PAPERS PENNSYLVANIA ASSOCIATION OF PUBLIC EMPLOYEES RETIREMENT SYSTEMS

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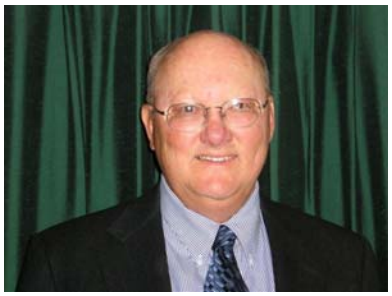
The mission of the Pennsylvania Association of Public Employee Retirement Systems (PAPERS) shall be to encourage and facilitate the education of its membership in all matters related to their duties as fiduciaries overseeing the assets of the pension funds with which they have been entrusted. It will 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.



From the PAPERS Executive Director

A Great Fall Workshop

We had a very successful fall workshop with over 50 people registered. The facilities at the Desmond Hotel and the presentations were all first rate. Below is a summary of some of the material presented.

Fall 2008 (Vol. 3, No. 4)

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It's Membership Renewal Time

PAPERS is now accepting memberships for 2009. Any PA public employee retirement system may become a Participating Member for $95/year. Entities that regularly conduct business with public pension plans may support the work of PAPERS by becoming Associate Members for $1,000/year. Current PAPERS members will be receiving 2009 invoices on or about Dec. 1st.

For details, contact Jim Perry *perryja1@comcast.net* or Doug Bonsall *douglas.b@verizon.net*.

What Pensions Mean to You? - *Beth Almeida, National Institute for Retirement Security* - Beth talked about the importance of maintaining Defined Benefit Pension Plans. She discussed the financial benefits that accrue to the local economy when retirees reinvest their pensions in the local economy. The benefits are multiples of the original investment by the governmental unit.

Economic Outlook - *Chris Probyn, Chief Economist, State Street Global Advisors* - Chris did an excellent job of discussing the state of the economy and explaining what we should expect in the near future. In his presentation entitled "Five Reasons to Worry about the World", he discussed the boom that lead to the bust we are experiencing in the U.S. today. He also discussed the major risks we face going forward. He talked about some of the stressors and some positives in the current environment.

Issues Facing Local Pennsylvania Public Pension Plans - *Alan Randzin, Treasurer Chester County; Craig Ebersole, Treasurer Lancaster County and Bernie Mengeringhausen, Controller Wilkes-Barre* - The panel discussed some of the issues they face on a daily basis in the operation of their pension plans. One major issue that all three discussed was the impact of political pressure on their ability to operate their plans.

Asset Allocation Trends - *James Allen, Secretary of PA Municipal Retirement System (PMRS)* - Jim gave a powerpoint presentation on the Asset Allocation study recently completed for PMRS and explained the rationale for the allocation selected by the PMRS Board.

Alternative Investment Strategies - *Seth Yablonovitz, Ashford Consulting Group; Frank Sustersic, CFA, Turner Investment Partners and Tony Cottone, Meridian Capital Partners, Inc.* - This panel explored

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From PAPERS' Executive Director
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several alternative strategies developed to deal with the current market environment and to help Plan Sponsors attain their actuarial targets. Tony focused on the Hedge Fund of Funds approach and Frank discussed more traditional enhanced approaches to alternative investments.

What You Should Know about Drops, COLAs & Pension Schemes - *Moderator: Joe Marcucci, Deputy Chief Counsel SERS and panelists Greg Stump, EFI Actuaries and Charles Friedlander, Municipal Finance Partners* – The panel talked about various benefit changes and how to determine the true cost and consequences of these changes in your pension or retiree healthcare benefits programs.

Taking Advantage of the Dislocation in the Credit and MBS Markets - *Vesta Marks - Utendahl Capital Management* - Vesta presented a power point presentation discussing the causes of the current financial crisis that we are facing and explored opportunities that are developing for investors as a result of the recent turmoil in the credit and mortgage markets.

How Global Warming will Affect Global Markets *Moderator: Jeff Clay, Executive Director, PSERS and panelists Kevin Bourne, Managing Director - HSBC Bank and Joaquim de Lima, Director - HSBC Bank* - Kevin and Joaquim presented a fascinating report about a study the bank recently completed for a major European Pension Fund to identify opportunities and pitfalls from the impact that global climate change may have on the financial markets and global investment practices.

Legal Issues Affecting Local Retirement Systems - *Moderator: Joauna Riley, City of Philadelphia Board of Pensions & Retirement and panelists: Jennifer Mills, PSERS/PMRS and John A. Nixon, WolfBlock.* Jennifer discussed pension forfeiture, domestic relations orders and other administrative legal issues. John focused on the recent decision by the IRS to begin taking a closer look at Public Pension Funds and to require them to request formal qualification letters to maintain their current favorable tax treatment.

Yes, plenty of important pension information was shared at the 2008 PAPERS Fall Workshop!

Jim Perry, PAPERS Executive Director

Special Thanks to our Fall Workshop Sponsors

- **EFI Actuaries**
  Washington, District of Columbia
- **GE Asset Management Inc.**
  Stamford, Connecticut
- **HSBC Bank**
  London, United Kingdom
- **Meridian Capital Partners, Inc.**
  New York City, New York
- **Schiffrin Barroway Topaz & Kessler LLP**
  Radnor, Pennsylvania
- **State Street Global Advisors**
  Boston, Massachusetts
- **Turner Investment Partners**
  New York City, New York
- **Utendahl Capital Management**
  New York City, New York
- **Vanguard**
  Malvern, Pennsylvania

Looking Ahead...

The 5th annual PAPERS Forum will be held April 15-17, 2009, at the Hilton Hotel in downtown Harrisburg. Look for information about this conference early next year and plan to attend.

Free Service for 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. 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.

Investors Fight Back:
Recovering Some of What Our Retirement Accounts Lost in the Wall Street Collapse

By: Andrew Abramowitz
Spector, Roseman, Kodroff & Willis, P.C.

The collapse of the subprime mortgage industry and the severe credit squeeze has brought dire financial distress to Wall Street, as well as towering waves of uncertainty for anyone with even the remotest interest in the financial markets. There is one element to this crisis, however, that is not at all uncertain: investor anger and despair.

Shareholders have watched as their investments in previously reliable companies – Merrill Lynch, Wachovia, Morgan Stanley, Fannie Mae, Freddie Mac, among others – have fallen over breathtaking precipices. The plunge in share prices has had, and is likely to continue to have, a significant impact on the retirement strategy of many Americans. Pension and 401(k) monies have been placed in corporations that – unbeknownst to the investing public – were excessively leveraged in collateralized debt obligations (CDOs), and in the midst of the fallout, the work force must now figure out a plan for the future.

Not surprisingly, the Wall Street collapse has triggered a substantial amount of litigation, both on a class-wide basis and individually by large investors who suffered extreme losses in a particular security. Investors feel deceived by these large financial institutions – not only was management over-committing to CDOs, but it failed to inform the market about the extent of these investments. Exposure to such securities, which are connected to the subprime mortgage industry, drained the corporate coffers as the real estate market

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Investors Fight Back

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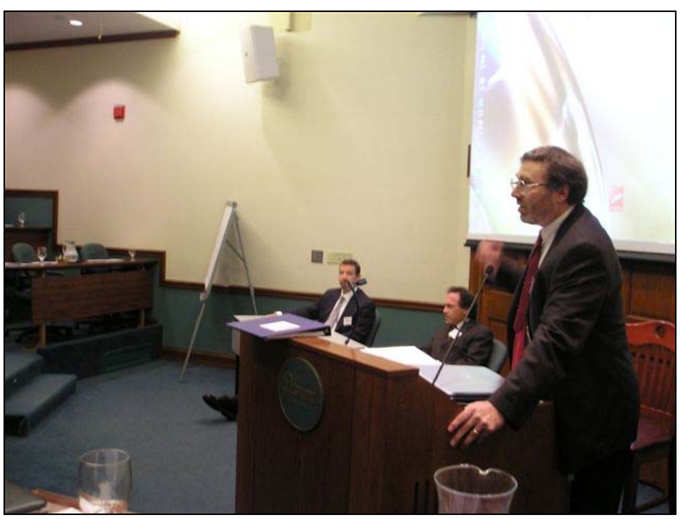
tanked and defaults on payments rose. These suits allege that senior management should have been wise to the risky nature of these investments – particularly given early signs of trouble in the housing market. Mortgage lenders such as Countrywide and New Century went public with their financial woes back in early 2007. Such storm warnings, investors claim, should have tipped off corporate boards as to the precariousness of tying up assets in that market.

These lawsuits, however, are not without their challenges. Investors may be hard-pressed to establish a breach of fiduciary duty on the part of management or a knowing violation of the federal securities laws. After all, the mortgage-backed securities market tanked fairly quickly and the housing market had been robust for years. The afflicted companies are sure to argue that they could not have foreseen that an investment vehicle that had been highly regarded by all would slide so drastically so rapidly.

Whether such arguments carry the day remains to be seen. However, it is clear that litigation is one avenue that investors will continue to explore in an attempt to recoup as much of their dwindled investments as possible.



A candid shot from one of the presentations at the 2008 PAPERS Fall Workshop

You Have Nothing to Fear but Fear Itself:
Understanding Turmoil in the Financial Markets

By: Alistair Lowe, CIO, Global Asset Allocation and Currency

The question on everyone's mind is what is going on in the financial markets and what will happen next. By the time you read this, I can guarantee markets will have moved and there will be new news, but I'll try to put things together in a bigger context. To understand why the markets are in turmoil and why the "bailout" had to happen, we need to review how we got here. Much of what follows is written with the benefit of perfect hindsight and inevitably includes some gross simplifications.

In the olden days, banks took retail deposits and lent money to borrowers. The challenge was that customers could take their money out any day, and loans were for longer periods. This borrow short and invest long strategy usually made money as the yield curve is normally positively sloped, and typically customers don't all pull out at the same time – unless they worry the bank will fail and they panic. To prevent this, regulators insisted on capital adequacy ratios as a way of limiting leverage, they had the right to regularly inspect banks to review their books, and they created guarantees to depositors in regulated banks. The FDIC website proudly claims that no one has lost a cent in insured accounts since the agency was created in 1933.

Loan Securitization

In the 1990s and 2000s, lending changed as banks securitized loans and sold them off to investors. This activity came with the encouragement of regulators and lawmakers, as it helped meet the government's priority of increased home ownership and the Community Reinvestment Act. It also benefited the banks themselves, as it allowed them to issue more loans and collect more origination fees. On the surface, these seemed like good things, and the process extended beyond mortgages to credit card receivables, auto loans, and other obligations. When this securitization process met up with financial engineering, the

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You Have Nothing to Fear

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underlying loan pools were sliced into different tranches, targeting different investor risk tolerances and having different credit ratings. The lowest ranked tranches took the first loss, and so on up the levels of seniority. The highest ranked piece received principal payments first and was expected to be protected from losses under virtually any scenario. As a price for this preferred position, the yield was naturally the lowest on the highest rated tranche, with yields increasing at progressively lower ratings.

A "shadow banking system" developed to originate and finance the loans that lay underneath these securities, with many different types of buyers investing in different tranches, including money market funds, the now infamous Structured Investment Vehicles ("SIVs"), and hedge funds. The last two often used leverage to boost expected returns.

This marriage of convenience ultimately got into trouble for a few reasons – firstly, underwriting standards for all types of loans slackened – partly due to companies wanting to grow rapidly, partly out of realization that the underwriters did not retain the risk and had no incentive to care. Secondly, a surplus of capital looking for investment opportunities drove spreads tighter, which led some investors to lever up more. With the way risk management models work, lower volatility allows more leverage, and this drove spreads even tighter in a self-reinforcing way.

Home Price Drops Lead to Deleveraging

Eventually, as house prices stopped rising in 2007 and the economy slowed down, spreads widened, prices dropped and volatility began to rise. Risk managers then forced selling, not only to stop losses, but also to reduce risk. The first high profile casualty was Bear Stearns' line-up of hedge funds. At the time the regulators, including Fed Chairman Ben Bernanke and Treasury Secretary Henry Paulson, said that the problem was contained. Instead, worried lenders continued to reduce available capital, forcing more sales, higher volatility, and in due course even more deleveraging. As financial institutions took write-downs, it reduced their capital and willingness to make markets, widening bid-ask spreads further. As bond markets price at the bid, not the mid, this led to still further write-downs. The shadow banking system started to wind down and liquidate, leaving a huge overhang of paper with no natural buyers.

Dysfunctional Cash and Bond Markets

The next stage was the "run on the bank." It is worth noting, that even when a financial institution has a pristine balance sheet with liquid securities, if everyone thinks it is going out of business, chances are it will. Clients will stop trading and pull deposits, and other banks will not offer it financing or use it as a counterparty. The troubled firm has little choice but to liquidate assets and shut down. If the assets are less than perfectly liquid and the firm is leveraged, equity and bond holders can potentially lose everything. It is this downward spiral which caused the demise or forced takeover of many venerable institutions.

By September, even before Lehman filed for bankruptcy and exacerbated the problems, cash and bond markets had almost stopped functioning. Bid-ask spreads for yields, even on investment grade bonds like AT&T, IBM and GE, widened out to 120bp (from single digits in early 2007) – equivalent to a 6% to 8% spread in price terms. LIBOR rates have skyrocketed across the maturity spectrum, with LIBOR/OIS spreads, which reflect the counterparty risk alone, surpassing 250 basis points. Before the middle of 2007, this measure of counterparty risk hovered in the range of 5 basis points. Most recently, on the morning of September 30th, even overnight LIBOR traded up to 6.88% for a short time as European banks desperately sought liquidity for quarter end.

This stress means that even perfectly good assets are being priced at bids well below any measure of intrinsic value because no one wants to buy. Borrowers large and small, public and private, are facing unprecedented strains. Even municipalities like New York City and the Commonwealth of Massachusetts are paying ridiculous interest rates or finding it impossible to raise funds.

The cost for quality companies issuing commercial paper has also increased significantly, if they can even issue at all. CP is a critical ingredient for all kinds of business operations around the world. Companies use CP to finance trade, inventories, and day-to-day operations. The pullback in this part of the market means that companies far away from Wall Street will not be able to function normally, which hits directly at the heart of Main Street.

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You Have Nothing to Fear
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Regulators Aim to Restore Confidence

This is what has captured the regulators' attention, and why they are trying everything in their power to fix and restore confidence. Increased FDIC insurance and Treasury insurance of money market funds are ways to stop people from pulling their cash out. The SEC and FASB recognized that distressed sales and no bids meant that there was no market to mark to, and they came out with guidance to allow mark-to-market flexibility with regard to distressed sales prices.

The essence of the "bailout" is to recognize that people have been forced to mark mortgage-backed bonds to below intrinsic value. Buying them at a higher price should infuse capital back into the system. Equally importantly, if pricing becomes transparent and everyone can mark at similar prices, it will remove uncertainty as to whether an institution has confessed to its problems. The challenge is how the government determines prices.

We would propose using a reverse auction procedure for the AAA tranche of each collateral pool. All holders can offer to sell desired quantities at various prices. The government would commit to purchase bonds at a single price high enough to win exactly half the bonds offered. Those who had marked below the auction price would book a gain on any sales. If the regulators and auditors then forced anyone who had marked above this level to write values down (and hopefully there would be few), then the fear of a player with bad marks would go away. The government could also then set a mechanical scale for pricing of lower tranches – perhaps $5-$10 less for each letter grade lower. This process should remove some of the overhang, force price discovery and consistent marking, and hopefully in aggregate cause some write-ups of assets that would free up capital.

The next action the regulators need to take is to reduce the gross levels of swaps. They have started this process with banks netting of their exposures against each other, and ISDA just reported that the notional value declined from $62.3 trillion to $54.6 trillion as of June 30.ii The next stage will be to push people to use a clearing house such as the Clearing Corporation, a Chicago-based trade processor and guarantor, which says that its new clearing house for credit derivatives will be in place by the end of the year.

Stability Will Return in Time

We believe that the global regulators will do all that it takes to restore confidence and stop the panicking. Once this happens, markets should recover a sense of stability. We do believe that the US is likely already in a recession, and that growth will be slow to the middle of next year. However, this is not new news and stock markets have been pricing it in for some time.
We would encourage our clients not to panic and to avoid the low-yielding mattress and Treasury bill alternatives. History shows that the discipline to rebalance back to strategic policy can provide generous benefits when the panic ends.

We think that small cap and REITs will underperform large cap. The dollar is likely to remain strong as the ECB is forced to cut rates. For the patient investor there is real value in investment-grade bonds, and opportunities to accumulate even high-yield issues over the next 6 months.

In conclusion, although there are very gloomy scenarios out there, we believe that the governments and regulators will get us out of this. Don't panic: you have nothing to fear but fear itself.

***Footnotes*:**
i State Street Global Advisors, Oct. 2008
ii Paul J. Davies, "CDS decline as sector bids to cut risk," *Financial Times*, Sept. 25, 2008.