PAPERS PENNSYLVANIA ASSOCIATION OF PUBLIC EMPLOYEES RETIREMENT SYSTEMS

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The mission of the Pennsylvania Association of Public Employee Retirement Systems (PAPERS) shall be to encourage and facilitate the education of its membership in all matters related to their duties as fiduciaries overseeing the assets of the pension funds with which they have been entrusted. It will be PAPERS' primary purpose to conduct an annual educational forum that provides the basis for improved financial and operational performance of the public employee retirement systems in the State. PAPERS will function as a central resource for educational purposes and act as a networking agent for all public plan staff and board members.

Fall 2007 (Vol. 2, No. 4)

In This Issue

CORPORATE GOVERNANCE

EXECUTIVE COMPENSATION

By Andrew D. Abramowitz (Spector, Roseman & Kodroff, P.C.)

A hot button issue in the world of corporate governance is executive compensation. The investing community is practically flooded with sensational news stories documenting eye-popping compensation packages for CEOs and other members of senior management. A prime example is the "mutually agreed" to resignation of Home Depot CEO Bob Nardelli earlier this year. After angry investors threatened a showdown at the annual meeting over Nardelli's $38 million annual salary that was by no means in step with shareholder gains, Nardelli resigned at the January board meeting. His exit, however, included a $210 million retirement package.

In response to apoplectic shareholders, the SEC has recently overhauled rules governing the disclosure of executive compensation. In publishing its final rules over the summer, the SEC seeks to provide investors with more clearly and completely presented information as to what and how executives are paid – particularly in view of the fact that the forms of compensation have developed in ways that are difficult for shareholders to fully grasp.

The SEC overhaul is designed to accomplish various objectives. Broadly, the rules require a description – both in table format and narrative – of all compensation to be paid to each executive, as well as when such payment is to be made (current or deferred). Similarly, companies must disclose equity-based compensation both from the current year and for the future. One notable addition to the disclosure requirements is a new column to the Summary Compensation Table that requires companies to provide the total compensation from all sources. Another key provision requires greater detail on compensation upon termination or resignation.

Despite the adoption of tighter SEC rules, it is clear that changes in the levels of pay bestowed upon corporate executives must come from board compensation committees. The SEC does not interfere with the free market for salaries and does not set compensation. Rather, it promotes transparency and as full understanding by investors as possible. Indeed, more stringent SEC rules could conceivably raise levels of executive pay: CEOs will become more knowledgeable about their counterparts' compensation at other companies, and could insist upon being paid at commensurate levels.

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EXECUTIVE COMPENSATION *(continued from page 1)*

In any event, it seems abundantly clear that boards must work harder to curb these jaw-dropping packages. The ratio in pay between CEOs and average employees has skyrocketed from 42:1 to 400:1 over the past twenty-five years alone. Boards, therefore, must align executive compensation with the long-term interests of the shareholders. This can be accomplished through, among many other things: performance-based compensation, the setting of compensation by independent directors, the retention of independent and experienced consultants, and the requirement that executives build and maintain substantial investment in the company's equity.

Become a Member of PAPERS

Participating Members (public employee retirement systems) and Associate Members (corporate sponsors) can apply online at www.pa-pers.org or contact:

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A 2008 PAPERS membership will be required before registration can be completed for the annual spring Forum. Dues notices for 2008 are being distributed to all current PAPERS members in late November.

Free Service Available to PAPERS Members

PAPERS Participating Members (retirement systems and fund administrators) can get one-year free access to *Public Pensions Online*.

This is yet another important reason to become a PAPERS member. You may simply go to www.publicpensionsonline.com/member/papers.html and fill out the requested information (name, email, retirement board, etc.). Once the application is submitted, an account will be activated and you will receive an email with your personal login information.

From the PAPERS Executive Director

I recently attended a national pension conference where, instead of the usual agenda of investment workshops and economic analysis, the focus was on ***Market Pricing of Pension Liabilities***. The argument here is that only by matching your pension liabilities and funding stream with risk free assets (e.g. treasury bonds) can you insure proper funding of public pension liabilities.

In my opinion the current system of using anticipated returns has served us quite well with the exception of the 2000-2001 downturn when the tech bubble burst. The idea of pricing liabilities at the existing 10- or 20-year treasury yield would create much larger funding requirements for existing pension funds. If you suddenly were to tell your local taxpayers that you have decided to use an interest rate assumption that would double your funding requirements, and thereby also double your current contribution requirements, the outcome would be very predictable. The result could be the end to defined benefit plans.

I suggest that you make sure you understand the ramifications of trading your current 7% to 8% earning assumption for a 4% to 5% rate. Your Fund's actuary can help with these calculations. It is important for trustees to be prepared for these discussions before you are under pressure to make decisions on these complicated and emotional issues.

We will have sessions to explore both sides of this topic at the Spring 2008 PAPERS Forum. Hope to see you there!

Jim Perry
PAPERS Executive Director

Planning Ahead

PAPERS Forums have already been scheduled for 2008 and 2009!

Reserve these dates now – **April 21-23, 2008** and **April 15-17, 2009** - and plan to attend these conferences of public employee retirement systems in Harrisburg. PAPERS will be returning to the downtown Hilton Hotel for the conferences in both of these years. More details later.

The U.S. Economic Outlook

By David H. Resler, *Managing Director and Chief Economist at Nomura Securities International, Inc.*

Despite an impressive 3.8% surge in real GDP growth in the second quarter and a seemingly healthy advance in the third quarter, which the consensus pegs at a 3% rate, the U.S. economy remains mired in what might best be described as a "growth recession." Real output over the past five quarters has expanded at a feeble 2% rate, well below the post-World War II average of 3.2%. Indeed, real GDP has grown slower than over the past five quarters only in periods of recession.

Significantly, the five-quarter growth rate is roughly a full percentage point less than the economy's presumed potential rate of growth, which owing to slowing population growth, is believed to be about 3%. Moreover, the mid-year bounce in growth did not contain the key elements of a sustainable upturn. For instance, domestic source demand grew just 2.1%, the fifth consecutive quarter of growth at 2.1% or less. One result of that weaker domestic demand, imports fell for the first time in over four years, adding about 0.5% to Q2 GDP growth. To be sure, third quarter developments suggest the sharp second quarter slowdown in consumer spending exaggerated the extent of moderation in household demand, but the third quarter rebound also appears to overstate the emerging trend in consumer spending.

Optimists stress that the economic slowdown mainly reflects the impact of the downturn in home-building. Since hitting an all-time high in January 2006, starts of new single–family homes have fallen by nearly 48%. As a result, investment in residential real estate adjusted for price changes has fallen by about 19.2% through the second quarter of 2007. The housing recession, which shows no sign of ending anytime soon, has reduced overall GDP growth by an average of about 0.8% since Q1, 2006. Put differently, the rest of the economy has expanded at a 2.8% pace over the past five quarters, quite close to the overall economy's presumed potential.

Virtually all metrics of housing activity point toward a continuing, if not deepening, downturn in the construction industry. While consensus forecasts reflect an optimism that the resilience shown by the rest of the economy will continue, some other sectors are beginning to show signs of strain. Though the home-building sector accounts for a seemingly modest 5% of real output, its fortunes affect a number of related industries, ranging from real estate brokering and housing finance, to a wide range of durable goods manufacturing. The longer and deeper the housing recession, the more likely these related industries will be affected. Indeed, job losses in industries closely related to the housing industry exceeded those in the residential construction sector in September.

The most serious form contagion, however, became evident in this summer's turbulence in the financial markets, which began with deepening strains in the mortgage market, whose innovative finance techniques undoubtedly inflated the housing boom. Unwinding the leverage that underpinned the home-building boom has only just begun. As this summer's financial market turbulence demonstrated, the breadth and depth of its eventual impact remains uncertain with the risks skewed toward a larger rather than a smaller negative effect.

Facing near paralysis in the money and credit markets this summer, the Federal Reserve and other central banks successfully stabilized the markets with massive infusions of liquidity. The Federal Reserve followed up with a surprisingly bold 50-basis point reduction in the federal funds rate target in September and it seems likely that policymakers will take further action in the weeks and months ahead.

Another recent development poses new challenges for the economy as nears the sixth anniversary of uninterrupted expansion. The surge in oil prices just ahead of winter could force consumers to divert a larger share of the household budget toward home heating and away from discretionary spending. Recall that a sharp increase in natural gas prices in the winter of 2000-01 led to an abrupt slowdown in consumer discretionary spending that helped drive the economy into recession that Spring.

Despite these threats to continued expansion, the consensus of professional forecasters judge the neither contagion from the housing slump nor surging energy prices will overwhelm the more positive forces that have propelled the expansion during the housing downturn. In particular, the strong global economy – powered by the accelerating modernization of the Chinese and other Asian economies – has spurred strong demand for U.S.-made goods and services. Indeed, export growth has contributed about 0.7% to the growth of GDP over the past five quarters – enough to offset nearly all the drag from the housing recession. Slowing growth in imports has also enabled domestic production to fulfill a larger portion of domestic demand, but too sharp a decline in import growth could sap some of the vibrancy from other economies. As with the trade sector, business investment in plant and equipment remains a solid support for expanding production. Like exports, however, a persistent slowdown in consumer spending could induce similar cuts in capital spending.

In the final assessment, the positives supporting growth seem to outweigh the negatives. The remarkable resilience demonstrated by the U.S, economy in the face of "shocks" ranging from natural disasters (hurricanes, blizzards, tornadoes, floods and wildfires) to man-made catastrophes (the 9/11 terror attacks, the accounting scandals, the tech bubble implosion, and the LTCM crisis) justifies optimism that the economic expansion will continue, albeit at a subdued pace.

First Fall Workshop Held in Pittsburgh

PAPERS held its first ever fall educational workshop in Pittsburgh on September 26th. Although the response was not as great as we had hoped, we were very pleased with the quality of the presentations and received many favorable comments from those systems that participated.

The opening session was a lively panel discussion on ***"The Proposed Statewide Municipal Retirement System"***. Obvious differences of opinion both pro and con were expressed by panelists: **Jim Allen**, Executive Director of the PA Municipal Employees' Retirement System; **James McAneny**, Acting Executive Director of the Public Employee Retirement Commission and **Diane Warriner**, representing State Senator Jane Orie.

Philip J. Orlando (photo insert) from Federated Investors presented ***"Economic & Equity Market Outlook"*** while **Gordon Johnson** of Allegiant Asset Management discussed ***"Why Small Cap Stocks Performance May Surprise you Going Forward".***

The afternoon was concluded with ***"Indexing 101"*** featuring **James Brophy** of Standard & Poor's and **Jim Zauner** of Dow Jones Indexes. PAPERS Executive Director **Jim Perry** moderated this presentation.

Special thanks to these corporate sponsors that provided financial support for this workshop:

- **Allegiant Asset Management/National City**
- **Dow Jones Indexes**
- **Federated Investors**
- **Information Management Network**
- **Standard & Poor's**

PAPERS hopes to sponsor one or more workshops in different parts of the state each year in addition to the annual Forum held in Harrisburg.

Pennsylvania Association of Public Employee Retirement Systems

4th Annual Forum

April 21-23, 2008
Hilton Hotel
Downtown Harrisburg, PA

The annual PAPERS forum is the most important conference for public pension plans in Pennsylvania. The conference is organized as the annual gathering of members of the Pennsylvania Association for Public Employee Retirement Systems (PAPERS). This year's program will focus on issues such as funding levels, asset/liability management, actuarial assumptions, fiduciary responsibility and liability standards, uniformity of retirement benefits across varying systems, investment management analysis, asset allocation decisions, the role of the consultant and money manager, prudent investing policy and guidelines, fee management and auditing controls. The conference also serves as the annual meeting for the PAPERS organization. A highlight of last year's program was Ron Ryan's (Ryan ALM) opening presentation, which provoked much discussion and controversy over his proposed focus on liability management. The fourth annual Papers Forum will follow up on that discussion with a debate between plan representatives and Mr. Ryan.

The Forum is once again being produced by IMN (Information Management Network). Details will be sent to all PAPERS Participating and Associate Members early in 2008. For advance information, contact:

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