

Letter from the US

State debate hots up

MARIA TERESA COMETTO

The debate about US public employees' pension benefits is hotting up, and the results will have a great impact on the pension fund industry. For the first time there is a discussion about the real costs of promises made by politicians to public sector employees and the bill to tax payers. In fact, the whole matter is extremely political, as one can see from the very different approaches of two neighbouring states, Wisconsin and Illinois.

Illinois is one of the most financially troubled states: its pension system has unfunded liabilities of at least \$80bn (€58bn). In order to pay its annual contribution to the state pension fund, Illinois sold \$3.7bn of bonds last February. But Governor Pat Quinn, a Democrat, is not thinking of any radical change of the public retirement system, besides the partial reform that was already approved last year (applying only for new hires). However, the Wisconsin Retirement System is one of the better funded plans in the country, according to a Pew Center on the States report, with a funded ratio of nearly 100%, based on its own assumptions.

But the new governor, the Republican Scott Walker, wants to look deeper at the state's

financial situation, even after he succeeded in raising the state employees' contributions to the fund from zero to 5.8% of their pay. So he may take further action after the release of new pension cost estimates, which were requested last October by the executive director of the State of Wisconsin Investment Board, Keith Bozarth (the details were not known at time of going to press). Bozarth thought it was time to revisit the pension state fund's assumption of an annual return of 7.8%: if it is lowered, contributions must increase or benefits must decrease.

Walker is one of the new generation of Republican governors who are not shy of confronting the unions on behalf of the taxpayers: his bill to curb dramatically the collective bargaining in the public sector has drawn protests from Democrat activists for weeks, but he went through all of that until he won. His next step could be to introduce a 401(k)-style plan for public sector employees, as he said he would during the electoral campaign. The same shift from defined benefit (DB) to defined contribution (DC) is being evaluated in many US states.

One vocal backer of this shift is Joshua D Rauh, associate professor of finance at the Kellogg School of Management at Northwestern University. "State and local governments have

failed to recognise the cost of promises provided by taxpayers," he wrote in an op-ed on the New York Times. "The public pension debt is actually \$3trn beyond the assets set aside." That figure comes from assuming investment returns lower than the average 8% used by the states and more in line with insurance companies' models. If the necessary increase in contributions is too high, the only alternative to start up DC plans, Rauh concludes, who suggests copying the model of the Thrift Savings Plan (TSP), which is working well for the employees of the federal government (see IPE January 2011).

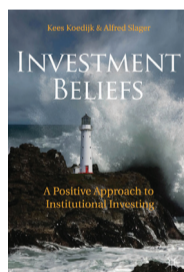
Opposing this solution is economist, Teresa Ghilarducci at the New School for Social Research. She claims that 401(k) plans would cost taxpayers more, because they have higher fees, they cannot retain good workers and they destabilise the economy and financial markets.

Other are concerned that 401(k) plans cannot provide sufficient retirement income. However, the experience of the private sector, with the shift from DB to DC plans, is reassuring according to Jack VanDerhei, the research director of the non partisan Employee Benefit Research Institute. His studies show that employees – after a full career of eligibility in a 401(k) plan – can have retirement payouts of between 43-57% of pre-retirement income. Which is acceptable when added to Social Security benefits, which can vary from 36-69% of pre-retirement income according to estimates by Aon Consulting and Georgia State University (GSU).

But research by the independent consultant Sylvester J Schieber, to be published in the Journal of Pension Economics and Finance, shows that the real issue is not the DB versus DC, it is about the retirement age in the public sector: state employees can often start claiming their pensions in their 50s, meaning they will get benefits over a longer period.

Books The wheat and the chaff

'Investment Beliefs: A Positive Approach to Institutional Investing', by Kees Koedijk and Alfred Slager, 2011, 205 pages



AMIN RAJAN

This book is long overdue.

It is as meticulous as it is insightful and its central contention is indisputable – namely: that the previously accepted guidelines and truisms in investments are open to challenge; that proactive, informed investors can positively impact investment outcomes through their actions; and that investment is an art, not a science.

Accordingly, investment beliefs are the new magic wand. Or, as the authors Kees Koedijk and Alfred Slager put it: "Having the right investment beliefs and putting them into practice is key to delivering the right results."

As I read this sentence, I was dumbstruck. Why? Because the term 'belief' at once conjured up images of self-evident truisms pontificated from on high; something born of conviction rather than facts; something that is invariant across time and space, like a religion.

However, my disquiet soon vanished in the ensuing pages. Beliefs are not static, the authors point out. They are an essential part of adaptive learning resulting from doing things in changing

environments. Such experimental learning can result from positive experiences. But negative experiences may be an even better teacher.

For example, in the pharmaceutical industry, new discoveries mostly stem from 'failing forward' – using the lessons from past failures to progress forward. In economics, it was elegantly summed up by that memorable quote from John Maynard Keynes: "When facts change, I change my views. What do you do?" To implement this adaptive process to investment, the book is divided into three parts.

The first paints the big picture and turns the spotlight on a number of elephants in the room long ignored by the boards of pension funds. Three merit mention. The majority of institutional investors devote insufficient time to formulate investment beliefs: failure to understand investment principles leads to herd mentality. Sound beliefs only make sense within a sound governance structure: governance is the alpha behind alpha. Investment beliefs held by pension plans are not the same as those held by asset managers: misalignment and mutual misunderstanding abound beneath the surface of seemingly cosy relationships.

The second part of the book covers investment beliefs and sounds numerous health warnings. Five merit mention. It is one thing to talk about alpha, quite another to deliver it: alpha is everywhere except in performance numbers. The past may be the best guide to the future, but

it's an imperfect one: the relationship between risk and return is volatile and unpredictable. Diversification can be highly elusive: its advantages disappear when we need them most – during a crisis. Long-term investing makes sense when you have long-term contractual liabilities: but ignore the short term at your peril. Costs matter: via their compounding effect over time, they are a key source of outperformance.

The third part highlights the process for embedding beliefs into the governance structure and communicating them. Here the advice is equally cogent. Know that the investment world is suffocated by jargon: nothing is what it seems. Finance is a relatively young, immature discipline: its claim to scientific precision is spurious at best, false at worst. Market data are limited, biased, or both: the ratio of 'noise' to 'signal' is very high. The trustees must learn to ask the right questions: the world of active investment has much chaff and little wheat.

The book has three over-riding merits. First, it gives real life examples of beliefs held by reputable institutional investors around the world and how they implement them to secure decent returns. This helps a lot to put meat on what the authors mean by this normative word 'belief'. Second, although there are 16 chapters, each stands alone. The reader can home in on any one of them without having read the previous ones. Notably, each one has a common framework: starting with helicopter view; followed by

a real life a case study; followed by the theory that touches on these issues; finishing with the debates of which to be aware. Third, the book is jargon free. The hot air that normally suffocates most investment books is mercifully conspicuous by its absence. This is one of the few books I actually enjoyed reading.

So who should read this book? Everyone involved in the food chain of investing: pension boards, endowments, trustees, professional executives, asset managers, and asset servicers.

Having said all that, I would have liked to know the authors' views on three sets of systemic questions that remained unaddressed for me. To start with, is it safe to talk about paradigm shifts in the world of investment which is cyclical and self correcting? In investment matters, there is always a tendency to oversimplify the past, over-exaggerate the present and over-complicate the future. The world of investment is best considered in terms of 10-20 year cycles. There is no 'old' normal and 'new' normal: just different normals.

Furthermore, how should the rise of emerging markets change our investment beliefs? These countries will be not only the main sources of funds but increasingly their destinations too. Their long-prevailing savings culture puts a premium on capital protection and income upside. How will their rapid ascendancy affect institutional investors in the West? Do we need new lenses to foresee their impacts?

Finally, how has globalisation added ever more 'noise' in the financial markets by randomly spreading investment decision-makers across the globe such that our time-honoured investment beliefs no longer work? Economies have decoupled, but markets have not. So how do we revise our beliefs about risk premia? What is driving it now and in the near future?

But this is a credible companion for those trying to make sense of how the contemporary art of investing is fundamentally changing.

Prof. Amin Rajan is CEO of CREATE-Research

In a 'death spiral'

'The Day After the Dollar Crashes: A Survival Guide for the Rise of the New World Order', by Damon Vickers, Wiley 2011, 190 pages

CHRISTOPHER WALKER

Damon Vickers is a Seattle fund manager who, like Sarah Palin, uses folksy 'straight talk' to captivate and terrify, asserting that "American Dream is dead" and the world is facing a "death spiral". He's an outsider, a maverick. How many fund managers do you know who confess to having lived in a car or a Buddhist monastery? And, like Palin, Vickers wears his green credentials on his sleeve: nauseatingly.

The central theme of Vickers' work is that we have all been too busy playing videogames and eating badly while those pesky liberals snuck up on us and created a bloated social security system. 'They' snuck Obamacare through at 1am, obviously so no-one noticed. 'They' are never clearly identified, but appear to be whomever is convenient – the liberals, then the 'conglomerates', the 'club of economic elites', the 'health-care industrial complex', the wicked Federal Reserve or quite simply 'the Government'.

So, thanks to the 'Illuminati' and the Democrats, the US is now sinking under a mountain

of debt. This last bit is true, although Vickers' numbers seem a little rich. Okay, the US owes \$13-14trn, but are there really \$60-80trn in unfunded entitlements and \$40-50trn in promises for new entitlements? Using a trick Vickers likes, that would mean around a million dollars for every working American. Too many numbers are thrown around in this book with little explanation and few footnotes – like when he tells us 97% of trees have been cut down in North America, and there are none left in Europe!

Anyway, the death spiral. Thanks to all this Illuminati-connived debt, the Chinese are going to wake up soon and say "we ain't buyin' another darn'd US bond". After 15 days of market gyrations, currency collapse and general world panic, we succumb to global revolution. Vickers gets carried away with some real "red meat for the blue rinses", describing terrified Americans who "lock their doors, load their shotguns, hide their children". He relishes this Armageddon, stating: "We need a social uprising." For we have sinned,

with all those burgers and consumer debt.

Religion, whether Christian or Buddhist, is never far away as Vickers leads us towards a New World Order. "We are seeing a surge in spiritual consciousness that gives me great hope," he says. It also seems to give him great arrogance. Arguing for the power of positive thinking, he asserts: "We create exactly what we think... that may sound like new thought mumbo-jumbo, but your belief is not required for this to be true."

Anyway, we get to the New World Order, after the 15 days of Armageddon, by all grouping together in a small western-pioneer-town kind of way, which (somehow?) turns into a global government, a global currency and – yes, I'm afraid – a new global messiah. As Vickers says, "let's just hope we treat him right this time".

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