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MEMORANDUM

DATE: July 3, 2007

TO: OPERS Retirement Board Members
Chris DeRose, Executive Director

CC: Jennifer Hom, Director – Investments

FROM: Investment Staff

RE: **Investment Articles**

Purpose

The paragraphs below summarize recent articles that are relevant to the OPERS Investment Division. The next page provides a detailed listing of the articles and the following pages provide the full articles.

In **economic news**, the variables of monetary policy are discussed; shrinking spreads and the risk of a recession have analysts growing increasingly negative on credit markets; Alan Greenspan and PIMCO enter into a mutually beneficial relationship; Asian monetary policy makers are criticized; and concerns surrounding the Chinese economy.

In **investment news**, Ennis Knupp + Associates offers its views on a fiduciary's obligations, responds to inquires from the Pension Real Estate Association (PREA) and reviews first quarter 2007 market volatility; private equity deals may have a bearish look ahead; real estate fundamentals continue to be strong; the development of platforms that can trade across asset classes continues; the Russell U.S. Index series reconstitution is introducing a methodology change to lower turnover.

In **pension news**, Keith Bozarth replaces David Mills as Executive Director of the State of Wisconsin Investment Board (SWIB); a study by McKinsey & Company warns of pension plan restructurings; the Teachers Retirement System of Illinois (TRS) appointed two senior investment officers; and early-retiring teachers may be putting a strain on the Ohio State Teachers Retirement System (STRS).

In **OPERS news**, the System's hedge fund-of-funds allocation doubles; OPERS selects Mercer Investment Consulting; and divestiture or restrictions of investments continue to receive much attention.

III.J. Investment Articles

Title	Source	Date
Economic News		
• Global Central Bank Focus	PIMCO	05/07
• Credit Market Bubble May Be at Bursting Point	Bloomberg	05/16/07
• Will Greenspan and Gross Merger Create Value?	Bloomberg	05/17/07
• Cheap Money Will Bite Asia if Wages Don't Slow	Bloomberg	06/11/07
• Princeling, Poet Tackle Chinese Economy that Refuses to Cool	Bloomberg	06/12/07
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• EKAdvisor 1st Quarter 2007	Ennis Knupp + Associates	04/07
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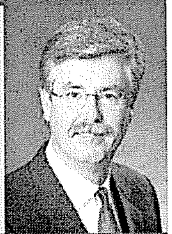
• Missouri Treasurer's Demand: Terror-Free Pension Funds	The Wall Street Journal	06/14/07
• Pension Bill Now Orders Only Partial Divestment	The Columbus Dispatch	06/06/07

Paul
McCulley



Global
Central Bank Focus

PIMCO

May 2007

Requiem For A Princess

On Friday, March 2, Morgan Le Fay unexpectedly passed away in her sleep, the result of her advanced nine years. She went peacefully, having romped about with me just the day before. All who knew her will miss her, none more so than me and my son, Jonathan. Her ashes rest in a beautiful marble urn, engraved with her name, in my home study, a gift from Jon's wonderful mom, Karen. And fortunately, the memory of Morgan will live in perpetuity through the Morgan Le Fay Dreams Foundation[1], which I established and funded just last December, with a special focus on charities providing aid and services to children.

I was sad for a few days, but no longer: Morgan lived a wonderful life, brought me and my family great joy, and will live in our hearts through her continuing good works. It now brings me great joy when I sign checks embossed with her name. Happily, too, as if engineered by Morgan smiling through holes in the floor of heaven, a new bunny came into our lives only a week later – Bun Bun, who Jonnie and I have renamed Bunnicula.[2]

A few days after Morgan's passing, while waiting to get a sandwich at the deli downstairs in PIMCO's building, I was flipping through the local newspaper and out jumped a big block ad, complete with picture, offering Bun Bun for adoption – by a retired couple, Al and Rhus. They had rescued her from a local park shortly after Easter two years ago, where she had been literally left to the wolves, presumably by parents who had misguidedly indulged a child's request for a bunny.

A company of Allianz Global Investors

Al and Rhus are moving to Arizona and wanted to find a home for Bun Bun, where she would be treasured as much as in their home. They interviewed me twice, once in their home and then in my home – they didn't want just anybody to adopt Bun Bun, but a family that would love her. When I told them the story of Morgan and they saw her lovely "condo" outside all empty, the decision was obvious, to both them and me: the search for a new home for Bun Bun was over!

And she is an absolute delight, responding already to her new name Bunnicula, and insisting that she not spend all her time in the condo, but also inside with me in my home study, running about and tickling my feet as I read and write. You will get to know her better come December, when we plan to continue the annual tradition that Morgan and I shared of chin wagging on these pages about the year ahead. But that will be then. Right now, I'm much more concerned about getting the second half of 2007 right!

How Long Can the Fed Fight a Lagging Variable?

Net job growth is officially a coincident business cycle variable, as declared by the Department of Commerce. Note the word "net" at the beginning of that sentence, meaning the net of both job destruction and job creation. Job destruction is actually an official leading indicator, as proxied by initial claims for unemployment insurance, a weekly series released every Thursday. In contrast, job creation is actually, and officially, a lagging indicator, as proxied by the average duration of unemployment (which is also proxied by the stock of continuing claims for unemployment insurance, a weekly series also released every Thursday). And finally, unit labor costs in manufacturing are also officially a lagging variable.

Thus, the featured statistics in the monthly Employment Situation Report, released (usually) on the first Friday of the month, are actually either coincident or lagging:

net nonfarm payroll growth is coincident and average hourly earnings (half of the unit labor cost calculation) is lagging. The only thing that is actually and officially a leading variable in the report is the length of the manufacturing work week.

None of this should come as a surprise to non-economists, who approach economic analysis more with common sense than with textbooks. And common sense tells you that employers do not preemptively hire and fire, but rather do so in reaction to something else. Similarly, merchants do not preemptively raise or lower prices, but rather do so in reaction to something else. And that something else is always and everywhere the state of order books, the stuff of future demand growth.

Soaring order books are the fuel for both job creation and pricing power (inflation) and swooning order books are just the opposite. Always has been and always will be. Yes, I know that inflation is, as Milton Friedman famously declared, "always and everywhere a monetary phenomenon." But he also intoned that the lags between monetary policy action and inflation reaction are "long and variable." And in that context, it is useful to remember John Maynard Keynes' wonderful commonsensical insight that in the long run, we are all dead. Thus, prudent monetary policy cannot be implemented in real time on the basis of Friedman's doctrine, regardless of how true it may be in the long run.

Prudent monetary policy must maximize a real-time utility function for society, otherwise known as cyclically fine tuning aggregate demand to aggregate supply potential, so as to minimize cyclical volatility in **both** unemployment and inflation. Or, if you prefer, prudent monetary policy must exploit and optimize the real-time trade-off between employment and inflation. Yes, for you economist readers, I know that there is no long-term trade off, that there is no long-term Phillips Curve[3].

Well actually, I don't know that, but will accept it as the gospel of our profession, because whether a long-term Phillips Curve exists or doesn't exist doesn't really matter for investment horizons that are relevant to what PIMCO does. The fact of the matter – both commonsensical and empirical – is that a cyclical Phillips Curve **does** exist, both because of price rigidities and frictions in the economy, and because as Alan Greenspan famously notes, human nature will never be repealed, and humans are inherently moody, both individually and collectively.

Which is the proximate reason that asset markets are inherently given to cycles of boom and bust: human nature is inherently given to momentum investing, not value investing. Or, as Will Rogers famously said about stocks, "Take all your savings and buy some good stock and hold it till it goes up, then sell it. If it don't go up, don't buy it." Translating that advice to the bond market, I reckon he would say, "buy some duration and hold it 'til the unemployment rate goes up. If it don't go up, don't buy it."

But it would not necessarily always be good advice, because while the Fed rarely rewards duration with lower policy rates 'til the unemployment rate goes up, the bond market **does** reward duration in anticipation of a rising unemployment rate, knowing that it will inevitably beget lower policy rates. Such has been the case since June 28 – yes, almost a year ago – when the 10-year Treasury yield peaked at 5.24%; today, it stands at 4.84%.

Regrettably, however, it stood at 4.42% on December 4. So, while a long duration position has worked since the yield peak last June, it has most certainly **not** worked since the yield trough in December. Thus, a corollary of Mr. Rogers' putative bond advice must be: once the duration market has discounted

Fed easing, the only reason to hold it is if you expect the unemployment rate to go up. If you don't, sell it.

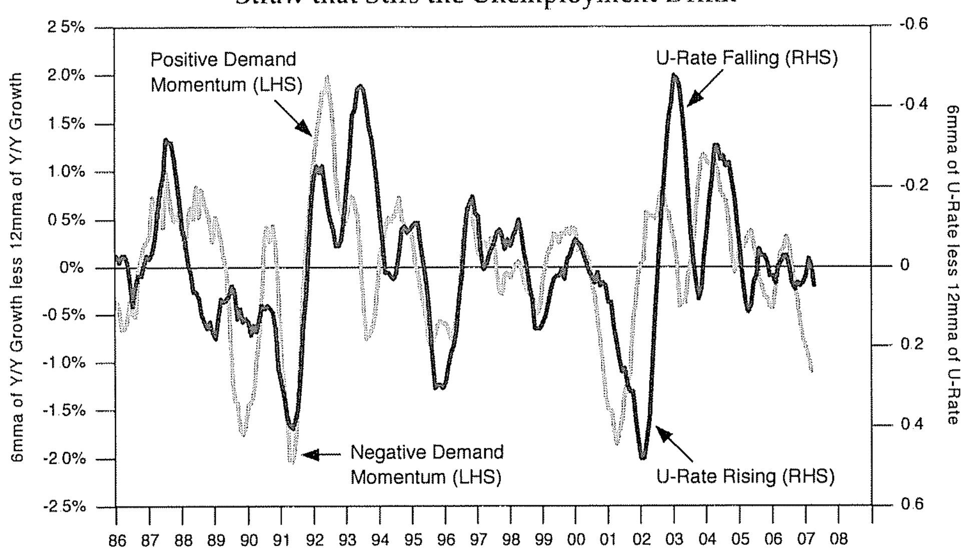
Here at PIMCO, we continue to expect the unemployment rate to go up. Thus, we are still (painfully, since December) long of duration, concentrated in the front end of the yield curve. And why are we still bearish on employment growth?

First and foremost, unemployment is a lagging variable, notably of momentum in discretionary aggregate demand. And discretionary aggregate demand has been unambiguously decelerating in recent quarters, and not just in residential construction, as displayed in the chart below.

The Great Puzzle

So why hasn't the unemployment rate already risen? It's the great puzzle, in the words of San Francisco Fed President Janet Yellen. The short answer to the puzzle is that the labor force participation rate has fallen, accounting fully for the drop from 4.7% to 4.5% for the unemployment rate over the last year. But this

Momentum in Discretionary Sales* is the Straw that Stirs the Unemployment Drink



*Discretionary Sales = Nominal Final Sales of Items Excluding Energy Goods and Housing Services

Source: PIMCO/Bureau of Labor Statistics/Bureau of Economic Analysis doesn't make sense when you look at nonfarm payroll growth, which, again in the words of Ms. Yellen, has been gangbusters. The labor force participation rate is decidedly pro-cyclical, meaning that it goes up as tight labor markets induce new entrants into the labor market; and it goes down when soggy labor markets lead the discouraged unemployed to drop out of the labor force. So, the short answer to the puzzle is the right answer only if nonfarm payroll growth really ain't gangbusters.

And new research by both Ray Stone[4] of Stone and McCarthy and Sheryl King[5] of Merrill Lynch suggest this is indeed the case. Please refer directly to their research for the exhaustive details, but the bottom line is simple. Detailed data in the Bureau of Labor Statistics (BLS) Business Employment Dynamics (BED) release, which comes out with a two-quarter lag, show employment growth of only 19 thousand in 2006Q3, while the nonfarm payroll tally for that quarter was over 450 thousand. More recently, the BLS's more timely Job Opening and Labor Turnover Survey (JOLTS) for April – last month! – showed job openings rose only 24 thousand, with this series essentially flat since last August. The JOLTS report also showed that new hires in March (this data subset is released with a one month lag) fell 29 thousand.

Something smells more than fishy here. Not that I'm accusing the BLS of any skullduggery. None! Rather, it is a historical fact that nonfarm payrolls – before annual benchmark revisions, which continue for six years! – understate employment early in recoveries (leading to the inevitable contemporaneous label of "jobless recovery"), while they overstate employment late in expansions.

And a key reason is that the BLS, while very good at counting heads at existing firms, must make an assumption, in real time, about the birth-death rate for firms, so as to estimate the net gain/loss in jobs as firms open and close, a never-ending feature of a capitalist economy. In the early years of expansions, the birth assumption systematically is too low and the death assumption is systematically too high, which results in "jobless recoveries," which turn out to be not-so-jobless recoveries upon revision. The exact opposite holds in the late years of expansions and particularly in recessions. Such is the case, it would appear, at present.

Thus, in contrast to last August, when the job tally for the year ending March 2006 was revised up some 800 thousand, a stunningly large revision, the opposite is likely to unfold in this August's benchmark revision for the year ending March 2007. Not to suggest, I hasten to add, that a downward revision equal to last year's upward revision is in the cards. The honest answer is that we don't know how big it will be. But available data, notably the BED and JOLTS data, point squarely to a downward revision.

So what, you say. Economists always bellyache about the quality of the data when they go against their forecasts. This is true. It is also true, however, that poor data can make for poor policy making, if and when the data is taken to be religiously true. This is particularly the case if the data is known to be lagging data of the business cycle, as is the case with the unemployment rate. Acting on the data, or refusing to act because of it, is the stuff of policy mistakes, sometimes known as recessions.

Bottom Line

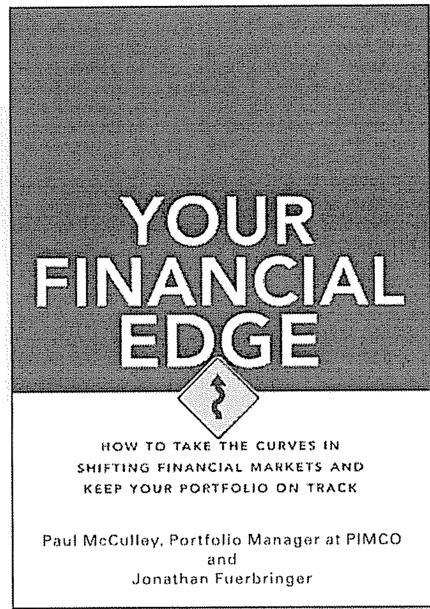
Recent months have not been fun, either at home or the office. Morgan died and the markets have unwound Fed easing expectations, as the unemployment rate has defied PIMCO's expectations of a climb.

But life goes on.

The time for mourning of Morgan has morphed into the time for celebration of her life through her Foundation. And the case for Fed easing is actually more robust now than it was last fall, as inflation ebbs ever closer to 2% and job growth slows, even as the unemployment rate stays stubbornly low on the back of a falling labor force participation rate.

In the fullness of time, there comes a time when time is full.

Paul McCulley
Managing Director
May 23, 2007
mcculley@pimco.com



My new book, ***Your Financial Edge,*** co-authored with retired New York Times Senior Journalist Jonathan Fuerbringer, is now available on Amazon.com for delivery starting June 8.

My royalties will all go to the **Morgan Le Fay Dreams Foundation.**

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1 *"Just-Right Ben?" global central bank focus, dec06/jan07, http://www pimco.com/LeftNav/Featured+Market+Commentary/FF/2006/GCBF+Dec+06+--+Jan+07 htm <http://www.pimco com/LeftNav/Featured+Market+Commentary/FF/2006/GCBF+Dec+06+-+Jan+07 htm>*

2 ***Bunnicula*** *is a children's book series written by James Howe about a vampire-bunny that sucks the juice out of vegetables. It is also the name of the first book in the series, published in 1979.*

The story is centered on the Monroe family and their pets and is told from the perspective of their dog Harold. The Monroes find a bunny at the cinema where they were watching a Dracula film. Because of this, they dub him Bunnicula. Their cat Chester, however, is convinced Bunnicula is a vampire and attempts to get Harold to help save the Monroes from the perceived menace.

A 1979 animated TV special by the same name was created based on the first book and aired on the ABC Weekend Special

3 *"The Costly Uncomfortable Reality About the Wrong Definition of Comfortable" Global Central Bank Focus, April 07, http://www.pimco.com/LeftNav/Featured+Market+Commentary/FF/2007/GCBF-+April+2007.htm*

4 *More Evidence of Problems with Payroll Data, May 18, 2007*

5 *Did Nonfarm Payrolls Hit A Breakpoint in 3Q?, May 17, 2007*

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BN Credit Market `Bubble' May Be at Bursting Point: Mark Gilbert
May 16 2007 19:28

Commentary by Mark Gilbert

May 17 (Bloomberg) -- The meteorologists of the global credit markets are fretting that the balmy weather investors have basked in for much of this decade is about to turn stormy. It's tricky, however, to identify the rods that might draw down lightning from the clouds.

Calling the turn in the credit cycle has been a losing strategy in recent years. War, pestilence, leveraged buyouts and the collapse of the U.S. subprime mortgage market have all been unable to derail the rally in corporate debt. As the reasons for concern accumulate, strategists are starting to reach for their furry bear suits.

``We are growing extremely negative on credit markets, which we see as in a bubble,'' Tim Bond, head of asset allocation at Barclays Capital in London, wrote in a research note this week. ``U.S. companies are re-leveraging aggressively in an attempt to substitute earnings-per-share growth for earnings growth. 2008 should see a fairly savage bear market for credit, a large rise in defaults and an end to easy liquidity conditions.''

Dresdner Kleinwort's analysts, led by London-based head of credit strategy Willem Sels, scrutinized this quarter's U.S. earnings growth. They concluded that the 12.5 percent average figure is misleading because it measures earnings per share and is distorted by stock buybacks.

Profit growth for the companies in the Standard & Poor's 500 Index is just 9 percent, and 3 percent for all U.S. ones. ``With net debt growing at 10 percent, leverage ratios are deteriorating,'' the Dresdner team wrote in a report this week. ``Clearly this is not in line with unchanged credit spreads.''

Shrinking Spreads

U.S. corporate bonds yield an average of about 96 basis points more than government debt, down from as high as 246 basis points in October 2002 and a five-year average of 111 basis points, according to indexes compiled by Credit Suisse Group.

Spreads on high-yield debt are down to a record low of about 300 basis points, compared with a 20-year average of more than 550 basis points, the indexes show. Spreads on euro-denominated bonds are also near their lowest ever, at about 31 basis points.

Investor appetite for junk bonds shows no signs of waning. Seven years ago, Thai Petrochemical Industry PCL defaulted on its bonds and was declared insolvent with debts of $3.5 billion in Thailand's biggest bankruptcy. This month, the company, now called IRPC PCL, the nation's biggest petrochemicals maker, plans to sell $400 million of new bonds.

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Trouble Ahead

The chorus of senior bankers warning that there's danger ahead grows almost daily, with Bank of America Corp. Chief Executive Officer Ken Lewis adding his voice this month.

``We need a deal to go bad, as long as we're not in it,'' he told the Swiss-American Chamber of Commerce in Zurich last week. ``We are close to a time when we'll look back and say we did some stupid things. We need a little more sanity in a period when everyone feels invincible and thinks this is different.''

The 2007 value of global mergers and acquisitions topped $2 trillion this week, some 60 percent ahead of the total at this time last year, which ended with a record $3.5 trillion. Investors, though, don't seem to get spooked by takeovers anymore.

``Credit spreads continue to go tighter with the market seemingly learning to live with the constant speculation surrounding possible bid targets,'' says Suki Mann, the senior credit strategist at Societe Generale SA in London. ``We're either heading for a spectacular collapse, which would likely be brought about by a major event impacting the global financial system, or we are going to stay like this for a while. We go for the latter.''

Recession Risks

Economists' forecasts and the shape of the U.S. Treasury yield curve, not to mention former Federal Reserve Chairman Alan Greenspan, are still suggesting there's a risk of U.S. recession this year, which would typically hurt creditworthiness and corporate-bond spreads.

The performance of the equity market, however, indicates the economic porridge is still fit for Goldilocks. The Dow Jones Industrial Average is at a record, up almost 8 percent this year, while the S&P 500 index has gained more than 6 percent.

It might not last. ``You are seeing mergers and acquisitions tittle-tattle that makes me concerned,'' Fidelity International Ltd.'s Anthony Bolton said this week. ``I can't tell you when it's coming, but I can tell you the precursors are there.''

Bolton has successfully called the turn in equity markets twice previously, dumping telecommunications stocks in the first quarter of 2000 and protecting his fund from a decline in U.K. stocks that ran from April to June last year.

Turn, Turn, Turn

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Will company earnings collapse as central-bank efforts to restrain inflation crimp economic growth? Will overly indebted borrowers seduced by central banks' easy-money policies at the start of the decade begin to default in droves? Does the current merger mania, with everyone bidding at premium prices for everyone else, erode lending standards to dangerously low levels?

``To everything (turn, turn, turn), there is a season (turn, turn, turn),'' sang Pete Seeger, channeling the Bible's Ecclesiastes text. ``A time to gain, a time to lose.''

When the credit markets finally turn, there will be plenty of time to lose the gains of recent years.

(Mark Gilbert is a Bloomberg News columnist. The opinions expressed are his own.)

--Editor: Henry.

Story illustration: for analysis of mergers and acquisitions on Bloomberg, click on {MA <GO>}. For more of Mark Gilbert's writing, click on {NI GILBERT BN <GO>}. To comment on this column by sending a letter to the editor, click on {LETT <GO>}.

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BN Will Greenspan and Gross Merger Create Value?: Caroline Baum
May 17 2007 0:12

Commentary by Caroline Baum

May 17 (Bloomberg) -- It was probably only a matter of time before Alan Greenspan and Bill Gross found one another. Or entered into a mutually beneficial relationship.

No two people garner as much media attention when it comes to Federal Reserve policy and interest rates as the former Fed chief (still, 15 months after he retired from the Fed) and the chief investment officer of Pacific Investment Management Co., based in Newport Beach, California, and home of the largest bond fund. (Full disclosure: About 5 percent of my Bloomberg 401(k) account is in Gross's Total Return Bond Fund.)

With Greenspan signing on as an adviser to Pimco, we can look forward to some ``economies of scale'' from the merger. For news organizations, for example, that means headline consolidation.

What other benefits might derive from the G&G combination? There's a chance the different styles of self-expression (Pimco's, long and windy; Greenspan's, terse and opaque) could produce a whole that is more palatable than the sum of its parts.

Then again, the combined assets could also lose value. We aren't likely to see official transcripts of Pimco's quarterly strategic outlook sessions and regular conference calls with Greenspan. (No doubt we'll get a leak here and there to help the reputation and/or positions of the partners.)

How about the combination of Greenspan's forecasting acumen, gleaned from more than 50 years of watching the ebb and flow of the U.S. economy (and a couple 100-year storms), and Pimco's Fed-watching capabilities? Can bad plus bad equal good?

Moving Target

In the fall of 2004, with the Fed's overnight benchmark rate at 1.75 percent, Pimco's Paul McCulley, who manages several short-term funds, was pushing the idea that the neutral funds rate -- a rate that neither stimulates nor restrains the economy -- was 2.5 percent.

On Dec. 14, 2004, when the Fed raised the funds rate to 2.25 percent, the fifth quarter-point increase in six months, McCulley said the Fed was ``getting close to having finished the journey away from accommodative and toward neutral.''

The journey took another 18 months and 325 basis points. McCulley's performance was certainly better than his forecast. Pimco's Short-Term Fund ranked in the top 35 percent of comparable funds for the last three years, with an average annualized return of 3.4 percent, according to Morningstar Inc.

Greenspan gets high grades for managing the economy, for rescuing it once disaster struck. His track record on forecasting, his ability to use those reams of data to see into the future, is less notable. He pooh-poohed the idea that the U.S. economy was in recession in late 1990 after it had already started. He was late to the party in 2000 as well, cutting rates aggressively in 2001 after he was tipped off that businesses were in trouble. And he was still worried about deflation in 2003 just as the economy was lifting off.

Greenspan Critic

While the G&G merger is a natural in certain respects -- big names leveraging off one another -- it's counterintuitive in another. Gross has been an outspoken critic of Greenspan.

In an Oct. 26, 2005, BusinessWeek interview, Gross said he preferred Greenspan's successor, Ben Bernanke. He criticized Greenspan's tendency of ``lowering rates whenever there was a crisis,'' which created excess leverage, ``bailed out the market'' and ``led to various bubbles'' -- first in technology and Internet stocks and then in residential real estate.

``That approach in the long term is destabilizing,'' Gross said. ``It promotes speculative activity. That's the corner that Greenspan has painted the economy into.''

That's hardly a glowing endorsement. Now Gross wants Greenspan in his corner? Why?

Exclusive Arrangement

Gross clearly isn't looking for trading tips or hedging strategies from the Maestro (unless it's tips on hedging a forecast). With $680 billion under management, the lion's share in fixed-income, Gross doesn't need another big name to attract investors. His $104 billion Total Return Fund outperformed 97 percent of its peers over the past 10 years, with a 6.9 percent average annualized return, according to Morningstar. That includes poor results the last 12 months, when Gross lagged behind three-quarters of comparable bond funds.

His quibbles with Greenspan's policies notwithstanding, Gross was apparently eager to hook the Big Fish once he was a free agent. On Feb. 21, 2006, he told Bloomberg News that Pimco had invited Greenspan out to speak ``because he is intelligent and has a command of the current situation. We would love to have him as a consultant or as an adviser.''

Yesterday's Wall Street Journal reported that as part of the agreement, Greenspan would not take on ``any Pimco competitor as a consulting client.''

BN Will Greenspan and Gross Merger Create Value?: Caroline Baum
May 17 2007 0:12

In the universe of bond funds, who would that disqualify? Everyone. Gross snagged Greenspan before anyone else could.

(Caroline Baum, author of ``Just What I Said,'' is a columnist for Bloomberg News. The opinions expressed are her own.)

--Editor: Dickson (jmg).

Story illustration: To graph the target federal funds rate, {FDTR <Index> GP W <GO>}. To read other Baum columns, {NI BAUM <GO>}. To comment on this column, click on {LETT <GO>} and send a letter to the editor.

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BN Will Greenspan and Gross Merger Create Value?: Caroline Baum
May 17 2007 0:12

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BN Cheap Money Will Bite Asia If Wages Don't Slow: Andy Mukherjee
Jun 11 2007 17:18

Commentary by Andy Mukherjee

June 12 (Bloomberg) -- Cheap money is fast becoming an expensive habit for Asia.

Easy liquidity has already pushed some asset prices out of kilter. Chinese stock markets are clearly overheated.

And while the fallout from a collapse in share prices in Shanghai and Shenzhen may have limited economic impact, bigger trouble is brewing elsewhere: in the labor markets.

Monetary conditions kept too loose for too long appear to have firmed inflation expectations.

Wages are rising rapidly, recording annual growth rates ranging from about 5 percent in Singapore and 8 percent in China and the Philippines to a staggering 14 percent in India.

Corporate profitability and expansion are now at risk.

A recent Duke University/CFO Magazine survey reveals that chief financial officers in Asia are bracing for a 10 percent increase in their wage bill in the next 12 months.

The CFOs expect labor productivity -- output per hour worked -- to grow only 4 percent.

A previous round of the survey, conducted at the end of last year was much more sanguine. It projected wage growth to outpace productivity gains by only about 1 percent.

Most CFOs in Asia are still optimistic about economic growth in the region. Yet, they are now responding to cost pressures by paring their capital-expenditure plans and by tightening their marketing and technology budgets, according to the Duke/CFO poll.

``First signs of weakness appear in Asia's growth story,'' the press release says.

The survey covered 172 companies in India, China, Japan, Singapore, Hong Kong, Taiwan, Indonesia, Thailand and Malaysia, as well as local units of U.S. and European multinationals.

Cheap Capital

Squeezing growth out of underpriced capital is a good way for policy makers to pull an economy out of a bad patch, and for politicians to get a rally going in asset prices. It isn't a recipe for keeping the good times rolling.

Yet that's what seems to be happening.

After a measly 27 basis-point increase last month in state-mandated bank deposit rates, one-year funds in China now pay 3.06 percent. Consumer prices in rural China rose 3.4 percent from a year earlier in April.

State Bank of India, the country's biggest lender, pays 8.25 percent on a one-year deposit even though the annual inflation rate faced by farm workers was 9.5 percent in April.

BN Cheap Money Will Bite Asia If Wages Don't Slow: Andy Mukherjee
Jun 11 2007 17:18

New Zealand's Dilemma

Those Asian policy makers who seek to actively manage inflation using short-term interest rates have a dilemma.

If they raise interest rates in response to a tightening job market, they invite yield-searching speculative capital.

And then, if the central bank buys the incoming dollars, domestic liquidity increases, stoking inflation. And if the central bank doesn't buy the dollars, it risks making the local currency too expensive -- too quickly -- for exporters.

This happened in New Zealand. With annual growth in private-sector wages, adjusted for productivity, close to a historic high, the Reserve Bank of New Zealand increased the benchmark official cash rate to 8 percent last week.

It was a surprising decision, which sent the New Zealand dollar to its highest in 22 years as carry traders zoomed in on the yield. Then, in an even more unexpected move, the central bank sold the local currency yesterday for the first time since floating it in 1985.

Trouble Ahead?

New Zealand is still on the right path.

The strategy of restraining interest rates to avoid inviting in ``hot money'' is eventually self-destructing because it allows inflation to take hold in the domestic economy.

Asian companies will eventually stop investing if the consumer doesn't have the purchasing power to buy their goods.

In most developing Asian countries, reliable, high-frequency data on productivity and wages simply don't exist.

This is a serious shortcoming. Production methods nowadays are modern; and even labor-surplus economies such as China and India are prone to skilled-worker shortages.

If the growing nervousness of Asian CFOs is a forward-looking indicator, then it may be time for central bankers in the region to do some soul-searching.

They have been complacent about wage inflation and their ability to control it. They are also wrong, perhaps, to view money-supply growth -- alarming in many countries -- as irrelevant. That indicator may herald an avalanche of price increases.

(Andy Mukherjee is a Bloomberg News columnist. The opinions expressed are his own.)

--Editor: Henry (jmg/jdu).

BN Cheap Money Will Bite Asia If Wages Don't Slow: Andy Mukherjee
Jun 11 2007 17:18

Story illustration: For a monitor of emerging-market stock indexes, see {EMEQ <GO>}. To graph the performance of the MSCI Emerging Markets Index, see {MXEF <Index> GP <GO>}. For Bloomberg News stories in emerging markets and bonds, click on {TNI EM BON BN <GO>}. To see more Mukherjee columns, click {NI MUKHERJEE <GO>}. To comment on this column, click {LETT <GO>} and send a letter to the editor.

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BN `Princeling,' Poet Tackle Chinese Economy That Refuses to Cool
Jun 12 2007 18:01

By Allen T. Cheng and Zhang Dingmin

June 13 (Bloomberg) -- Signs that China's economy is at a boiling point are hard to miss. Sparks rain down on Beijing from night-and-day construction. Inflation is accelerating. Investors clamor to buy stocks valued at 45 times earnings.

To cool expansion in the world's fastest-growing major economy, Premier Wen Jiabao turns to a team of technocrats led by central bank Governor Zhou Xiaochuan, 59, the ``princeling'' son of a Communist Party leader, and Ma Kai, 60, a poet who heads the nation's top economic-planning agency.

Zhou and Ma must contend with a managed currency and an economy skewed toward exports. Record trade surpluses flood the nation with money, fueling asset bubbles and raising the risk of excessive factory investment and overcapacity. At stake is China's ability to prolong its economic boom, which constitutes a tenth of global growth.

``If 2007 turns out to be another year of talk but no material results on the economy, China's senior leadership will suffer a major credibility blow,'' said Stephen Roach, chief economist at Morgan Stanley who becomes the firm's Asia chairman this month.

China's economy has grown more than 10 percent for five straight quarters. Its trade surplus soared by a bigger-than-expected 73 percent in May to $22.45 billion, the customs bureau said on June 11. Inflation jumped 3.4 percent last month from a year earlier, the highest rate in more than two years, the National Bureau of Statistics said yesterday.

Soaring Stocks

As cash flows to stocks from bank deposits, the benchmark CSI 300 Index has soared 98 percent this year. That has strengthened the case for China's government to increase interest rates, the World Bank said in a report last month.

While Zhou has raised rates and ordered banks to set aside larger reserves, his monetary tools are blunted by China's managed yuan, its mix of a free and planned economy, price controls, state companies that don't care about the cost of capital and the lack of a developed bond market.

``It's not as simple as a Fed rate hike to cool down'' growth, said Robert Subbaraman, chief economist at Lehman Brothers Asia Ltd. in Hong Kong.

One of Zhou's assets is experience. He headed China's foreign-exchange administration when Thailand's currency plunged in 1997, triggering the Asian financial crisis, and he chaired the nation's securities regulator when stocks slumped during

2001 and 2002.

Sharp, Refined, Calm

``He's extremely sharp; he's very refined, very quiet, very calm,'' said Laurence Brahm, the Beijing-based author of ``China's Century: The Awakening of the Next Economic Powerhouse.'' ``He has his own agenda. He knows exactly what needs to be done, where the shock points are and how fast he has to move.''

Born in eastern Jiangsu province, Zhou is a ``princeling'' -- the local term for leaders' offspring -- as the son of Zhou Jiannan, a government minister under Deng Xiaoping, who opened up China's economy starting in 1978.

Zhou senior was a close friend of Jiang Zemin, Communist Party leader after the 1989 Tiananmen Square crackdown and later China's president, according to Cheng Li, author of ``China's Leaders: The New Generation.''

The central banker has a reputation for seeking faster and broader currency reform than the State Council, China's cabinet, has been willing to approve.

`More-Aggressive Changes'

``It's well known in Beijing that the central bank pushed for more-aggressive changes to the exchange rate than took place in 2005,'' said Stephen Green, senior economist at Standard Chartered Bank Plc in Shanghai.

China revalued the yuan by 2.1 percent against the dollar in 2005. Economists believe Zhou argued for a 5 percent appreciation, rather than the 2 percent favored by the commerce ministry, Green said.

Ma's domain as head of the National Development and Reform Commission is macroeconomic policy and approving major construction projects such as power plants. He's also a poet and calligrapher, according to the state-run China News Service.

Born in northern Shanxi province, Ma was among the first post-graduate economics students after the Cultural Revolution, Mao Zedong's purge from 1966 to 1976 of party ``revisionists,'' according to China News.

Ma, too, has the right political pedigree: His parents served in the revolutionary army that won China's civil war in 1949, the monthly Xiaokang magazine reported last year.

`Huge Influence'

``Ma Kai has huge influence over the economy,'' Hu Biliang, senior economist at the Chinese Academy of Social Sciences, said in Beijing. ``Unlike the U.S., where growth is led by consumption, growth in China is led by investment, especially government investment.''

Ma's agency has ordered the closure of obsolete coal mines and steel plants to rein in capacity; cracked down on approvals for power, metals and coal projects; and plans to move toward market prices for resources such as water, electricity and oil.

Still, Ma can't always prevent provincial party officials from pursuing projects to enrich themselves or to boost local economic growth to secure promotion, according to Peng Xingyun, an economist with the Chinese Academy of Social Sciences.

``Too much lending comes from local Communist Party people tapping local bank managers on the shoulder,'' said Mark Williams, Asia economist for Capital Economics Ltd. in London. ``Many of the firms that get money in this way don't really care about the cost of capital.''

--With reporting by Nipa Piboontanasawat in Hong Kong and Shamim Adam in Singapore. Editor: Panckhurst (mpg/cus)

Story illustration: To graph China's annual economic growth, click {CNGDPYOY <Index> GP <GO>}. For more economic data from China, see {ECST CH <GO>}. For the top Bloomberg stories about China, click {TOP CH <GO>}.

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IN THIS ISSUE

PRUDENCE

BY NANCY WILLIAMS, PRINCIPAL AND LEADER OF EK'S FIDUCIARY SERVICES GROUP

Society sets high expectations for the trustees of pension plans, university endowments, charitable foundations, and private trusts. These expectations ought to be high: trustees, as fiduciaries, control crucial financial decisions that determine the scope of educational and charitable programs, and even the quality of life of their beneficiaries.

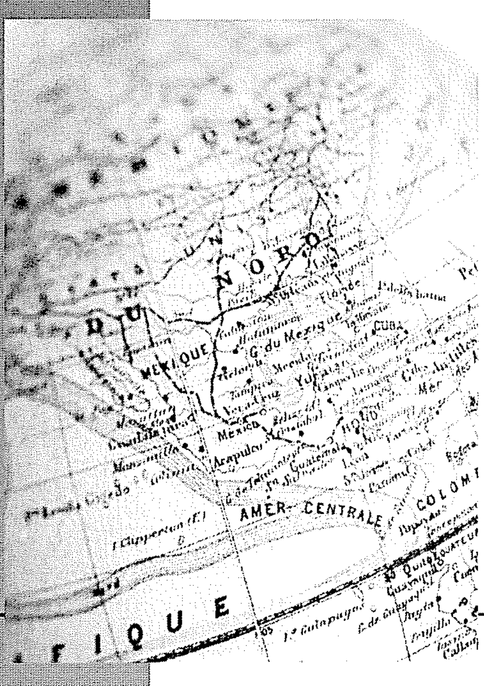
Central to a fiduciary's obligations are two duties: loyalty and prudence. Loyalty requires trustworthiness and dedication to the interests of the beneficiaries. Prudence is defined as well-founded and scrupulous decision making. These are important ideals, but they require translation and application to financial decisions: how can a newly-appointed fiduciary, or an experienced trustee facing a new situation, know if he or she is making financial decisions prudently?

Trust law does not provide a "sliding scale" of prudence, allowing new fiduciaries to be less prudent than the more seasoned. To the novice trustee this might seem an unreasonably high standard. But beneficiaries of a trust, whose interests must be put first, typically are not in a position to evaluate a fiduciary's actions, and the law cannot let them be harmed through a trustee's inexperience. As more than one court has stated, subjective good faith—defined as "a pure heart, but an empty head"—is no defense of imprudent action. Accordingly, we highly recommend in-depth orientation, including fiduciary training, for individuals nominated to the board of a public or corporate retirement plan, foundation, or endowment.

To support their own judgments, and provide knowledge they lack, many fiduciaries rely on experts. This can include experts on the board itself, on the sponsor's staff, or independent experts, including consultants. In fact, trust law, including ERISA and the Uniform Prudent Investor Act, often requires that fiduciaries either be experts themselves, or engage experts. Cont'd on Page 4

VIEW OF REAL ESTATE

BY SCOTT BROWN, CFA, PRINCIPAL AND LEADER OF EK'S GLOBAL REAL ESTATE GROUP



The *Pension Real Estate Association (PREA) Quarterly* featured a piece in its Winter 2007 issue titled, "Global Consultants' Views on Real Estate." Scott Brown responded to a collection of questions that PREA asked, in addition to three other investment consultants representing the countries of Australia, China, and the United Kingdom. The following is an excerpt from that article which includes Scott's responses to PREA's inquiries.

PREA: How is real estate viewed within the institutional investment community in your country? Is it an accepted, mainstream asset class? If it is, is this a relatively recent phenomenon? If it is not, is it on the road to becoming one?

Scott Brown: When does an idea become "mainstream" anyway? For long-term investment programs that have the ability to bear some degree of illiquidity and have the staff to oversee real estate investments, the real estate investment allocation has become an accepted portfolio diversifier. However, it is considered one of the "alternative asset classes," thus the conundrum in considering real estate, or anything labeled "alternative," as "mainstream."

...Cont'd on Page 3

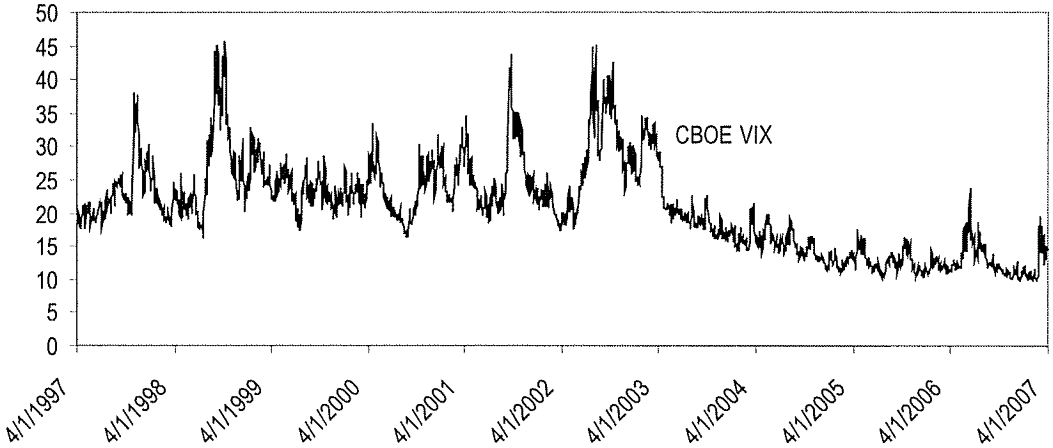
Market Watch

After nearly eight months of relative stability in the U.S. stock market, volatility returned during the first quarter of 2007. A correction in the Chinese stock market prompted the Dow Jones Wilshire 5000 Stock Index to fall 3.4% on February 27. During the last few years U.S. stock market volatility has been at its lowest levels in a decade. From 1997 through 2003 the Chicago Board Options Exchange (CBOE) Volatility Index (VIX) was consistently above 20 and it broke 40 in 1998, 2001, and 2002.

Note: The CBOE VIX measures expected near-term volatility in the U.S. stock market based on S&P 500 Index option prices.

Returns as of 3/31/07	First Quarter	One Year
U.S. Stocks	1.4%	11.3%
Developed Non-U.S. Stocks	4.1%	20.2%
Emerging Markets Stocks	2.3%	20.7%
U.S. Bonds	1.5%	6.6%
U.S. Treasury Yields	**3/31/07**	**3/31/06**
2-year Treasury	4.58%	4.82%
10-year Treasury	4.65%	4.86%
30-year Treasury	4.84%	4.90%

U.S. Stock Market Volatility
4/1/97 to 4/2/07



Source: CBOE

EK Update

BY STEVE CUMMINGS, CFA

We were recently honored when our own Richard Ennis and Jim Knupp received the 2007 Matthew McArthur Award, granted by the Investment Management Consultants Association. The award acknowledges those who have made outstanding contributions to the profession of consulting. Although their careers in the industry date to before the founding of EnnisKnupp, we have greatly benefited from their pioneering ideas. Personally, it has been a distinct honor to work with these two industry leaders and to have the privilege of leading the firm they created.

Commitment to our clients has been our primary focus since EK opened its doors and as your needs change, so do our offerings. In that vein, we've experienced a number of exciting changes, the most recent being our office expansion. As our capabilities in alternatives and fiduciary services have expanded along with our traditional consulting relationships, so has our staffing, with over 100 employees on board now. We now occupy the entire 16th floor of our building, giving us ample breathing room for future growth. Personnel recruiting is a vital and renewing function at EK. Making sure we grow with our clients needs has brought a lot of new faces to the firm—perhaps you have had the occasion to meet one of them.

As Henry Ford, founder of Ford Motor Company, once said, "Coming together is a beginning; keeping together is progress; working together is success." We are grateful to Richard and Jim for coming together over two and a half decades ago, thankful that we continue to keep our staff strong and growing, and honored to work together with each and every one of our clients.

On average, what is the percentage of pension plan assets allocated to real estate? Has this changed much in recent years? Does the percentage differ by plan size?

Generally, 5% to 10% is the range of target policy weightings. Generally, we see the allocation closer to 10%. Allocations have continued to grow toward the higher end of this range over the past few years.

How do pension plans invest in real estate? Is it primarily through direct investments or commingled funds? What about joint ventures with local developers?

Yes, yes, and yes. This is in transition currently within the institutional investment community in the U.S. The separate account was the primary methodology previously, but that is transitioning to commingled fund investments. Though there are direct investments being made through joint ventures with local developers made by institutional investors, this is becoming less common. Local developers have a tendency to joint venture with established real estate investment fund managers.

Have you witnessed a shift in pension fund real estate investment strategies toward the higher end of the risk-return spectrum (increased use of financial leverage and more allocation to value-added and opportunistic plays)?

We have not seen a secular shift toward higher-risk strategies and thus a shift upward in the beta of real estate portfolios in general. We have seen a continually increasing level of sophistication of institutional investors with respect to their knowledge of real estate and appropriate real estate portfolio construction processes. More dollars are being allocated to commingled funds in the higher-risk end of the real estate investing spectrum. We are working on more mandates in this regard but generally only after the core portion of a real estate allocation has been put in place and is being monitored adequately. The average suballocations to both value-added and opportunistic strategies generally range between 25% and 35% of the total of the real estate allocation on average, with value-added being a larger focus than opportunistic.

What percentage of a pension fund's portfolio would you recommend should be in international real estate today? How about in three years, five years, and ten years?

When considering such a recommendation, an investment consultant needs to first take into consideration the client's overall asset allocation and whether global equities are appropriate, which they are for most U.S. institutional investors. Thus, this is not a real estate asset allocation question only. Generally, a U.S.-based fund's liabilities are dollar-denominated, which is an important consideration. Once it has been established that global equities are appropriate for the client's portfolio, the appropriate allocation to global real estate generally mirrors the global equities allocations 20% to 30%. This adds additional diversification to the overall and the real estate portfolios and opens up the opportunity set. With respect to three, five, and ten years, I would expect this process to be the same from an asset allocation process and a portfolio construction process into the foreseeable future.

Is there a preferred way to invest abroad-by region, vehicle, strategy, or property type? For which regions and types of investors would you recommend foreign investing in core private real estate? How do you justify foreign versus domestic real estate?

A top-down allocation process is appropriate by currency/region, country strategy, vehicle, and property type. Investment management talent and relationships in the regions are critical to finding deals from the bottom up that fit into the proper top-down allocation. Local joint-venture partners that have verifiable experience and expertise are a very important part of the investment process.

Institutional investors that have their domestic real estate investment program in place across the core, value-added, and opportunistic strategies and have appropriate monitoring and reporting processes in place are those that should be considering the expansion of their real estate allocation globally.

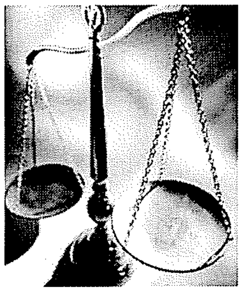
Generally, there should be a domestic allocation of the private equity real estate and a global allocation to private equity real estate. As far as regions and types of investor, those are different plan to plan.

Do you see any particular investments playing out as more or less compelling investment opportunities by property type, vehicle, region, and/or segment, and will these differ by region or type of investor?

No. This should differ investor to investor. Each investor has a different set of goals and objectives for the real estate allocation and, as such, for the global real estate equity allocation. For example, some would say that the London office and Paris office markets are both "tighter" and, as such, better markets than New York City currently. That does not mean that endowment XYZ should go and buy an office building in Paris. In addition, investors need to recognize emerging market real estate investment risks and consider them thoroughly before investing in such markets....Cont'd on Page 4

Prudence.....cont'd from page 1

Trustees should be careful to engage experts with training and experience that are suitable for the situation they will oversee. Beware the "generalization of expertise": an expert in one area might not have adequate knowledge in a neighboring specialty. For example, a highly skilled anesthesiologist may not be able to give advice about a heart problem. Likewise, an investment manager of corporate bonds might not have expert knowledge on venture capital, his general financial expertise notwithstanding. The fiduciary is obligated to investigate and determine what sort of expertise is called for, and then select an expert with the right knowledge and skill.



When choosing experts on investments, fiduciaries should assess a number of factors:

1. Educational attainment and professional credentials.
2. Breadth of knowledge of investment theory, and relevant practical applications.
3. Experience with similar funds and investment portfolios, and track record in solving problems.
4. Available information resources, such as proprietary databases and research.
5. Internal quality assurance processes.
6. Peer review standards.
7. Willingness to consider alternative points of view, and creativity of solutions.
8. Policies on ethics and conflicts of interest.
9. Frequency and clarity of communication with clients.
10. Quality of written reports.

As financial markets and investing techniques evolve, so do standards of prudence for institutional investors. Practices that were satisfactory ten or twenty years ago may not be seen that way today. For example, the due diligence process for equity real estate investment has become more complex, due to the development of more sophisticated portfolio construction techniques. For individual properties, due diligence has expanded to include new valuation concerns, environmental issues, and changes in accounting methods.

Alternative assets call for due diligence that is different from what is required for traditional asset classes. In private equity, for example, special attention must be paid to the strength of the general partner team, the economics of the partnership, reporting policies, and other governance issues that do not arise in examinations of conventional stock or bond managers.

Institutional investors can expect a steady stream of new investment products and vehicles, and with them new requirements for due diligence. The best consultants are fluent in current standards, and can anticipate what is coming.

Being chosen to serve as a fiduciary is an honor, but with it comes serious responsibility. We understand the need for prudent processes and procedures, expertise in many asset classes, keeping abreast of fiduciary standards, and, accordingly, assisting fiduciaries is central to our work. Thank you for your continuing confidence in EnnisKnupp.

View of Real Estate.....cont'd from page 3

At this point in the real estate cycles, how would you advise your clients to think about comparing the risk-adjusted returns for the U.S., the UK, Western Europe, Central and Eastern Europe, Japan, Asia excluding Japan and India, India, and South America?

Portfolio construction globally should consider expected returns asset class by asset class as opposed to historic returns. Portfolio construction within the private equity real estate investment arena should, much the same, consider expected returns region by region, strategy by strategy, and property type by property type. Macroeconomic forecasting and expectations need to be part of the annual asset liability and portfolio optimization processes.

In comparing risk-adjusted returns for real estate for monitoring purposes, an analyst needs to be very careful. There are a couple of important assumptions: that real estate returns are transparent and comparable and that risk-adjusted returns for real estate are valid. After considering these assumptions and the data, investors compare historic risk-adjusted returns in the same manner they do for other asset classes globally.

What do you see as the primary risk of investing in each of these regions?

In the more "emerging markets" listed, repatriation of capital back to the investor in the U.S. is a key risk. In the developed countries, for an institutional investor, having the best investment managers with the best relationships and ability to maneuver through and efficiently process the different information that is available market to market and choose investments that fit the prespecified mandate of the fund is important.

If you would like to receive a copy of the PREA piece in its entirety, please contact your EK consultant.

THE WALL STREET JOURNAL. ONLINE

May 29, 2007

Private Equity: Is Deal Frenzy Nearing End?

Big Firms Split in Views Over Pace of Buying; Stock Prices May Suffer

By HENNY SENDER
May 29, 2007; Page C1

It would be a fool's game to predict the end of the private-equity buying frenzy, but certainly some signals are there.

Over much of the past two years, the prevailing private-equity mantra has been to buy as many companies as possible and then sell as much debt as possible to help pay for them. Now, the biggest private-equity firms are beginning to diverge in their views.

Henry Kravis, the co-founder of Kohlberg Kravis Roberts & Co., recently has described current conditions as a golden age for private equity. But Ripplewood Holdings LLC Chief Executive Timothy Collins, at a conference in Tokyo earlier this month, called current conditions a bubble that would end badly.

David Bonderman

Carlyle Group co-founder David Rubenstein at the same conference also was bearishly looking ahead. "There hasn't been a failure for five years. We need to prepare people for the reality that some deals will fail," he said. He added: "Greed has taken over. Nobody fears failure."

Caution on the part of even some of the players could be bearish for stocks, coming at a time when one of the biggest supports for the stock market is the assumption that private equity will buy bad companies because they are inexpensive and good companies because they are good. Should private-equity firms pull back, that support could vanish.

Some analysts say that without a widespread belief in the appetite of LBO firms for publicly traded companies, stock prices would be far lower.

Not long ago, a buoyant stock market would hardly have paid heed to the views of private-equity firms. No longer. At $281 billion, U.S. private-equity deals have more than tripled from a year ago, accounting for 35% of all mergers and acquisitions, up from about 16% last year, and most of them involve publicly traded targets, according to data from Thomson Financial.

For its part, Carlyle has been the Cassandra of the industry for several months now. The year opened with "state of the industry" letter from Carlyle co-founder Bill Conway that warned his firm's investment professionals about froth in the buyout market and instructed them to be careful in their deal-making.

They have heeded that warning. Carlyle has been mostly on the sidelines this year and hasn't been involved in any of the year's 10 biggest U.S.-targeted deals. Meantime, private-equity titan Blackstone Group has notched just one of the 10 biggest U.S. deals. That contrasts with KKR, which has been a part of $120 billion of buyouts in 2007, including five of the biggest eight in the U.S., according to Dealogic.

Then there's TPG (formerly Texas Pacific Group), which accounts for two of this year's largest U.S. deals, including the pending $32 billion buyout of Texas utility **TXU** Corp., where it is partnered with the bullish KKR. This past week it teamed up with the private-equity arm of **Goldman Sachs Group** Inc. to buy wireless provider **Alltel** Corp. for $25.7 billion, the third-biggest U.S. leveraged buyout in history, Dealogic notes.

TPG, though, is also showing signs of caution about the markets. This month, for example, TPG has taken advantage of others' optimism to sell large chunks of the remaining shares it holds in ON Semiconductor Corp. and MEMC Electronic Materials Inc., companies it has owned since 1999 and 2001, respectively.

Other signs of TPG's caution include its quitting the group that included Bain Capital and Thomas H. Lee Partners during the bidding for radio-station operator **Clear Channel Communications** Inc. Bain and Lee subsequently sweetened their offer twice, to $39.20 a share from $37.60 -- significantly improving their chance of securing shareholder support. It would have been better for the two to have let the deal die, walk away and show that they have discipline, says the head of a unit that focuses on private-equity firms at one big investment bank.

"We increased the price by about $700 million on a $27.5 billion deal, all from debt," says a spokesman for Thomas H. Lee. "That's the smallest percentage increase in cash of any public deal we've seen. The crucial change is the 30% [that will remain listed] for the public on a completely heads-up basis. That's a lot of value for the public without increasing our downside risk."

TPG also dropped out early in the bidding for Dollar General Corp., which ultimately went to KKR in a $6.9 billion deal. By the end of the process, no competing bid came close to the amount KKR was willing to pay, according to bankers.

Some middle-market firms also say this is a better time to sell than to buy. "This economy is not going to get better, especially for manufacturing and industrial companies," says Michael Psaros, managing partner at KPS Capital Partners. "We are selling everything that isn't nailed to the floor at prices that are between stunning and inconceivable."

Indeed, KKR has been winning auctions by paying far more than any of its rivals, opponents say, leading to fears that industry-wide returns will drop as a result of paying such high prices.

A person close to KKR says rivals who question why KKR is buying so much or paying so much may be jealous and frequently lose by only trivial amounts rather than the large amounts they claim.

Being bold has worked out well for KKR before. Johannes Huth, head of KKR's operations in Europe, bought a series of companies in Germany when those firms were out of favor early in the new millennium.

Today, many of those investments have done so well that Mr. Huth sits on the six-person management committee at KKR and is widely regarded as one of the likely successors to Mr. Kravis and his cousin George Roberts to lead the firm.

And deals KKR did earlier in this deal-making cycle in which the firm was believed to have overpaid have been quite successful, such as PanAmSat.

The industry has seen this divide before. Some private-equity firms pulled back in the second half of 2005, only to regret the decision as the debt markets threw money at their braver counterparts.

Steve Schwarzman, founding partner of Blackstone, has told investor conferences that while one of his bigger mistakes was not bidding more aggressively for Hertz, which Ford Motor Co. in 2005 sold to Clayton Dubilier & Rice Inc., Carlyle and a unit of Merrill Lynch & Co., "today the biggest risk is high prices."

"Almost everything can go wrong now," said David Bonderman, one of the founders of TPG, at a recent conference. "Two years ago, we slowed down. Last year we got unskeptical. This year we are more cautious again."

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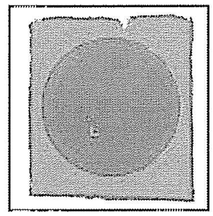
Perspective



June 2007

Current market update

Both the US private and public real estate markets produced solid performances in 2006 and thus far, in 2007. While the fundamentals supporting real estate investments are still sound, we do not believe these performance levels are sustainable because of pricing shifts that have occurred in recent years. Nonetheless, because of its ability to provide diversification for a portfolio and its low correlation to most other asset classes, we still maintain that real estate should be part of an asset allocation line-up.

The NCREIF Property Index[1] returned 16.6 percent for the year ended December 31, 2006 while the NAREIT™ Equity Index[2] returned 35.1 percent for the year. On a global basis, the EPRA NAREIT Global Real Estate Index[3] returned 42.4 percent for 2006. The performance of real estate markets in 2006 was spurred by the moderate growth in the economy and the continuation of capital flows to the sector.

	YTD thru 1Q 2007	2006	2005
NCREIF Property Index	3.6%	16.6%	20.1%
NAREIT™ Equity	3.5%	35.1%	12.2%
EPRA NAREIT Global	6.2%	42.4%	15.4%
S&P 500®	0.6%	15.8%	4.9%

The strong private real estate market provided a good backdrop for public real estate activity during 2006, and a key factor driving REIT performance was the high level of merger and acquisition activity. With a significant number of public real estate companies being bought out by private buyers, the activity was a solid indication that certain investors felt that REITs were fairly valued compared to the underlying real estate and that net asset values were not drastically inflated. Though by historical measures, REITs are highly valued, and we believe that a risk of a price correction exists, particularly if the private market should slow down.

However, real estate fundamentals continue to be strong, which should allay fears, to a certain extent, of a bubble in the US private real estate markets. While many factors can affect the real estate market, the US economy is still poised to provide real estate the environment to produce steady cash flows to investors in this sector. As with any asset class, investor sentiment and the overall economy are two of the biggest factors that could influence overall performance. The supply-demand fundamentals for real estate suggest an opportunity to increase occupancies and rental rates resulting in growth in net operating income, albeit in varying degrees across markets and property types. This income growth, if achieved, should trigger continued positive performance from the sector. Over the past few years, performance has

[1] The NCREIF (National Council of Real Estate Investment Fiduciaries) Property Index is a benchmark for private real estate investments. As of March 31, 2006, this index represented 4,756 assets with a total market value of $202 billion.

[2] The NAREIT Equity Index is a benchmark for publicly traded real estate investment securities and includes all tax-qualified equity REITs that trade on the NYSE, AMEX, or the NASDAQ National Market List.

[3] The EPRA NAREIT Global Real Estate Index is a benchmark for publicly traded global real estate securities.

been strong as capital has flowed into the real estate sector in anticipation of improving fundamentals. Now with the improvement in fundamentals realized, capital flowing into the sector is anticipated to slow, and, therefore, we expect performance to return to more normal levels and produce lower results in 2007 than experienced in 2006.

Sector performance			
NCREIF Sectors	YTD thru 1Q 2007	2006	2005
Apartment	2.9%	14.6%	21.2%
Industrial	3.2%	17.0%	20.3%
Office	4.6%	19.2%	19.5%
Retail	3.1%	13.4%	20.0%

Performance in the apartment sector slowed in 2006 compared to 2005 in part due to the almost complete halt of condo converters who had been aggressive purchasers of rental properties in 2005 and 2006. The slowdown in the housing market had, and should continue to have, a positive effect on the apartment sector. With many potential buyers unwilling to risk devaluation in housing prices, the rental market seemed a better option for them. Nonetheless, the outlook is more difficult to predict and could vary widely by market. Markets that experienced significant condominium development and conversions might see some of these units offered as rentals. This could increase vacancies and slow growth but markets with high levels of immigration and echo boomers should experience better-than-average rental growth.

Industrial assets continued to perform well in 2006 due to sustained increases in global trade and inventories. Additionally, this property type exhibited high levels of cash flow relative to the other asset classes (as has been the case historically). Market selection and changing trade dynamics will continue to be a driving force for performance, with assets located in transportation hubs and ports exhibiting the best opportunities for improvements in fundamentals and continued strong performance.

Though retail faired well at the beginning of the new millennium, and even through the earlier slowdown, it appears to have reached its peak in this cycle. While retail returns remained strong from an absolute perspective in 2006, they declined more rapidly than the other property types. The housing slowdown has contributed to the slowdown in the retail sector.

While still at manageable levels, vacancy rates have begun to rise as rental rates declined in 2006. Additional slowdowns in consumer spending and pressures on publicly traded retailers to improve profit margins are two areas that could expedite the downward trend in this sector.

The majority of the privatization activity occurred in the office sector, where fundamentals continue to improve. Even with more new construction in the pipeline than in the recent past, rental demand still appears to exceed supply. Oversupply is not expected to be an issue as rental rates are rising at a slower pace than building and labor costs, so new construction growth will likely remain slow. This should continue to give landlords pricing power over tenants as vacancy levels decline, particularly in the primary office markets.

As in the past, but more so now if the economy and real estate markets should slow down, geographic market selection is a key component in providing future outperformance. The ability to filter through economic and demographic data and selectively choose geographic locations is an essential part of the process.

Global real estate securities investing update

While the recent consolidation activity in the US REIT market slightly decreased the size of the universe, the overseas real estate market continues to grow as REIT legislation activity increases across Asia and Europe. With the formation of REIT-like structures worldwide, property investors are able to have greater access to the global capital markets. Strong capital inflows into the global real estate securities market are expected to continue through 2007 and REIT structures in Germany and Italy are expected to be fully implemented during the year (the REIT structure went into effect in the UK at the beginning of the year).

EPRA NAREIT Global Real Estate Index Regional Returns	
Region	2006
North America	36.3%
Asia	36.5%
Europe	67.0%

The global REIT market also benefited from the large amount of privatization activity in the US REIT market. Upon the announcement of the US sector's largest take-private deal, large cap real estate stocks rose in the UK, which is a clear sign that companies are drawing capital from around the world.

The strength of the London market and its growth as a global center of commerce led continental Europe to become the highest returning region in the EPRA NAREIT Global Real Estate Index. With office markets improving throughout Europe, the outlook for increased leasing activity looks promising. As oil prices decline and banks feel less pressure to raise interest rates, Europe's yield curve is one of the few in the world with a positive slope. Overall, economic growth in Europe is expected to be slow, but solid.

The Asia Pacific region was led by Singapore where office rents increased and growing tourism and low unemployment led the country to high real estate returns. Across Asia, increased consumer spending will likely boost retailers to look for additional space in the coming year, and corporate expansions during 2006 helped to fuel the office sector where vacancies should continue to fall.

Because most funds in the global REIT space do not yet have three-year track records, longer-term performance is hard to evaluate, but this should not deter investors from making an allocation. As always, it is important to consider the manager's philosophy, methodology and ability to execute its strategy. The US REIT market still remains a large portion of the global universe, so confidence in a manager's US capabilities is an important factor to consider. With a healthy global trade market, a worldwide effort to tighten interest rates and improved transparency and liquidity, we expect the proliferation of global REIT strategies to persist and provide investors the means to further diversify their real estate allocations.

Product highlight – Infrastructure

Infrastructure as an asset class is growing, and its low correlation to the equity market and stable and predictable cash flows have caught the attention of institutional investors. Even though infrastructure funds are relatively new to investors in North America, in Australia and Europe, infrastructure investing began in the 1980s and took hold in the 1990s. It has become popular in North America within the last few years primarily because it has become a common way to finance improvements and build roads, rail lines, sea ports, water and power distribution facilities and other civil infrastructures. There is a great need in North America to update existing infrastructures, and investment managers are forming infrastructure funds to capitalize on the long-term, capital-intensive projects which are required to fulfill these major social and economic needs.

These investments generally produce attractive risk–adjusted returns, but as with any investment, there are risks to investing in infrastructure funds. Because the assets are usually run or regulated by a government entity, regulatory issues are a key concern for investors. The long-term nature of these investments makes them subject to credit and default risks, and the high leverage used in financing these transactions exposes investors to inflation and refinancing risks.

While there are several dimensions of risk involved, the characteristics of infrastructure assets typically ensure that financial performance is less sensitive to economic cycles than with other asset classes. Infrastructure funds share many characteristics with private real estate and private equity funds, but infrastructure should be considered an asset class of its own. Infrastructure funds can be attractive additions to a portfolio, but to realize the full diversification benefits they offer, they should not be used as substitutes for real estate or private equity allocations.

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>>> Larry Tabb, Special Contributing Editor

Is Multi-Asset Trading DOA?

THE LANDSCAPE is littered with the ghosts of failed products, platforms, businesses and good ideas that were too expensive, not properly targeted or launched before their time. Is multi-asset trading, or the ability, from a single platform, to trade across products, one of these flawed concepts?

It's easy to blow off multi-asset trading as DOA. Trading across products violates almost everything I have learned, namely: Wall Street makes money through focus; systems developed for multiple purposes serve none; the industry's technologies follow P&L codes, which are vertically (by product) not horizontally (by customer) aligned; and if you make it too complex, nothing gets deployed.

But we shouldn't write off the trend so quickly. First, focus becomes less important as more products are electronically traded. Computers can focus on virtually everything simultaneously (given enough resources) and increasingly are calling the shots. While good human traders can outperform a machine, even the best traders can't keep up with machines trade by trade, day in and day out.

>>> **Firms and vendors are starting to develop analytics and trading platfoms that can trade across asset classes.**

Investors also are changing the investment dynamic. Money managers are looking outside of traditional investments in record numbers. Where are all these managers finding outsized returns?

While some returns will come from holding equity, competition is forcing investors to segment and dissect various cash flows and risks, and attempt to arbitrage them. For instance, investors are playing the capital structure arbitrage game, as an equity isn't just a percentage ownership of a company — it is a percentage ownership of the projected corporate cash flows influenced by corporate risk, product risk and industry risk. Cash flows can be modeled through fixed-income instruments (either via corporate bonds or even sovereign debt with derivative overlays), and various risks can be mitigated through sector indices, currencies plays, options of various flavors, credit default swaps and other derivative instruments.

Executing on these strategies, however, takes data, analytics and the ability to execute with precision across what has been a series of nonaligned markets and trading and processing platforms. But firms are reorganizing both their business and technology infrastructures to be more customer-focused as more trading strategies and customers look to develop cross-asset investment strategies.

Technology platforms are following suit. Firms and vendors are starting to develop analytics and trading platforms that can trade across asset classes and geography.

But developing a multi-asset trading platform isn't easy. It requires firms to understand their clients' needs and requires more-sophisticated services-based architectures that will allow easier integration of very disparate products, analytics and transactions across a wide number of vertically aligned back-end systems.

Today's multi-asset trading platforms are also most likely to be light-weight, front-end platforms that facilitate the analysis, decomposition, execution and reporting of multi-asset strategies. But many of these transactions are flowing from integrated front ends to traditional single-product, siloed back ends, as multi-asset back ends are more difficult and expensive to build and have less need, as most products are margined, settled, cleared and accounted for by product.

So is the idea of a new set of multi-asset, global trading platforms just wishful thinking or the next new wave? A bit of both. But while it certainly will take years, if not decades, to consolidate the mid and back offices across product and geography, within three to five years most firms will have customer-facing platforms that will trade across products, geography and trading styles. <<<

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Russell reconstitution includes new rules

The Russell U.S. index series reconstitution, which takes effect after markets close on Friday, is introducing a change in methodology to reduce turnover, allowing the indexes "to slightly diverge from holding exactly 1000 stocks" in the Russell 1000 large-cap index and 2000 stocks in the Russell 2000 small-cap index, according to an analysis by Northern Trust Global Investments. Russell will introduce 5% percentile banding — 2.5% above and 2.5% below market caps for the cutoff points of the Russell 1000 and Russell 2000.

Also, companies determined to be so-called U.S. benefits-driven incorporations will be eligible for inclusion even though they are incorporated offshore. Of the 40 companies expected to be added to the Russell 1000, 36 companies — with a combined market capitalization weight totaling 2.91% of the index — are expected to be BDIs, the report said. They include Schlumberger Ltd. and Tyco International Ltd. In the Russell 2000, 46 companies — with a combined weight of 2.8% of the index — expected to be added will be BDIs.

About $3.8 trillion in assets is benchmarked to the index series, including $613 billion in indexed funds.

PLANSPONSOR.com™ Don't go it alone News

Wisconsin Finds a Replacement for Mills

May 14, 2007 (PLANSPONSOR.com) - Keith S. Bozarth, currently CEO of the Orange County Employees Retirement System in California, has been appointed executive director of the State of Wisconsin Investment Board (SWIB).

Bozarth has had fifteen years of experience with four public pension systems including the Teachers' Retirement System of Illinois and both the State Employees' and Public School Retirement systems in Missouri. According to a press release, his experience includes nine years in a CEO role with oversight of both the investment and benefit functions.

SWIB conducted a wide-ranging search which it says generated a large field of very skilled and experienced applicants from both the public and private sectors. Trustees engaged the services of executive search firm EFL Associates to conduct the search.

Bozarth is replacing David Mills who became Executive Director in 2003. Earlier this year Mills announced his intention to retire upon appointment of a successor, but has agreed to remain available to assist through the transition. Bozarth will begin his duties at SWIB on June 25.

Assets under management at SWIB are $93 billion, including the nearly $87 billion in trust funds of the Wisconsin Retirement System (WRS), which provides benefits to over 533,000 current or former employees of state agencies, the university system, school districts and most local governments.

The WRS is the 9th largest US public pension fund and the 24th largest public or private pension fund in the world.

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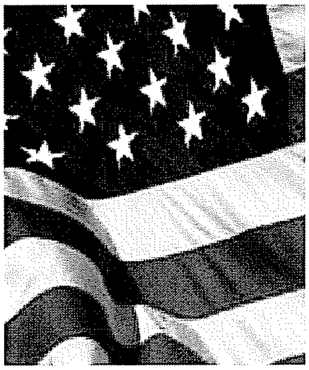
News



Corporate plans in danger

by Ronan McCaughey 23-05-2007

US – A new study has reportedly predicted up to 75% of US corporate pension plans could be frozen or terminated within the next five years.

The findings from McKinsey&Company said the return of private defined benefit plans to health fund levels would rapidly boost the number of companies opting to freeze or terminate their plans from the current level of 25%.

The management consulting firm was also said to have warned looming accounting and regulatory changes would force plan sponsors to rapidly implement different approaches to portfolio construction.

McKinsey&Company said this could mean dominant money managers would compete with insurers and investment banks to meet their needs.

At least US$1trn of the $2.3trn now in private sector pension plans will be invested in different products and solutions by 2012, according to the study.

As a result, allocations to active domestic long-only equities are expected to drop by 67%, with long-duration fixed-income, hedge funds and private equity picking up the bulk of those losses.

See related country profile

News

Chicago

TRS Illinois appointments

by Elizabeth Pfeuti 23-05-2007

US - The Teacher Retirement System of the State of Illinois (TRS) has appointed two new senior investment officers.

Lamar Villere has left the position of domestic equities officer he has held at TRS since 2005 to become senior alternative investments officer.

Meanwhile, Scottie Bevill, who has served in various capacities during his 15 year tenure at TRS, has taken the role of senior investment officer for global bonds and real return.

TRS CIO, Stan Rupnik, said: "TRS is pleased to redeploy Lamar and Scottie's high-calibre skill sets in the alternative investment arena. Our members will be well served by their investment expertise and strong work ethic."

Bevill is expected to continue to oversee aspects of the emerging manager program and minority owned investment manager and broker programs.

TRS voted in December 2006 to add a 2.5 % allocation to absolute return strategies and a 10% allocation to real return.

The fund has also carried out a major shake up of asset allocations.

As an example, Invesco and Pyramis Global Advisors recently both lost $1.2bn each, in international equity mandates in a cull of six managers.

See related country profile

Early retirements burden fund

Conservative group says schools hurt by teachers' flight

Friday, June 8, 2007 3:38 AM

BY JAMES NASH

THE COLUMBUS DISPATCH

Ohio teachers are retiring at an average age of 58, putting a strain on the state's retired teacher health-care fund and contributing to an overall shortage in the number of teachers, according to an economic analysis released yesterday.

The State Teachers Retirement System gives teachers an incentive to retire at age 55 -- once they reach 30 years of service -- after which their contributions to the pension begin to outweigh their salaries, economists for the Dayton-based Thomas B. Fordham Institute concluded.

Many early-retiring teachers then return to the classroom while collecting their pensions, a practice known as double-dipping. The Fordham researchers said there are nearly 20,000 teachers collecting salaries and pensions at the same time in Ohio.

"It's just a peculiar unintended consequence of this particular system," said Terry Ryan, vice president of the Fordham Institute, a conservative policy center that specializes in education.

Ryan and University of Missouri economist Michael Podgursky, who worked on the Fordham report, said Ohio's generous pension plans, combined with the retirement of baby boomers and longer life expectancies, conspire to put a growing burden on education budgets.

Teacher retirement costs currently account for about 10 percent of per-pupil spending in Ohio, a figure that increases to more than 14 percent when nonteaching employees are added, Podgursky said.

"It's expensive and it's absorbing more, just like Social Security, of our tax dollars," Podgursky said.

STRS officials disputed many of the points in the report, including the assertion that tax dollars are on the line. In a statement late yesterday, spokeswoman Laura Ecklar said the pension system is self-funding with no obligation for the state to bail it out.

Ecklar also pointed to statistics showing that many teachers are staying longer. Since 2000, 35-year retirements have increased by more than 330 percent, she said.

More than two-thirds of teachers who retire and return to the classroom while collecting a pension do so as substitutes or temporaries, Ecklar said.

"When they say the pension fund undermines efforts to attract and retain good teachers, I don't see anything in this report that points to that," Ecklar said.

jnash@dispatch.com

P&I Daily
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Ohio doubles hedge funds of funds allocations

Ohio Public Employees' Retirement System, Columbus, doubled its allocations to its two hedge fund-of-funds managers, **Crestline Investors** and **Pacific Alternative Asset Management,** which now will run $50 million each.

The board of the $77.6 billion fund also heard presentations on the effects of a state House bill that would require public funds in the state to divest from holdings in public and private foreign corporations doing business in Iran. Michele Kowalik, a spokeswoman for OPERS, said the bill would cost the fund $244 million a year in lower investment returns.

A memo prepared by Tom Sherman, government relations officer for OPERS, explained the fund opposes the bill because of its effect on investments. "While no one at OPERS questions that the bill is well intentioned, state law clearly provides that the OPERS board and staff are under a fiduciary responsibility to act in the exclusive best interest of our members and our duty of loyalty is to our members." Mr. Sherman prepared his remarks for the House Financial Institutions, Real Estate and Securities Committee, but his

P&I Daily
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Mercer chosen as Ohio PERS consultant

Ohio Public Employees Retirement System, Columbus, selected **Mercer Investment Consulting** as its investment consultant, pending contract negotiations, spokeswoman Michele Kowalik confirmed. Mercer replaces Ennis, Knupp & Associates, which had been the $81 billion fund's consultant for six years. No reason was given for the switch.

THE WALL STREET JOURNAL. ONLINE

June 14, 2007

PAGE ONE

CUTTING TIES

Should States Sell Stocks To Protest Links to Iran?

In Ohio, Rep. Mandel Pushes for Pullout; White House Opposed

By NEIL KING JR.
June 14, 2007; Page A1

COLUMBUS, Ohio -- Three years ago, Josh Mandel was fighting insurgents as a Marine in Iraq. Today, as a freshman state legislator here, he's aiming at another big target: Iran and its nuclear program.

In March, weeks after he was sworn in, Rep. Mandel startled veteran lawmakers when he announced plans for a bill that would force the state's five public pension funds to divest themselves of stock in foreign companies doing business in Iran. The funds manage over $180 billion in assets, and among the companies targeted were more than a dozen with major investments in Ohio, including Japan's **Honda Motor** Co.

Josh Mandel

"The state should not be investing people's hard-earned dollars in countries that are sworn to America's destruction," says the 29-year-old Republican lawmaker.

A new legislative movement is tapping a wellspring of anxiety over Iran and its perceived threat to U.S. troops in the Middle East and to U.S. allies such as Israel. It has sparked fierce debate over what role local governments should play in guiding U.S. foreign policy and in directing the investments of the nation's huge public pension funds, which altogether hold more than $1 trillion in assets. (See related article.[1])

At least 14 other statehouses across the country are considering similar anti-Iran efforts. Last week, Florida Gov. Charlie Crist signed the nation's first Iran-divestment bill into law, and the California Assembly unanimously passed a bill forcing the state's two huge public pension funds, with more than $410 billion in assets, to shed their Iran-related assets. That bill is now headed to the state Senate. Texas, Illinois, Michigan and New Jersey, among others, are also weighing divestment legislation.

Some of the bills broadly target all companies active in Iran, while others focus on companies involved only in its energy sector.

STAKES IN IRAN

• **What's New:** Fifteen statehouses are weighing

Congress is offering unusual support, as both parties search for ways to increase pressure on Iran. Last month, Democratic Sen. Barack bills that would force public pension plans to bail out of companies doing business in Iran.

- **What's at Stake:** The nation's public pension funds hold more than $1 trillion in assets.
- **What It Means:** The legislative movement has sparked debate over the role local governments should play in guiding U.S. policy and in directing the investment of public pension funds.

Obama and Republican Sen. Sam Brownback, both presidential contenders, introduced legislation to support the local divestment bills and to shield divestment legislation from potential lawsuits challenging the states' right to enact laws that impact foreign policy.

The effect of the state divestment laws is likely to be mostly symbolic, as legislatures intend to give the funds a year or more to shed the targeted shares. Still, proponents hope divestment will weaken Iran's economy and destabilize its government. In the 1980s, a divestment campaign led dozens of U.S. companies to cease doing business in South Africa, helping end the apartheid system.

More recently, pressure over Sudan's handling of the atrocities in Darfur helped push British engine-maker **Rolls-Royce** PLC and two of Europe's largest technology companies, Germany's **Siemens** AG and Switzerland's **ABB** Ltd., to announce they are pulling out of the country.

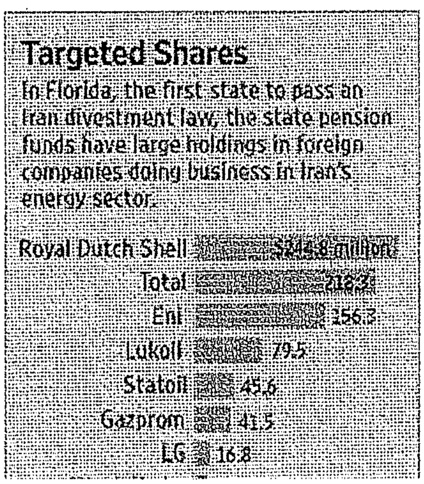
Big Implications

The effort has big implications for the public pension fund industry. Forcing the sale of tens of billions of dollars in foreign-equity holdings in dozens of blue-chip companies could cost the funds tens of millions of dollars in administrative costs alone. Furthermore, the funds argue that buying and selling assets for political reasons undermines their responsibility to shareholders, and could set a precedent for passing laws targeting investments in China or elsewhere.

"No one is for terrorism," says Laura Ecklar, a spokeswoman for Ohio's second-largest fund, the $75 billion State Teachers Retirement System, which has strongly opposed the Mandel bill. "But no matter how noble the cause, pension funds shouldn't be used to set foreign policy."

The Bush administration is strongly opposed to the legislation, arguing that it threatens to torpedo the larger diplomatic effort to isolate Tehran. The U.S., Britain, France and Germany -- along with China and Russia -- have been stepping up economic pressure on Iran to try to persuade it to stop its uranium-enrichment work, which they believe to be part of an effort to develop nuclear weapons. The U.S. also alleges that Iran is supplying Shiite militia groups in Iraq with weapons, which are being used to kill U.S. troops.

While U.S. companies have long been barred from operating in Iran, more than 200 multinationals have investments there, from British-Dutch oil giant **Royal Dutch Shell** PLC and French telecommunications-equipment company **Alcatel** SA to Sweden's electronics company **Telefon AB L.M. Ericsson**.



Companies targeted by the various Iran bills say they are paying close attention to the effort. But so far, none appear to have backed away from doing business in Iran as a result. Many dispute the efficacy of economic sanctions, and all say their investments are unrelated to Iran's nuclear program.

Ohio's effort is driven by Mr. Mandel, who joined the Marines in 2000 after finishing college. He was summoned to Iraq in 2004, where he served for eight months as an intelligence specialist in al Anbar province, one of the roughest areas of the country.

Over 6-feet-tall and rail thin, Mr. Mandel is so young people mistook him for a page when he first arrived in Columbus. Citing his Marine affiliation, Mr. Mandel refuses to comment on Iraq. His campaign platform focused not on the war abroad, but on local issues like attracting jobs to the area and protecting the tax base of local schools.

The legislator says he got the idea for the bill in December, after reading an opinion piece written by Missouri's Republican state treasurer, Sarah Steelman. One of the movement's most-outspoken proponents, Ms. Steelman last year launched a "terror-free" public fund in Missouri that filters out shares from companies doing business in Iran, North Korea, Sudan or Syria, countries listed by the U.S. government as sponsors of terrorism. In 2005 she persuaded the state's retirement system to shed shares in the same companies.

Knowing he would need help battling the pension funds, Mr. Mandel recruited another newly elected Republican, Rep. Shannon Jones, to co-sponsor the bill. "When Josh came to me with this, I said, 'We're going to do what?' It was a crazy idea, but I was taken by it immediately," says Ms. Jones, a former congressional staff aide and Republican campaign worker from outside Dayton. "I couldn't get over the fact that my own retirement money is investing in a little bit of terror."

The two spent more than a month drafting the bill, introducing it in April along with a lengthy written defense to pre-empt potential criticism. While some senior Republicans were leery, the bill attracted 29 co-sponsors out of the state House of Representatives' 99 members.

But it drew immediate fire from Ohio's pension funds. Administrators complained that the measure, if passed, would affect shares of more than 170 international companies and require the funds to sell, by one estimate, more than $9 billion in holdings. Administrative costs of divestment alone would top $60 million, they said.

Rallying Forces

Rallying their forces, the funds emailed "action alerts" to thousands of the state's 1.3 million current and retired state employees, alleging that the bill could gut their retirement and health-care accounts and urging them to call their local representatives. "A delayed response may be devastating," read one alert sent out in May by the Ohio State Teachers Retirement System.

RELATED ARTICLE

- Missouri Treasurer's Demand: 'Terror-Free' Pension Funds[2]
6/14/06

An even louder outcry arose from Ohio's industrial belt. The bill, which roped in companies with even small engagements with Iran, affected not only Honda, but **DaimlerChrysler** AG, **Bridgestone** Corp., Siemens and **ThyssenKrupp** AG, all of which have factories in Ohio. The pension funds estimated that the targeted companies employed more than 45,000 workers in the state.

One of the first critics to pull Mr. Mandel aside was Rep. Matt Szollosi, a freshman Democrat. His message: The bill would chill the investment climate in Ohio, a state already hard hit by the loss of manufacturing jobs. "I told him straight out that DaimlerChrysler has a new Jeep plant that straddles my district," Mr. Szollosi recalls. "They've invested up to $2.5 billion in that plant... . The bill as introduced would have had a devastating impact on Ohio from an economic-development standpoint."

'Dangerous Precedent'

The Ohio Chamber of Commerce also lobbied lawmakers to oppose the bill. Linda Woggon, who heads the chamber's governmental-affairs shop, sent a memo in May to members saying the bill would set a "dangerous precedent" by inserting politics into investment decisions and could put "our state's business climate at risk, especially in today's global economy." Most of the state's major newspapers, including the hometown Columbus Dispatch, editorialized against the bill.

Mr. Mandel's bill won some significant backers, too. James Woolsey, a former director of the Central Intelligence Agency under President Clinton, flew in to testify in favor of divestiture. Local Jewish groups organized a letter-writing and telephone campaign to push the bill. The powerful lobbying group, the American-Israeli Political Action Committee, also sent in advisers.

Then Ohio House Speaker Jon Husted, a Republican initially wary of the bill, advised Reps. Mandel and Jones how to beat back opposition. He said the bill had to get smaller, and shouldn't target companies active in Ohio.

So in May, Mr. Mandel and Ms. Jones decided to follow Florida's lead and only go after companies with investments of more than $20 million in Iran's energy sector. Many divestiture efforts focus on companies with investments in energy, which accounts for more than a quarter of Iran's total economic output. The companies include French energy company **Total** SA, Norway's **Statoil** ASA, and Malaysia's Petronas.

But the authors in Ohio also expanded the bill to include companies investing in Sudan's oil fields, in a bid to put pressure on the Sudanese government over Darfur.

On May 30, Mr. Mandel brought in some of his most powerful supporters -- Iraq war veterans. In Ohio and other states, the carnage in Iraq, fueled in part by Iran-supplied weapons, has given emotional impetus to the divestment movement. At the hearing, the father of an Ohio Marine told lawmakers how his son was killed last year in Iraq by a bomb traced back to Iran.

That day, the narrower bill sailed through the financial institutions committee by a vote of 17 to five. Backers included early critics like Rep. Szollosi, and, unexpectedly, Ohio's third-largest fund, the $12.5 billion Ohio Police and Fire Pension Fund. The fund had decided to remain neutral on the issue, a move seen as giving tacit support to the bill.

Hundreds of the fund's 52,000 active and retired members have served in Iraq. "Our members see things a little differently, say, from the teachers or other state employees," says fund director William Estabrook.

Last week, Speaker Husted postponed a full vote on the measure, and proposed a compromise in which the funds would voluntarily divest themselves from half of their Iran energy-related holdings within six months, and the remainder after that. In exchange, the House would refrain from passing mandatory legislation. Two days later, all five of the state funds agreed to the deal, though Rep. Mandel says he hasn't decided whether to support the compromise or push for a full vote of his bill.

Legislation in other big states has faced less opposition. Florida's Iran-divestment bill -- enacted into law last week -- won the backing of state veterans groups, the local AFL-CIO, and the state teachers union. The law, which also targets Sudan-related investments, takes aim at the shares of 25 companies in the $150 billion Florida Retirement System Fund, the state's main public pension fund. On the Florida list are Russia's two huge energy companies, OAO Gazprom and OAO Lukoil.

The fund put up little public opposition to the bill, despite an initial estimate that it could cost the fund up to $22 million in administrative fees.

California's divestment bill is the handiwork of freshman state Assemblyman Joel Anderson, a Republican from San Diego, who portrays the drive as a matter of simple investment logic. "Any idiot understands that Iran is a dumb place to be parking taxpayer money," he says.

Like Mr. Mandel, Mr. Anderson originally tried to push through a bill targeting the shares of all foreign companies in Iran. But he also finally settled on legislation focused on Iran's energy sector. His revised bill, which Gov. Arnold Schwarzenegger supports, could go before the California Senate as soon as September.

Divestment supporters are moving to another challenge. State pension funds invest much of their international holdings in index funds, making it impossible to shed individual company shares. Following Missouri's lead, Louisiana and other states are now looking to create funds that would bar the shares of companies active in any country listed by the U.S. as sponsors of terrorism.

The Bush administration is taking aim at states' efforts. Deputy Treasury Secretary Robert Kimmitt blasted the legislation in a speech last month, saying, "Our economic sanctions against Iran are intended to engage, not confront, our allies."

Mr. Mandel doesn't buy that there's a conflict between state measures and the administration's efforts in Washington. "The federal government is doing what it can," he says. "And so are we."

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Missouri Treasurer's Demand: 'Terror-Free' Pension Funds

By CRAIG KARMIN
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Sarah Steelman, the Missouri state treasurer, is emerging as a thorn in the side of a set of powerful global investors.

As pension funds face pressure from politicians to divest themselves from Iran and other countries deemed terrorism sponsors, she has staked out a zero-tolerance approach to investments like these. That's given the 49-year-old Republican a prominent voice in the wave of new legislation -- from Ohio to California -- targeting the $1 trillion pension-fund industry.

Ms. Steelman's own state legislature has declined to go along with her campaign. But a dozen other states -- including Florida, California and Texas -- have passed laws that could compel pension funds to divest themselves of holdings in companies that do business in countries like these. While U.S. companies are banned from doing business in those countries, many foreign companies are active there.


Missouri State Treasurer

Sarah Steelman, Missouri treasurer, contacted all 49 other state treasurers about terror-free divestment laws.

The list of companies potentially affected is extensive. Ms. Steelman says that nearly 500 big foreign companies and multinationals do at least some business in what the U.S. government considers terror-sponsoring nations.

Proposals in other states are considerably less far-reaching than what Ms. Steelman would like to see. For instance, some states focus on prohibiting investments in just a couple dozen companies in Iran's energy sector.

Last summer, Ms. Steelman unveiled what she calls a "terror free" fund -- a small fund, intended as a model, designed to avoid investments in nations considered terror sponsors. In its first eight months of existence, her fund has returned 27%, she says. "People said fund performance was going to suffer. We've shown that's just not true."

Many pension funds dismiss those returns, pointing out that the period is too short to be meaningful.

The dispute raises questions about what role taxpayer-supported pension funds should play in world affairs. Funds argue that while legislative efforts like these may be well-meaning, they conflict with a fund's fiduciary duty to get the best returns for beneficiaries. Complying with the anti-terror push, they say, could crimp returns.

Some fund managers also argue that the approach is misguided: Funds would have more influence over the offending companies by bringing pressure on them as shareholders.

"When you divest, you lose your place at the table," says Clark McKinley, spokesman for the California Public Employees' Retirement System. The $244 billion pension fund opposes pending legislation that could require Calpers to sell billions of dollars of investments in companies with Iran links.

The Center for Security Policy, a conservative Washington, D.C., think tank, says that it has identified 100 public pension funds in the U.S. that have about $188 billion invested in companies doing business in nations branded terror sponsors by the U.S. government.

"There is not a public pension fund out there that is not seriously looking at this issue," says Mark Tulay, a director at Institutional Shareholder Services, a consulting firm.

Ms. Steelman and other divestment proponents often cite the situation in South Africa two decades ago, when government sanctions and pension-fund divestment were widely credited with helping end the apartheid regime.

Ms. Steelman embraced the antiterrorism issue early on in her term, which began in January 2005. She started by examining the backgrounds of the broker-dealers employed by the Missouri state treasury. She says she fired two European banks after learning of their business ties to Iran.

She hired a money manager to screen for links to Iran and other blacklisted states for her new terror-free fund. That small $7 million fund invests Missouri money set aside for cultural activities.

Ms. Steelman spent much of 2006 reaching out to state lawmakers and contacting all 49 of the other state treasurers about passing terror-free divestment laws. She has also offered guidance to officials in other states on how to respond to pension-fund objections.

"As soon as we introduced the legislation, we scrambled to find experts on the topic," says Joel Anderson, the California assemblyman who sponsored his state's bill calling for divestment from companies doing business in Iran. Ms. Steelman has "been very helpful with the hurdles we had to overcome." The bill passed unopposed in the Assembly earlier this month and now heads to the California Senate.

Ms. Steelman has had less luck winning over the pension funds -- in her state or elsewhere. The antiterrorism bills vary from state to state: Some call for rapid divestment in more than 100 companies, while others are limited to about 20 and call for sales only after the funds talk to the companies.

Missouri's biggest public pension fund says it is waiting for clarification from Washington. "I'm looking for the federal government to give guidance on which companies to divest from, not the opinion of third-party organizations," says Steve Yoakum, executive director for the $32 billion Public School Retirement System of Missouri.

In general, pension-fund managers say complying with the new laws will cost money and hurt returns. Calpers, for instance, estimates that if the current bill becomes law, the fund would have to sell about $2 billion in investments at a cost of as much as $25 million. Calpers estimates that had a version of the California bill been in place in the past five years, it would have reduced the value of the fund's holdings by $725 million.

California State Teachers' System, a $171 billion pension fund, hasn't estimated the cost of compliance with the bill. But Calstrs Chief Executive Officer Jack Ehnes says he think a more effective strategy would be to make the case to these companies as major shareholders. "The first step is active engagement with the companies," he says.

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IRAN OR SUDAN TIES

Pension bill now orders only partial divestment

Wednesday, June 6, 2007 3:34 AM

BY JAMES NASH

THE COLUMBUS DISPATCH

Ohio's public pension funds will have to dump more than $500 million in investments with companies that do business with two countries connected to terrorism, legislative leaders decided in a compromise yesterday afternoon.

Instead of approving a bill that would have required the state's five public pension systems to divest all of their nearly $1.1 billion in investments tied to Iran and Sudan, House leaders decided to ask fund executives to voluntarily give up half of those investments by year's end.

They were given 48 hours to decide whether to agree to the deal brokered by House Speaker Jon A. Husted, R-Kettering, after several hours of private meetings. The compromise came after weeks of sometimes emotional debate over whether the money of retired state employees should be used as bargaining chips in national-security policy.

The original bill would have forced the pensions to withdraw investments in all companies that do business with Iran. Reps. Josh Mandel, R-Lyndhurst, and Shannon Jones, R-Springboro, later agreed to strip the bill down to energy companies, but it was expanded to include Sudan.

U.S. officials accuse Iran of fomenting religious violence in Iraq as well as developing nuclear weapons. Sudan is accused of harboring terrorist groups and standing by as Arab militias slaughter black Africans.

Pension board members and advocates for retired state employees have resisted any attempts to let political or national-security considerations restrict pension investments.

"It's like the old saying, the devil is in the details," said Laura Ecklar, spokeswoman for the State Teachers Retirement System. "The fact that there's still conversation is certainly always good. That we can accomplish this goal without mandated legislation is a step in the right direction."

Advocates for retired state employees had urged lawmakers to reject any restrictions on pension investments, saying it's unfair to penalize retirees over abstract global-security considerations. There was, however, little data on whether reinvesting $1.1 billion in Iran- and Sudan-connected pension assets would yield lower returns. The Public Employees Retirement System estimated that it would lose $244 million a year, but its calculation was based on an early version of the bill.

Mandel and Jones insisted that the pensions could yield higher returns. They pointed to the example of Missouri, where they said a terrorist-divestment law resulted in a 3.9 percent increase in returns.

Mandel and Jones could not be reached late yesterday.

Husted spokeswoman Karen Tabor said the House speaker hopes that pension executives will voluntarily pull retirees' money out of companies with ties to Iran and Sudan.

"We as a state need to be cautious because clearly there are funds that support terrorism," Tabor said.

William Winegarner, executive director of Public Employee Retirees, an advocacy group for Ohio pensioners, said he remains concerned about any attempt to link pension investments to foreign policy.

"Our position has been all along that the legislature should not be mandating in any way, shape or form the investment policies of the retirement systems," Winegarner said. "The retirement systems have a fiduciary responsibility to their members to handle their money properly. We feel that this particular bill was based on emotions."

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