight of investment banking firms.
- Regulation of futures and securities markets would be harmonized but the CFTC and SEC would not be merged. The CFTC and the SEC would report to Congress on all existing conflicts in statutes and regulations with respect to similar types of financial instruments and recommend any changes deemed necessary.

New regulatory entities to improve oversight of financial institutions:

- A Financial Services Oversight Council would be created to gather information, identify emerging risks, advise the Fed on firms whose failure could pose a threat to financial stability and provide a forum for resolving jurisdictional disputes between regulators. The Council would replace the president's Working Group on Financial Markets and would have a full-time staff at Treasury. Members would include the Secretary of the Treasury, the chairman of the Board of Governors of the Federal Reserve System, the director of the National Bank Supervisor, the director of the Consumer Financial Protection Agency, the chairman of the SEC, the chairman of the Commodity Futures Trading Commission, the chairman of the Federal Deposit Insurance Corporation and the director of the Federal Housing Finance Agency.
- A New Consumer Financial Protection Agency would be created as a single, primary, independent, federal supervisor to protect consumers of credit, savings, payment and other financial products. The agency would coordinate enforcement efforts with states and work with the Department of Justice to enforce the statutes under its jurisdiction in federal court.
- A Financial Consumer Coordinating Council would be created to establish mechanisms for state attorneys general, consumer advocates and others to recommend to Congress how to close legislative or regulatory gaps. The Council would also sponsor studies, perform consumer testing, share information and find solutions. Council members would include the heads of the SEC, Federal Trade Commission, the Department of Justice and the Consumer Financial Protection Agency and other state and federal agencies.
- The SEC's new Investor Advisory Committee would be granted permanent status. This group was formed to advise the commission on regulatory priorities relating to new products, trading strategies, fee structures and disclosure.

New measures to rein in executive compensation at financial institutions:

- Standards and guidelines to better align executive compensation practices of financial firms with long-term shareowner value. The new rules would be crafted by the administration in coordination with Treasury, federal banking regulators, the Federal Reserve and the SEC.

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Administration's Plan…

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- SEC authority to require that all public companies hold non-binding shareowner votes on the compensation packages of senior executive officers.
- SEC authority to require that compensation committees are more independent.

Improved, timely disclosure of accounting, potential conflicts of interest and complicated financial instruments:

- Enhanced executive compensation disclosure requirements from the SEC.
- A review of fair value accounting rules by the Financial Accounting Standards Board, the International Accounting Standards Board and the SEC . The aim of the review would be to identify changes that could provide users of financial reports with both fair value information and greater transparency regarding the cash flows management expects to receive by holding investments.
- Improved and standardized disclosure practices for originators, underwriters and credit rating agencies involved in the securitization process. Issuers of asset-backed securities would be required to disclose loan-level data (broken down by loan broker or originator) to the SEC.
- Tighter oversight of credit rating agencies by the SEC. Credit rating agencies would be required to maintain policies and procedures to manage and disclose conflicts of interest; differentiate ratings on structure products from ratings on other traditional debt securities; disclose credit rating performance measures; and provide greater detail about their methodologies for rating structured products. The plan also calls for regulators to reduce their use of credit ratings in regulations and supervisory practice.
- Common fiduciary obligations for investment advisers and broker-dealers who provide investment advice about securities to investors. Broker-dealers would also be required to provide simple and clear disclosure to investors and be prohibited from engaging in certain conflict of interests and sales practices.

Expanded SEC authority to strengthen investor protections:

- Advisers to hedge funds, private equity funds and venture capital funds whose assets under management exceed a certain threshold would have to register with the SEC under the Investment Advisers Act. The SEC could use the data to assess whether any fund poses a threat to financial stability.
- The SEC would study the use of mandatory arbitration clauses in broker-dealer and investment advisory accounts with retail customers and prohibit such clauses if the commission deems them harmful to investors.
- The SEC would create a fund to pay whistleblowers for information that leads to enforcement actions resulting in significant financial awards. The fund's coffers would be filled from cash that the SEC collects from enforcement actions that is not distributed to investors.
- The SEC would be able to bar individuals charged in enforcement actions from aspects of the financial industry rather than a specific segment of the industry.

Following release of the plan, Treasury Secretary Timothy Geithner testified before the Senate Banking Committee on June 18 that regulators were ill-equipped to spot threats because each was assigned oversight of individual institutions and none were assigned to look out for the system as a whole. "A patchwork of supervisory responsibility; loopholes that allowed some institutions to shop for the weakest regulator; and the rise of new financial institutions and instruments that were almost entirely outside the government's supervisory framework left regulators largely blind to emerging dangers," Geithner said.

Senate Banking Committee Chairman Christopher Dodd (D-Conn.) and House Financial Services Committee Chairman Barney Frank (D-Mass.) said that Congress would pass legislation implementing the administration's regulatory reform plan by the end of this year. Dodd, however, echoed concerns raised by many investors and other parties about the plan's expansion of the Federal Reserve's regulatory authority over all companies noting that "there is not a lot of confidence in the Fed at this point."

Geithner defended the administration's plan to beef up the Fed's powers. He said the Federal Reserve, not the new Financial Services Oversight Council, is best positioned to respond to a financial crisis because "you don't convene a committee to put out a fire." He added that the Fed already supervises and regulates bank holding companies, including all major U.S. commercial and investment banks. "Our plan gives a modest amount of additional authority - and accountability - to the Fed to carry out that mission." Geithner also was quick to point out that the plan also removes some of the Fed's authority by transferring its oversight responsibility for consumers to the new Financial Consumer Coordinating Council.

Candid Pictures from PAPERS 5th Annual Forum – May 2009

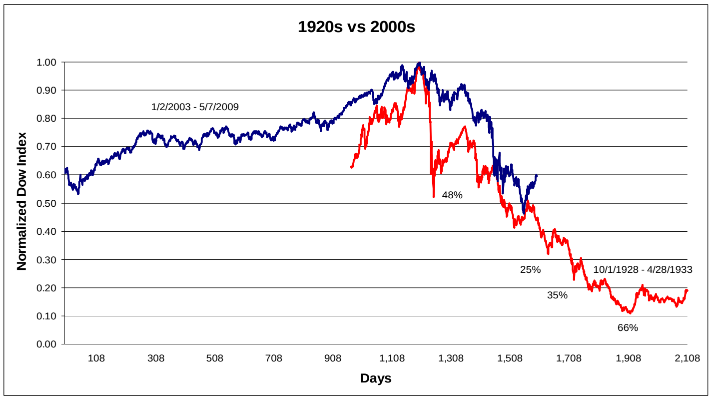
"History Does Not Repeat Itself, But It Sure Does Rhyme" - *Mark Twain*

By: **Shawn C.D. Johnson**
Chairman, State Street Global Advisors Investment Committee

The question I am asked most by clients these days is, "is this a bear market rally?" Perhaps more concerned clients ask "are we entering a depression?" No one really knows for sure, but the subject does deserve some thought.

From a very high level there are four similarities between what happened in the 1920s and 1930s and what is happening today. First, the problem of the 1920s boom/bust started in the US. Our current crisis also started in the US. Second, there was excess leverage in the system fueling the speculation in the 1920s. This excess leverage was generally in the form of buying stocks on margin by individual investors. Today's crisis has much more to do with leverage in retail mortgage products, broker dealers and absolute return strategies – but it is leverage nonetheless. Third, we have home price deflation in the US at the national level. While we have had local real estate price corrections in past recessions, we have not really seen material national home price level declines since the 1930s. Lastly, we have massive policy intervention in the form of fiscal and monetary stimulus. In 1930 this came in the form of the Smoot-Hawley Tariff Act, which dramatically increased taxes on goods imported to the US. Today's intervention is in the form of fiscal stimulus and something economists call "quantitative easing." You could also simply call this "fixed income market manipulation," but it is just another form of policy intervention. In this case, the government is buying mortgage debt in astounding amounts — estimated to be in the hundreds of billions of dollars — to keep mortgage rates low in an effort to stabilize, or perhaps re-inflate, home prices.

The truth is while some of the governmental actions taking place around the world today are helping in the short run, we need to admit that we are making mistakes. Hopefully, the mistakes won't be as disastrous as those in the 1930s, but we need to realize we won't get everything correct. That shouldn't prohibit the central banks of the world from being the lenders of last resort, but we should realize that sometimes trying to keep things working the way we are used to often inhibits us from finding the new normal.



Source: Yahoo Finance, SSgA Analysis
The above example is for illustrative purposes only. Past performance is no guarantee of future results

As they say, a picture is worth a thousand words. The ***above*** chart depicts the Dow Jones Industrial Average indexed to the market peak both today and back in the 1920s. I wonder what people were thinking when the market rallied 48% after the 1929 crash, only to fall further over the coming years? I doubt today's equities market will follow the same pattern, although we too are experiencing a nice rebound after a tremendous downturn. The only thing I can conclude from looking at the data is that it is simply too early to tell if we are headed into a worsening situation. Certainly the market's behavior seems to indicate that the worst is behind us. However, I am not convinced that the future is one without trouble.

The US economy runs on credit. A tremendous amount of credit has been removed from the system and has yet to be replaced. This is also true in much of Europe. Most US recessions since WWII have been inventory corrections. This recession was started via a liquidity crisis in the asset backed mortgage market, which has never before been the precursor to a recession.

The uniqueness of this recession has unusual implications for different asset classes. Liquidity continues to be at a premium. This has caused a bubble in short term US Treasury securities. And the broader fixed income market would be suffering from continued illiquidity if the government were not "actively managing" it. Real estate of all kinds, particularly commercial property, is suffering from price declines and the inability to refinance. The asset backed marketplace, usually used by banks to manage cash and cash like investments, continues to not function properly. The TALF program launched by the Federal Reserve was put in place simply to re-launch new issuance of the

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History Does Not Repeat…

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highest credit tiers of consumer asset backed securities. This segment has shown signs of life but TALF overall has been marginally successful in breathing life back into ABS markets as new consumer asset backed issuance is far lower than the historical norm and the commercial mortgage backed market remains closed.[1] So, we are a long way from where we were, and we are not yet at a 'new normal'. I doubt we will ever see the asset backed marketplace return to its former state, which means the economy will have to find a new balance sheet to finance everything from auto loans to credit cards to student loans.

So what is an institutional investor to do in a market like this? The peril of managing a diversified portfolio using a maximum return/minimum variance strategy shows its weakness at a time of crisis. Just when you need help from diversification asset correlations move to '1' and values drop across all asset classes. Most institutional investors are unable to move quickly due to numerous factors such as size or committee decision making, and they are slaves to a consultant driven long-term asset allocation framework.

In addition, the industry generally models risk as a function of price volatility. Most risk models don't model liquidity, it is assumed, particularly in asset classes that have been very liquid for decades (like asset backed securities).

Going forward you will likely see asset classes return to some level of normal correlation albeit at higher volatility levels. Some fixed income instruments, particularly asset backed securities, will simply mature over time with investors seeking to deploy capital elsewhere. In addition, non-lending investment mandates will grow rapidly for the foreseeable future. Given the state of the economy, cash yields will likely remain low for a long time to come. The only exception to this is that if we enter a period of inflation (which is unlikely) or 'stagflation' (which is much more likely) the Federal Reserve may have to raise rates to limit inflationand defend the US dollar, which would simply cause the recession to be longer than it otherwise would be. I expect that the short-term strength of the US dollar followed by its long-term weakness will likely become the issue that most institutions will have to grapple with in the next few years.

I seem to recall a time when interest rates on 10-year US Treasuries were well over 10%. Could US corporate bonds trade inside of US Treasuries? Let's hope we don't end up there.

So, the answer to the question is that in order for this not to be a bear market rally, the US economy needs to start growing again as we enter 2010. Otherwise, the US equity market price levels are discounting growth that is pretty far out into the future. When was the last time you heard a US CEO talk about top-line growth? That doesn't mean the equities market will decline - it might just do nothing for a while.

As to whether this is the front end of a depression or not, it is simply too early to tell. The US credit market needs to find a 'new normal' in order for the US economy to find a 'new normal.' For that to happen we need to ease the federal government out of its current market support role, thus de-leveraging it, without further market disruption and in time to keep the US dollar from declining. No matter what, that will take time.

[1] Remarks from William Dudley, President and Chief Executive of the Federal Reserve Bank of New York, June 4, 2009.

Shareholder Education Website

PAPERS Associate Member Broadridge Financial Solutions has launched a new shareholder education website *www.shareholdereducation.com* designed to provide retail shareholders with important information about the proxy voting process. The website details the proxy voting process and includes information on proxy materials, methods in which shareholders can cast their votes, and a brief history of the evolution of the proxy process – including the new Notice and Access form of proxy materials that many shareholders have begun to receive.

Shareholders can also find helpful investor links, as well as a glossary of investment and proxy terms that could be important to retail shareholders as they track their investments and vote their proxies. The site also features an interactive tutorial that guides users through the proxy voting process from start to finish.

The goal is to provide education and information to the investing public – and to increase awareness of, and participation in, the important proxy voting process.

Credit Rating Agencies and the Economic Meltdown

By: Andrew D. Abramowitz
PAPERS Corporate Advisory Committee & Partner, Spector Roseman Kodroff & Willis, P.C.

Anyone who participates to any extent in the investment realm – *investors of all sizes, issuers of securities, investment brokerage houses* – is at least vaguely aware of the role of credit rating agencies in the market. Rating agencies, such as Standard & Poor's, Fitch, and Moody's, evaluate the creditworthiness of the issuers of securities and the securities themselves, and publish a corresponding rating for the investment community. Money managers rely on these ratings because the nature and amount of risk a client will tolerate informs all types of investment decisions.

Rating agencies, however, have come under increasing scrutiny in recent years, particularly since the financial crisis. The criticism has come in many forms, but it seems to have been triggered by the subprime meltdown and the errors in judgment that many rating agencies have made with respect to mortgage-backed securities. Some have accused the rating agencies of having too close of a relationship with the companies whose securities they evaluate, thus creating the potential for a conflict of interest. Others have charged that the rating agencies have dropped the ball in terms of due diligence. They have, in effect, posted high creditworthiness ratings for instruments that don't deserve them, thus encouraging investment in debt securities that have a much greater likelihood of default than investors could reasonably anticipate. At the end of the day, these accusations lay a portion of blame for the subprime meltdown at the feet of the major credit rating agencies – specifically, S&P, Fitch, and Moody's.

This is a pertinent topic of conversation because institutional investors, including public pensions, have recently sought to hold the rating agencies accountable for these purported transgressions – especially since the rating agencies had massive increases in revenue during the real estate boom, no doubt benefiting from their own rosy broadcasts. In the past, redress against the rating agencies has been challenging. They have defended themselves with the First Amendment, arguing that like the press, their reports are protected except where a plaintiff can prove "actual malice" in the publication of a particular rating. S&P made that very argument to Congress in fighting against enactment of the Credit Rating Agency Reform Act of 2006, which was designed to allow the SEC to hold rating agencies accountable for unreliable ratings and other abuses. The Act permits the SEC to inspect the agencies, even if it does not permit them to exercise any control over their methodologies. However, the very enactment of the law opened the door to a preemption argument from the rating agencies – namely, that only the SEC could take action against them, not private investors.

But things may be changing. Two federal court decisions within the past year give investors hope. In February, a court in New York found that some elements of a cause of action under the federal securities laws were satisfied in a class action against Moody's brought by the Teamsters Local 282 Pension Trust Fund (and others). In that case, *In re Moody's Corp. Securities Litigation*, the court made a number of encouraging findings, including that the plaintiffs had adequately alleged that Moody's misrepresented its independence and ratings integrity, particularly in the face of revelations that it changed its ratings at the request of certain issuers. The court noted that there is a real potential for conflicts of interest, due to the fact that the institutions paying Moody's for a rating are the very ones that would benefit from a positive rating.

Likewise, last July, a federal court in Ohio upheld certain claims by New York pension funds against Fitch. The claims, in *In re National Century Financial Enterprises, Inc. Investment Litigation*, arose out of credit ratings of National Century Financial Enterprises by Fitch and Moody's. The ratings were unduly positive, and when National Century went bankrupt amid allegations of financial fraud, the plaintiffs lost the value of their investment. That court held that the New York pension funds adequately stated a claim for negligent misrepresentation and aiding and abetting fraud.

While neither of these decisions represents a determinative finding of liability, they could very well energize institutional investors – including those in the public pension world – who have been burned by the subprime meltdown. In an investment community where so many money managers rely upon the research and reports of credit rating agencies, accountability and recovery of improperly obtained profits does not seem like too much to ask.

Too Soon To Stay Comeback?

While Private Real Estate Struggles, Listed Real Estate is Showing Signs of Life

By: Ronnee Ades

PAPERS Corporate Advisory Committee & Head of Alternatives, FTSE Group

Over the past few months, there have been whispers that real estate is making a comeback. But what does this really mean? When referring to real estate for portfolio allocation purposes, it is safe to assume that we are talking about commercial, or income-producing, real estate as opposed to the housing market. Examples of commercial real estate include office buildings, storage facilities, retail space, and apartment complexes.

There are two broad markets for commercial real estate – the private market and the public market. The private market is much larger and involves the purchase of commercial property through direct investment or private equity pools on the equity side, or the purchase of credit derivatives such as commercial mortgage backed securities (CMBS) on the debt side. Unfortunately, the performance of private commercial real estate is still rather dismal as fundamentals across all property types remain poor. With weakening demand from consumers, income from rentals has been declining and vacancy rates have been increasing. Hotel properties have also experienced significant pressure on revenues with record low occupancy rates. The current credit crisis with banks unwilling to lend has made financing (and refinancing) of real estate properties nearly impossible. Banks are not making loans for the purchase, development and/or refurbishment of commercial property, and secondary markets have slowed to a near stand-still. All of this has hurt property values and contributed to fewer and fewer transactions in private real estate markets.

Publicly listed commercial real estate consists of real estate companies that own and manage properties and list on public stock exchanges. Real Estate Investment Trusts (REITs) are a primary example of this type of real estate. Investors can purchase these companies' stocks on the equity side, or their bonds on the debt side. Investors can easily move in and out of such holdings because they are tradeable, whereas private property investments are illiquid. Because of listed real estate's inherent liquidity, its performance tends to lead private real estate both on the way down and in recovery. When equities markets began their sharp decline in late 2008, REITs and other listed real estate were sold off quickly because they are tradable and their stock prices were negatively affected. Private property values, on the other hand, take longer to reach their bottoms and to recover from them.

What is happening now seems to be the beginning of a recovery for the REIT market as listed real estate stock prices are rising and have shown dramatic improvement after having lost 73% in total returns since their previous peak on February 7, 2007. As of the market close on June 23rd, 2009, US equity REITs have gained almost 51% from hitting their trough on March 6th, 2009. Another positive signal beyond stock price recovery has been the $18.6 billion in new capital raised this year by REITs. They have been able to tap the public equity markets and use the funds to pay off debt and strengthen their balance sheets. It also puts them in a good position to take advantage of the sale of distressed properties, something the private side of the market cannot easily do.

Across all major geographic regions, including Europe, the Middle East, Africa, Asia-Pacific, and most notably North America, share price of public real estate companies have risen about 30% to 40% since March. The FTSE EPRA/NAREIT North America Index, which includes US REIT giants such as Simon Property Group, PublicStorage, and Vornado Realty among its top constituents, posted a 74% recovery since the beginning of the year. So while it may be too soon to say "comeback," there are encouraging signals from the publicly listed real estate market.

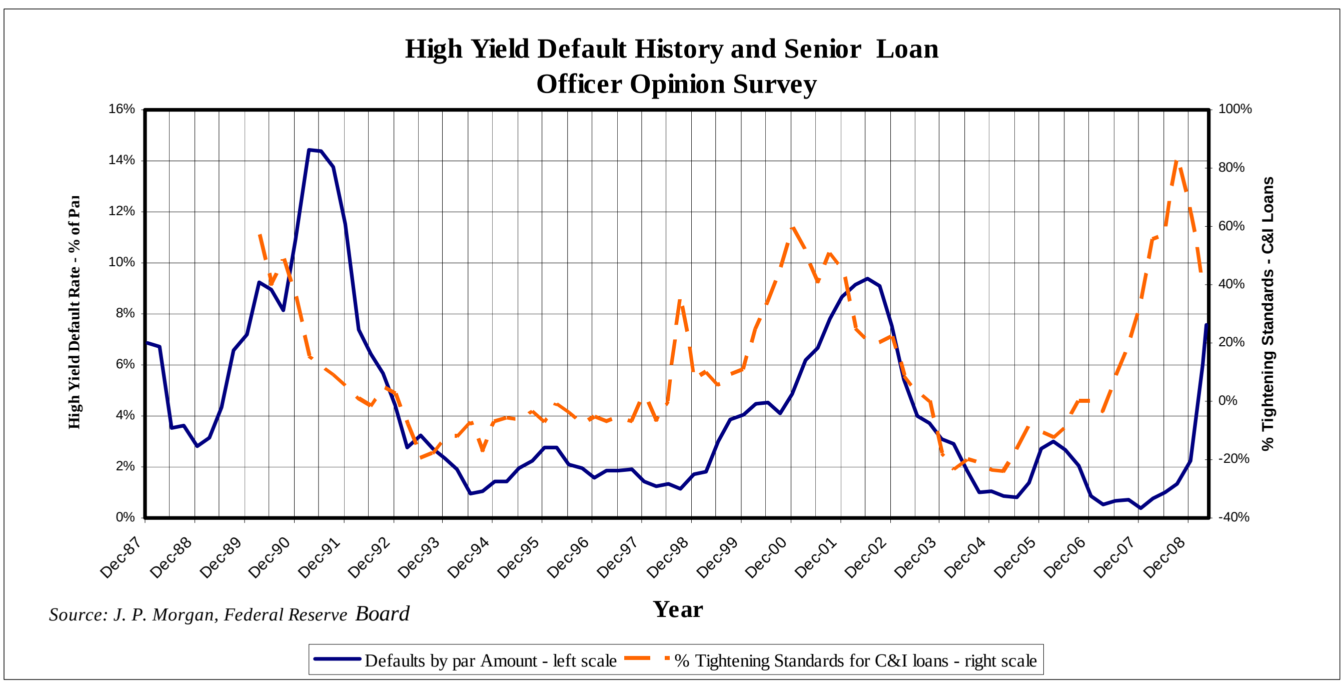
This Time the Government is on Our Side

By: Robert Levine CFA

The worst is over. The current economic downturn was driven by the credit markets and so will the upturn. Although the private sector is not yet ready to lend, the governments of the world are working furiously to provide liquidity.   This liquidity will ultimately lead a credit-driven recovery that will permit businesses to function and allow the economy to begin growing again.

In a typical credit crunch, otherwise sound businesses go bankrupt due to a lack of liquidity –e.g., when they cannot get funding for debt refinancing, completion of partially funded new projects, working capital, etc. As a result, defaults increase in all credit sectors, including the High Yield Bond market. In the recession of 1990-91, the government restricted credit, thereby exacerbating the downturn and harming corporate borrowers. This time around, the government has turned the liquidity spigot wide open. This government intervention is the reason that we cannot look at the default peaks of the 1990s as precedent for the future. While the default rate will increase, defaults should be fewer than would have been the case without government intervention.

The need for liquidity is clear. Twenty years ago, the government imposed stringent lending restrictions to prevent highly leveraged transactions. As a consequence, High Yield bond defaults rose to a peak of over 14% (by par value) from 1990 to 1991. The Senior Loan Officer Opinion Survey compiled quarterly by the Fed measures the proportion of banks that are tightening or loosening lending standards. While data from the survey only goes back to 1990, the chart below shows vividly how the progressive tightening of standards for commercial and industrial loans that began early in 2007 and reached a crescendo during the financial meltdown late last year presaged the credit meltdown of 2008/2009.



While the run-up in default rates during the current recession is reminiscent of the early 1990s and may ultimately exceed the previous peaks, meaningful differences exist that support an approaching bottom of the economic downturn. Today, governments here and abroad are firmly committed to ending the crisis. Rather than looking for scapegoats, they are pouring tons of liquidity into the financial system. This is different from the environment twenty years ago, when leveraged finance was viewed as a device for facilitating hostile takeovers.

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But some things remain the same. Bidding competition among take-over firms pushed leverage in target companies to levels that could not withstand the 1990-91 credit contraction. Both then and now, LBO firms frequently added fuel to the fire by dividending back initial equity investments to themselves so that they "played with the house's money." Managements of companies in mature industries, such as building products, also did leveraged recapitalizations, paying large dividends to shareholders partly in order to forestall hostile raids.

In 1990, there was a populist political backlash against hostile leveraged transactions stimulated by fear of job losses that appeared to hurt local communities. Some of the raiders were not politically adept, which may have added to the antagonism. While it is true that similar financing strategies have been employed in the current highly leveraged period, with some of the same players, most of the transactions have been consensual. Twenty years ago, the negative sentiment toward *hostile* takeovers was reflected in the popularity of such books of the time as *The Predators' Ball, Den of Thieves*, and *Barbarians at the Gate*.

Partially as a consequence of the popular outrage of the takeovers of the late 80's/early 90's, the Federal government moved to rein in lending for highly leveraged transactions. The Fed prohibited banks from lending into so called "HLT's". S&Ls and insurance companies were discouraged or barred from investing in all below investment grade debt. The consequence was the elimination of natural buyers for the asset class, contributing to the credit crunch and economic decline that ensued. Not only was bank lending constrained, but the bond market was essentially closed to corporate borrowers.

This time, the regulators are trying to unfreeze the banks and credit markets. In the current crisis, the sheer breadth of the institutions and individuals involved directly in borrowing and lending excesses has prompted governments around the world to take action to do whatever is possible to restore balance to the financial system. As a result, the percentage of lending officers that are tightening bank lending standards is beginning to retreat from the historic highs reached at the end of last year.

A major problem, however, continues to be that the inclination and capacity of the banking system to lend is greatly reduced. The former investment banks, now commercial banks, have had to de-lever substantially in order to comply with regulatory capital standards. There is also some legitimate concern as to the adequacy of the reserves for toxic assets still on their books. As portfolio lenders, we think that they are being overly cautious in their underwriting.

Under these conditions, we believe that other parts of the capital markets must, and will, recover in order to provide the liquidity needed to get the economy growing again. Our government wants and needs this to happen. To date, it has focused on supporting the banking system by providing capital, raising deposit insurance limits, guaranteeing bank debt issuance, and supporting securitization through the TALF. The Fed is also acting aggressively to keep rates on government bonds low, stimulating borrowing while leading investors to search for more attractive yields. Unlike the early 1990s, the government is not impeding the capital markets and is allowing them to begin the healing process.

Investors have recognized the oversold condition of credit markets and have shown a strong appetite for investment grade corporate debt, convertibles, and debt issues by High Yield companies. Much of this new financing has been used to repay bank debt, extending maturities for the issuers and improving capital ratios in the banking sector. With the government now aligned with the capital markets, we now expect to see a credit-driven recovery that will permit businesses to function and allow the economy to begin growing again.

Mr. Levine, a long term investor in High Yield Bonds, is the Chief Executive Officer of Nomura Corporate Research and Asset Management, Inc. [NCRAM.] The views expressed in this article are his and do not necessarily reflect those of NCRAM or its affiliated entities.

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