



NCPERS 2011 Public Safety Conference

NCPERS concluded another successful Public Safety Employees Pension & Benefits Conference last month. This year's conference took place in a new location at Rancho Las Palmas, in Rancho Mirage, CA. Well attended by 250 public safety officials, trustees and administrators, the program provided members with valuable information and tools on how to embrace and adapt to change. NCPERS president Pat McElligott's opening remarks encouraged attendees to fight for financial safety. He told the audience that their hard work and dedication would be necessary for public pensions to be viable and strong over the coming years.

Dr. James Kee of South Texas Money Management provided an economic forecast for the upcoming year. Martin Schulz from PNC Capital Advisors and Alexander Kozhemiakin of Standish Asset Management spoke on trends and investment opportunities in emerging markets and how it now "covers a wide array of asset classes and countries with differing levels of development, wealth and risk." Ullico's Daniel Aronowitz and Arthur J. Gallagher Risk Management Services' Karen Graham presented the audience with fiduciary liability exposures. A discussion on DROP plans was covered by a panel of speakers including Bill Estabrook of the Ohio Police & Fire Pension Fund, Louise

Gates of Gabriel, Roeder, Smith and Bill Ackerman of Klausner & Kaufman. The crowd was able to participate in a little role play as Lydia Lee of Loeff, Cabraser, Himann & Bernstein presented the good, the bad and the ugly of pension safety and fiduciary liability alongside Hagens Berman Sobol Shapiro's Peter Bokon. Day one closed out with Paulette Lambert's presentation on health, nutrition and the ten goals for healthy eating.

Tuesday's program proved to pack just as much information as the day before. Dr. Thomas Barnett of WikiStrat wowed the crowd with his presentation on the past, present and future of globalization. He was able to breakdown the flow of people, flow of money and equity resources for the audience. EFI Actuaries' Greg Stump covered the past, present and future of public safety retirement benefits and Shana Saichek of Saichek Law Firm explained the advantages of a pooled retiree medical trust over individual health savings account. Pat Devaney from the Associated Fire Fighters of Illinois and Sean Smoot of the Illinois Police Benevolent & Protective Association shared Illinois' "We Are One" campaign with attendees. This media campaign represented an unprecedented partnership among labor across Illinois and highlighted just how much we depend on public employees in our communities. Terry Mumford from Ice Miller presented on

the questions the IRS is raising about public safety plans while Leon "Rocky" Joyner from Segal and William "Flick" Fornia of Pension Trustee Advisors discussed the response to proposed GASB accounting rules.

The final day of the conference begin with a presentation from Greg Kinczewski of Marco Consulting Group on making sense out of 2011 shareholder votes on executive compensation. The achievability of investment return assumptions of public safety plans was covered by Gary Bruebaker of the Washington State Investment Board. Rick Miller of OMERS gave insight on the asset allocation and benefits of investing in alternative asset and Kathryn Cimera from Bingham Mchale advised on how to minimize risk in evaluating disability claims. Steve Maviglio from Californians for Retirement Security presented on the anatomy of a public pension PR campaign. Hank Kim, NCPERS Executive Director and Leon "Rocky" Joyner wrapped up the conference with a legislative update on the latest developments in Washington, D.C. and information on the Secure Choice Pension Plan. Full presentations from the 2011 Public Safety Conference can be viewed at <http://www.ncpers.org/archives.php?pageid=58>. For more information on the Secure Choice Pension Plan please visit <http://www.retirementsecurityforall.org>. ♦

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Notes From Mongolia and China

By Martin Schulz and Calvin Zhang

On the surface, Mongolia and China look to be in drastically different phases of maturation; however projects in Mongolia could soon catapult the nation into a new direction. Following are some observations about these countries:

MONGOLIA

Mongolia is a landlocked nation of 2.7 million people located between Russia and China. Originally the land of Ghengis Khan, it was under Soviet influence until its own Democratic Revolution in 1990. Today, the country operates under a free market economy with dominant industries in agriculture and mining; however it remains relatively poor with an estimated nominal GDP of around \$6 billion in 2010.

What peaked our interest in visiting Mongolia is the construction of a huge gold and copper mine, Oyu Tolgoi, which is being developed by Ivanhoe Mines and Rio Tinto. The mine is expected to produce, at low estimates, 46 million ounces in gold, which for comparisons sake is more than China's official gold reserve and about a third of the U.S. gold reserves at Fort Knox. The mine will also yield an estimated one-half million tons of copper a year for over ten years. The project has been budgeted for a capex of \$5.5 billion, nearly the GDP of Mongolia itself. They are employing an estimated 14,000 workers for the build out and with the mine 22% finished, the first production cycle should start in the first half of 2013.

In our visits, we noticed an extremely polarized society. It is speculated that five people control approximately 80% of the wealth of the nation, but the general hope is that this mine will completely transform the nation. Mongolia has the potential to be the mining equivalent of Saudi Arabia in the oil markets. The Mongolian government owns approximately one-third

of the mines, so the goal is to use this mining revenue to balance society and redistribute income to the benefit of all. We believe Mongolia is on the forefront of many big changes and are at the beginning of a fast growth phase. The country is expanding quickly and we see many similarities to China just a short time ago.

CHINA

The remainder of the trip afforded the opportunity to spend some time in China. The following four themes were reinforced by our observations:

- **Inflation is a big problem.** Across the board, prices are up considerably and some of these are affecting corporations and consumers differently. Labor costs are rising quickly, up between 15 and 20% year over year. Paper pulp prices are up 40% year/year, chemical costs up 20% year/year, and dynamite costs up 30% year/year. For consumers, while they have seen food costs and real estate costs rise (pork prices are up 50% year over year), consumer product companies are restricted from raising prices. This is certainly having a negative impact on margins. While we think this affects their attractiveness in the short term, in the long term, companies can adjust by launching new products without price restrictions. We also have seen evidence that costs are trending down in the second half, so we look for continued evidence that inflation is waning.
- **Consumption habits have changed dramatically.** Particularly amongst younger consumers, luxury goods such as Burberry and Louis Vuitton are especially popular. And despite general wisdom, prices on these goods are actually higher in China as there are no discount

stores and a very high luxury goods tax. One reason why consumers are so strong is the aforementioned wage gains, which are contributing to wealth and disposable income. Unlike many others worldwide, the Chinese have multiple sources of income and remain very interested in finding new sources of wealth.

- **Real Estate is constrained.** Though the market is cooling, there is limited ability to buy apartments. Mid-sized developers are having funding issues due to slow sales. Finally, there is growing support to expand the '36 City List' where purchase of apartments is limited to long-term residents.
- **Infrastructure is in a state of growth.** Despite the rhetoric on government spending and slower growth, this is not echoed in the infrastructure, construction, and machinery industries. Roads,

Martin Schulz, managing director, and Calvin Zhang, senior analyst/portfolio manager, are primary members of the PNC Capital Advisors international growth team. In managing the portfolio, the team members frequently meet with government and business leaders throughout the world to monitor and assess economic conditions. Fluent in German and French, Mr. Schulz received a B.A. in international relations from Cornell University, graduating magna cum laude, and an M.B.A. in international business and a J.D. from George Washington University. Mr. Zhang is primarily responsible for research and analysis on Asian growth-oriented securities for the portfolio. He earned a B.A. in English and computer science from the South China University of Technology and an M.B.A. from the University of Rochester.

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Five Policy Prescriptions for Europe

By Tom Fahey, Senior Global Macro Strategist

The European sovereign debt crisis continues to hemorrhage risk throughout the financial markets. While investors like to think there is a magic policy response, in our view, the crisis is a chronic illness likely to deliver ongoing bouts of acute pain to the financial markets.

In gauging the outlook for the eurozone, analysts and investors have set forth varying policy prescriptions for troubled countries and the European Central Bank (ECB). The following actions, which are not mutually exclusive, summarize the scope of recommendations.

- Apply fiscal austerity and hopefully grow out of debt
- Expand the ECB's balance sheet by purchasing large amounts of sovereign debt
- Create a fiscal union,¹ issue eurobonds and cede sovereign fiscal authority
- Restructure or default on sovereign debt, recapitalize banks and start fresh
- Exit from eurozone membership

APPLY FISCAL AUSTERITY, HOPEFULLY GROW OUT OF DEBT

Troubled countries in Europe are following the first prescription, but growing out of debt will likely take years. There are no guarantees that fiscal austerity will reduce costs, raise productivity and improve the potential rate of GDP growth. Productivity and growth trends for many countries in Europe have been very weak during the past decade. Investing in their sovereign bonds could require a leap of faith that these economies can grow and generate income to service debts. In our estimation, Europe's ongoing challenge will be its ability to grow.

Leading economic indicators in Europe are signaling recession risk as we head into 2012. Against this backdrop, many investors have been losing faith that some European countries, like Italy, will be able to grow and generate enough income to meet debt obligations in the long run. Therefore, the pool of sovereign bond investors is shrinking, making it difficult for countries to refinance large amounts of debt. As a result, risk premiums have risen on the major Spanish, Italian and even French, debt markets.

EXPAND THE ECB BALANCE SHEET

If demonstrating the ability to grow is a chronic challenge, then bouts of acute pain will likely accompany poor economic data and inadequate

policy responses. Without economic growth, Europe needs a "Plan B," which leads to the remaining policy prescriptions. Our view is Europe needs a lender of last resort in one form or another to stop the run on sovereign debt. Despite ECB purchases, yields on Spanish and Italian debt remain very high relative to German bonds. In our opinion, the ECB buying program is not convincing investors it will be a true lender of last resort. Expanding the ECB balance sheet could ease the acute pain and anxiety permeating throughout the capital markets. The ECB in theory has unlimited purchasing power and could temper risk premiums if it guaranteed to buy any euro-denominated debt trading outside a certain yield spread to German

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Don't Wait Till it's Too Late: A proactive approach to data security

By John Reidy

As a Trustee or Administrator of a pension fund, your members rely on you to protect their retirement assets. Your membership should also have the same level of confidence in the way in which you are protecting another valuable asset, their personal information. Due to the daily functions that your retirement board is required to perform, your retirement office is probably storing confidential information such as member's name, address, birthdate, social security number, bank accounts, and information pertaining to health insurance and medical records. This type of information is considered Personal Identifiable Information and can be used to steal a person's identity or gain unauthorized access to one's financial accounts. In the first quarter of 2011, there were over 65,000 new malware threats discovered on the internet every day. As these types of attacks increase, security policies and procedures must be kept up to date in order to protect against the many new threats that might put someone's personal information at risk.

Over the past several years, there have been several highly publicized security breaches at both corporate and government entities. For example, in April of 2011, Sony's Corporations Online Gaming Network was attacked and information of 100 million customers was compromised. From May 2007 through April 2010, the Social Security Administration exposed personal identifiable information of more than 36,000 individuals. In April 2011, it was reported that the Texas State Comptroller's office exposed the names and social security numbers of 3.5 million residents for nearly an

entire year. These and many similar incidents have caused state and federal governments to enact legislation designed to minimize the threat of a security breach in the future and provide policies and procedures for organizations to follow if they are exposed to such a breach. The 112th Congress is set to undertake the adoption of the most comprehensive set of cyber security policies that have ever been introduced at the federal level. Even though there might be variations between cyber security policies at the federal and state levels, the fact still remains that organizations that maintain personal identifiable information should put in place appropriate policies and procedures designed to protect this information from being exposed to the public either accidentally or through malicious means. With the overlapping of federal and state guidelines, public entities such as public employee pension funds often fall in a "gray" area that might leave them exempt from complying with a specific set of data security regulations. However, this does not mean that public employee pension funds are immune from the data security risks that continue to threaten both private and public institutions.

The cost associated with a data breach can often come in both monetary and non-tangible forms. For example, in 2010 organizations exposed to a breach spent \$214 per exposed record. This includes the costs to investigate the breach, notification, credit monitoring for the individuals whose data was exposed in the breach, and the legal fees and claims associated with incident. To put things in real life perspective, it could cost a pension fund with 1500 total members more than \$320,000 to

cover the expenses that could arise from such an event. There are also additional long term costs associated with a data breach that cannot be monetized. The reputational damage and the business interruptions that the breached organization could incur can have lasting impact on its credibility and viability as an institution. In these challenging times, publicity from the media regarding such a data breach is something that public employee pension funds should aggressively try to avoid. It is this type of negative press that can be distracting to the true mission of public employee pension retirement systems.

Even though there is no fool-proof way to protect your retirement system from exposure to a data breach, there are a number of things that can be done in order to provide significant protection for your membership's personal information. The publicity surrounding this topic has created a new cottage industry of companies that provide in-depth security audits and assessments of all types of organizations. Security consultants will review your retirement board's processes and procedures and then make recommendations of how and where to make necessary improvements. Since most retirement boards provide similar types of membership services, there are several vulnerability points that are consistent from one board to another. One area that a security consultant will review will be how your retirement board manages its paper and electronic records and files. They will review the types of information that is contained on these documents, and then determine how they might be used, distributed, stored and then destroyed. Even though

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Insight into Commodities

By Jodie Gunzberg, CFA

COMMODITIES DEFINED

Commodities are fungible, raw materials used to produce all types of goods, from food to gasoline and even to build infrastructure like bridges. There are five major sectors that comprise the commodities market: agriculture, base metals, energy, livestock, and precious metals.

A LOOK INSIDE THE COMMODITY MARKETS

The key to understanding commodity investing is to realize the relationships between the commodity spot, futures, and storage markets and the role of hedgers and speculators.

THE SPOT MARKET

Commodities are bought and sold for cash in the spot market. If more commodities are produced than consumed, then inventories will increase causing an excess so there will be downward price pressure. On the other hand, if more commodities are consumed than produced, inventories will decrease which may cause a shortage so there may be upward price pressure.

Since spot prices can be volatile, the futures market was developed to help commercial producers and consumers insure their operations. For example, a farmer (producer) might sell short corn futures to offset the risk from a decline in the price of corn. Conversely, a cereal maker (commercial consumer) might buy long corn futures to offset the risk from an increase in the price of corn. While the hedger's goal is to offset earnings volatility, speculators will try to profit from positions, providing greater liquidity that likely contributes to lower price volatility.

THE FUTURES MARKET

The relationship between the expected future spot price and the futures

price begins with a theory, which assumes more producer than commercial consumer hedging. This is because it is easier for commercial consumers than producers to substitute. For example, a food label might state, "may contain one or more of the following: soybean oil, palm oil, or canola oil." This is so the manufacturer can use the cheapest oil without reprinting labels. Clearly, it is more difficult for the canola seed grower (producer) to plant palm trees.

This imbalance may cause the futures price to be lower than the expected future spot price, which is also known as net short hedging pressure, since producers want to be short futures in order to hedge their price risk.

However, there are times when commercial consumers hedge more than producers (net long hedging pressure) to protect themselves against price increases. For example, consumers of agricultural commodities may be willing to pay a premium above the expected future spot price for protection against a price spike due to adverse weather conditions.

Over time the futures price must converge to the expected future spot price, so if there is net short hedging pressure, the futures price will be forced to rise over time. Alternatively, if there is net long hedging pressure, the futures price will be forced to fall over time.

THE STORAGE MARKET

The relationship between the price of a futures contract that expires near and the price of one that expires further out is driven by the cost of storing the underlying commodity.

Commercial producers use inventories to fill gaps between production and sales, and commercial consumers use inventories to fill gaps between consumption and purchases in the storage market.

The decision of whether to buy

and store a commodity until a certain time or to buy a futures contract for delivery at that time should be based on convenience yield. It is the marginal benefit to the inventory holder from holding a marginal unit of inventory and increases as inventories decrease.

While the price of storage is not directly observable it can be inferred by the opportunity cost. If a commodity is placed into storage for a set time to be delivered in the future at a set price, then the interest is forgone by selling the commodity on the spot and investing the proceeds in a riskless security. A profit or loss from the difference between the spot price and the futures price will be realized, and the costs of placing and keeping the commodity in a storage facility must be paid.

COMMODITY INVESTING THROUGH FUTURES – BACKWARDATION AND CONTANGO

The reality of buying commodities in the spot market and storing them can be impractical, so most commodity based investment products employ futures. However, term structures in futures may detract from total return.

Usually when inventories are scarce or difficult to store, the convenience yield surpasses the cost of storage plus the forgone interest from selling the commodity. As a result, the futures that expire sooner are more expensive than the futures due further out. The shape of this futures curve would be downward sloping or in backwardation, thus investors profit from being long by selling expensive and buying cheap. On the other hand, when inventories are plentiful, the cost of storage plus the forgone interest from selling the commodity surpasses the convenience yield. Therefore, the futures that expire sooner are cheaper than the futures due further out. The shape of this

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NCPERS Group Voluntary Life Insurance Plan To Make Benefit Improvements in 2012

Responding to requests from Life Plan sponsoring public retirement systems, the NCPERS Life Plan will adopt the following benefit improvements beginning with open enrollments in 2012:

- The age for dependent child life insurance coverage will be increased from 21 to 26. The current definition of a dependent child does not change and will not necessarily match the dependent definition for health plan coverages under federal health care reform (PPACA). However, the maximum coverage ages will be the same.
- In those states where “civil unions” are allowed by law, the definition of a dependent spouse will be expanded to include these relationships. This change will not apply in states where civil unions and/or domestic partnerships are not permitted.

OVERVIEW OF THE NCPERS GROUP VOLUNTARY LIFE INSURANCE PLAN

- The Plan has been offered to NCPERS retirement plans as a member benefit for over 40 years.
- The Plan currently insures over 100,000 active employees, retirees and their dependents.
- The Plan paid almost \$15 Million in life insurance benefits to public

- employees and retirees in 2010.
- NCPERS developed the Plan to supplement pension benefits and provide enhanced financial security:
 - For younger employees it provides additional family support when accrued pension benefits are lowest.
 - For older employees, it provides added financial support in times of need.
 - For retirees, it offers additional life insurance protection that is not easily obtained at older ages.

KEY FEATURES OF THE NCPERS LIFE INSURANCE PLAN

- Guaranteed issue coverage. No medical underwriting required.
- No minimum enrollment requirements.
- 24 Hour coverage. Pays in addition to any other group or individual life insurance.
- Includes spouse and dependent life insurance coverages.
- Includes Accidental Death and Dismemberment (AS&D) coverage.
- Maximum benefit of \$325,000 (including AD&D insurance).
- Level premium payment over your lifetime. Either \$16 or \$17/month, depending on option selected.
- Voluntary coverage. No employer/retirement system contributions required.

- Allows retirement system to offer a new member benefit at no direct cost.
- Coverage can be continued into retirement. No maximum age limit.
- Flexible administration. Premiums can be paid either by payroll deduction or direct payment by plan participant.
- Implementation allowance available to new retirement system Plan sponsors to help offset any indirect start-up costs.

NEW NCPERS LIFE PLAN SPONSORS

Since the 2007 introduction of the Family Protection Plus Plan, which does not require payroll deductions for premium payments, the NCPERS Life Plan has added the following new retirement plan sponsors:

- Arkansas Local Police and Fire Retirement System
- Chattanooga Fire and Police Pension Fund
- Dallas Police and Fire Pension System
- Illinois Public Pension Fund Association
- Ohio Police and Fire Pension Fund.

For more information about this valuable benefit of your pension plan’s membership in NCPERS, please contact Bill Robinson at (800) 628-5691 or Bill_robinson@ajg.com ❖

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transportation, and traffic are improving and despite the tragic crash in late July, China’s new high-speed rail system has been a success highlighted by convenient and efficient service.

Certainly, this trip afforded us the perspective of two drastically different, yet strangely similar nations at

very distinct points in their growth cycle. Overall, we continue to be encouraged by the things we see as investors, not only at the broader macro level, but at the company level as well. ❖

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Pension Policy and the Courts - A Never Ending Evolution

By Robert D. Klausner, NCPERS General Counsel

The importance of the judicial system in the formulation of long-term retirement policy cannot be understated. From constitutional questions to rulemaking to the definition of “pensionable compensation,” court decisions can ratify or repeal longstanding practices. Below are some examples of very recent decisions illustrating the importance of following what goes on at the courthouse:



STATUTE REQUIRING THE PAYMENT OF VOLUNTARY HEALTHCARE PREMIUMS FROM RETIREE PENSION PAYMENTS DOES NOT VIOLATE CONSTITUTIONAL PROTECTIONS.

A Union and individual retirees brought suit against the state and the state pension system seeking a declaration that a statute mandating that the system deduct premiums for voluntary healthcare coverage is unconstitutional. Healthcare benefits and pension benefits are administered through separate systems under separate statutory authority. The statute at issue provided that the retirement system was required to deduct a specified insurance premium for all members receiving such healthcare benefits. The Plaintiffs argued that the statute violated the state’s constitutional protection against impairment of contract. The lower court found no constitutional violations. The court found that there was impairment to a vested contractual right, but that the impairment was not substantial, and thus did not violate the constitutional prohibition on impairment of contract.

The New Hampshire Supreme

Court affirmed. The court reasoned that the retirees would have been required to pay insurance premiums regardless of whether the premiums were deducted from pension benefit payments or whether the retirees were separately billed. Therefore, the New Hampshire Supreme Court agreed that any contractual impairment was not substantial and did not violate any constitutional protection. “The plaintiffs acknowledged at oral argument that the crux of this dispute is not whether the State may charge retirees a premium toward their healthcare, but how the

State can collect that premium. Given that the retirees who are covered must pay the premium in one manner or another, we cannot say that any alleged alteration of contractual obligations is anything other than minimal.”

STATE EMPLOYEES’ ASS’N OF NEW HAMPSHIRE V. STATE OF NEW HAMPSHIRE, 161 N.H. 730 (2011) PENSION BOARD’S ESTABLISHMENT OF 30-DAY DEADLINE TO CONVERT DISABILITY APPLICATION TO APPLICATION FOR NORMAL RETIREMENT CONSTITUTES IMPROPER RULEMAKING.

A pension Board denied a member’s application for retroactive service

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ACHIEVEMENT: BALANCING RISK AND RETURN

AT PNC CAPITAL ADVISORS, our investment approach is measured and disciplined. Our dedicated teams of investment professionals manage client assets in a variety of strategies — fixed income, municipals and domestic and international equities — with the goal to generate alpha. The firm’s story is one of proven processes and strong results. To learn more about our strategies, call Brian Harrington at 410-237-5514 or visit pnccapitaladvisors.com



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retirement benefits as untimely because she filed it more than 30 days after the Board denied her application for normal disability retirement benefits. After being notified of the denial of her disability benefits, the applicant was advised that she could convert her application for disability benefits into an application for normal retirement (for which she was eligible)

within 30 days. However, there was no legal authority for the 30-day deadline. The applicant appealed the denial of disability benefits and did not immediately apply for normal retirement benefits. She applied for normal retirement benefits several years after the Board's denial of her disability application, but prior to the ultimate resolution of the appeal regarding denial of disability benefits.

In applying for normal retirement, the applicant sought benefits retroactive to the date when she first applied for disability benefits. The Board repeatedly denied the applicant's request for retroactive benefits and litigation ensued. The court found that "[t]he Board's November 2006 letter advised [the applicant] of her right to appeal its decision, and, because she exer-

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bonds. However, the ECB appears to be handcuffed by its own rules and its intent to keep the profligate countries' feet to the fire. In addition, as an independent central bank, it has strong objections to monetizing debt. Thus, there is no lender of last resort to support the sovereign countries in crisis.

FISCAL UNION

Even if the ECB were to expand its balance sheet, it would only be buying time, because monetary policy has a limited impact on long-run potential growth. The next policy prescription, a fiscal union and eurobond issuance, would create a quasi-lender of last resort for the sovereign bond market. The market is experiencing a run on sovereign bonds and there is no institutional backstop in Europe to stem it. Some call the lack of a fiscal union the fatal flaw of the eurozone because a fiscal union could restrict profligate spending by weaker members while facilitating transfer payments to sovereigns facing a liquidity crisis. In our view, once the eurozone countries gave up their sovereign currencies and the ability to control their own money supplies, which could service debts indefinitely, a backup liquidity facility was needed. The European Financial Stability Facility (EFSF)² has some resemblance to a fiscal union because it provides liquidity to sovereigns that have lost access to the capital markets. However, with only €440 billion in

lending power, it has a very limited scope, especially considering the €300 billion in debt Italy has to refinance during 2012.

Investors talk of leveraging the EFSF's assets to €2 trillion in order for the facility to be a credible lender of last resort for the sovereign bond markets. A leveraged EFSF could ease the acute pain hitting the markets. However, the ECB would probably be called on to supply the leverage, thereby expanding its balance sheet—something it seems reluctant to do. Leveraging the EFSF through the ECB could be an option worth pursuing if it allowed the ECB to circumvent its rules of operation; however, the ECB Governing Council appears split over the potential merits of this proposal. Alternatively, turning the EFSF into an insurance scheme that absorbs the first 20% to 40% of losses could perhaps also work to leverage the fund size toward a more meaningful amount in the €1.5 to €2 trillion range. These are creative options that have the potential to reduce the pain in financial markets; however, short of growing out of debt, these options would just transfer the credit risk without eliminating it.

A fiscal union could be a nice addition to the structure of monetary union, but we don't believe it is likely to form any time soon. The political objections are significant; it would require treaty changes, unanimous member acceptance, and lengthy democratic debate because it would leave huge contingent liabilities on the balance sheets of each sovereign country,

particularly the larger countries of France and Germany. The German constitutional court on September 7 threw cold water on the potential for eurobonds when it said, "the *Bundestag*, as the legislature, is also prohibited from establishing permanent mechanisms under the law of international agreements which result in an assumption of liability for other states' voluntary decisions, especially if they have consequences whose impact is difficult to calculate." A fiscal union would require significant centralized control over fiscal policy—a development few countries seem willing to cede at this point.

RESTRUCTURE OR DEFAULT ON SOVEREIGN DEBT—RECAPITALIZE BANKS

That brings us to the fourth policy prescription. Reducing the debt overhang is critical to helping the European economy improve its growth prospects. Removing the threat of default and uncertainty that comes with excessive debt levels could help improve the real capital investment decisions that drive GDP growth. If a country is unable to grow and meet its obligations, default and debt restructuring have to be part of the solution. The question then becomes who owns the debt and whether they are strong enough to take the loss. It is this uncertainty that is infecting the capital markets—who is going to take the haircut³ on the debt and will it cause a domino effect throughout the financial system?

The IMF calculates that the sovereign debt crisis in the high-risk countries of Greece, Ireland, Portugal, Italy, Belgium and Spain is affecting €300 billion in assets. This is not an estimate of potential losses but gives an idea of the scale of assets being affected. On the positive side, €300 billion is equivalent to only 3% of eurozone GDP.

EXIT EUROZONE

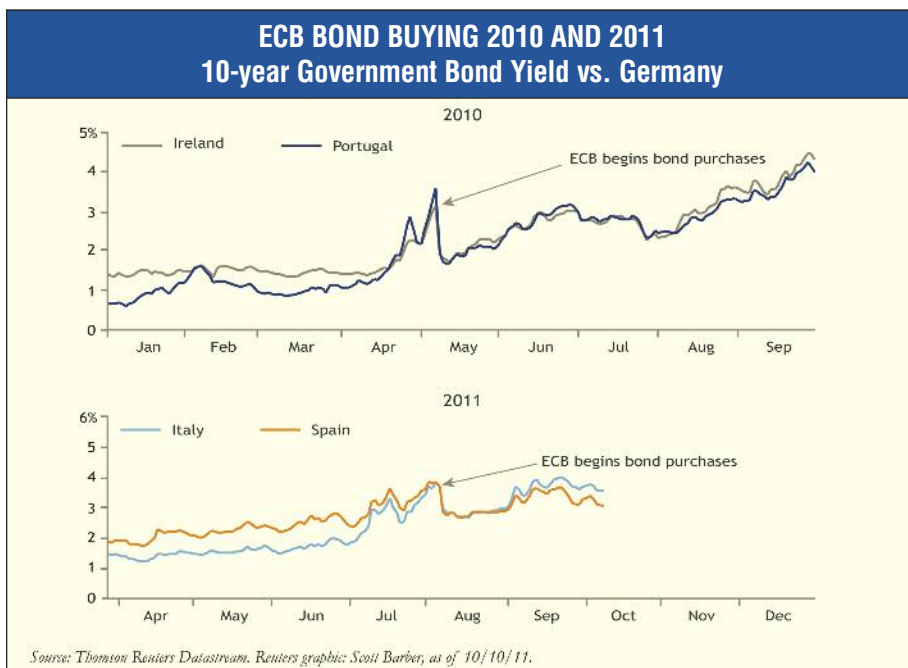
The final prescription, troubled countries exiting the eurozone, still seems like a very low probability event. Anything can happen, but the cost and complexity of exiting the euro would be significant. The founding members of the euro explicitly created a “no-exit” clause because one country leaving could damage all members of the eurozone.

The exiting country, after becoming insolvent under the burden of euro debts, would still have to apply fiscal austerity, raise a primary balance surplus and recapitalize its banks and corporate sector. We believe countries would choose to default and restructure but stay within the eurozone. After all, the relatively healthy euro members are doing a worthy service to troubled countries by providing them with liquidity while exposing their sovereign balance sheets to large contingent liabilities.

CONCLUSION

The European sovereign debt crisis is chronic. It cannot be resolved until countries can demonstrate the ability to grow and improve their budget deficits. The immediate need is to stop Europe from hemorrhaging risk into the global financial markets. That can only be done by the ECB because it is Europe’s most effective and high profile euro-area institution and the banking system’s only lender of last resort. Until the ECB steps up to commit sufficient liquidity, the overall septic conditions of European risk will likely continue to infect the global capital markets.

THE ECB NEEDS TO DO MORE BUYING...



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¹Fiscal union is the integration of the fiscal policy of nations or states. Under fiscal union, decisions about the collection and expenditure of taxes are taken by common institutions, shared by the participating governments. (Wikipedia)

²The EFSF was created by euro-area member states in 2010. According to the organization, its mandate is to safeguard financial stability in the eurozone by raising funds in the capital markets to finance loans for euro area member states (www.efsf.europa.eu).

³A haircut is a percentage that is subtracted from the market value of an asset being used as collateral (Wikipedia).

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most data breach notification requirements apply only to breaches involving data in electronic format, stealing personal information from paper documents is still very common. Protecting these documents should be considered a major priority in your board's formal security policy. Other exposure points that a security consultant might review can include how your board communicates with its service partners such as the employers, financial institutions, IRS, DOR, actuaries, law firms, doctors, and health insurance companies. Your retirement staff is constantly communicating with service partners outside of the retirement board. Many of these communications are done through email or

“snail” mail and can include sensitive personal information. How this data is transmitted and received is an area that many organizations can greatly improve on. There are many tools available designed to protect sensitive information during electronic transmission. However, encrypting and protecting sensitive information is another step in the process that many staff members simply overlook. Taking the extra step to make sure that electronic transmissions of data are encrypted and secure can go a long way in protecting the assets of your membership and ultimately the mission of the board. The commitment to protect sensitive membership data is one that has to start at the board level and then fully adopted by the fund's staff and its affiliates. Though you might not receive any

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financial gain by protecting your membership data, we all have something to lose if a public employee pension fund becomes a victim of a breach of its member's personal information. ❖

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futures curve would be upward sloping or in contango, consequently investors lose from being long by selling cheap and buying expensive.

Generally, the prevailing condition is contango because the storage costs are positive and there is no shortage. This has been a concern for investors since it detracts from the total return of commodities.

ADDING COMMODITIES TO A PORTFOLIO

Despite the contango, commodities are considered attractive due to the historically low correlations to traditional asset classes such as stocks and bonds.

Chart 1: Cumulative Index Returns Monthly Data from 3/31/01-3/31/11

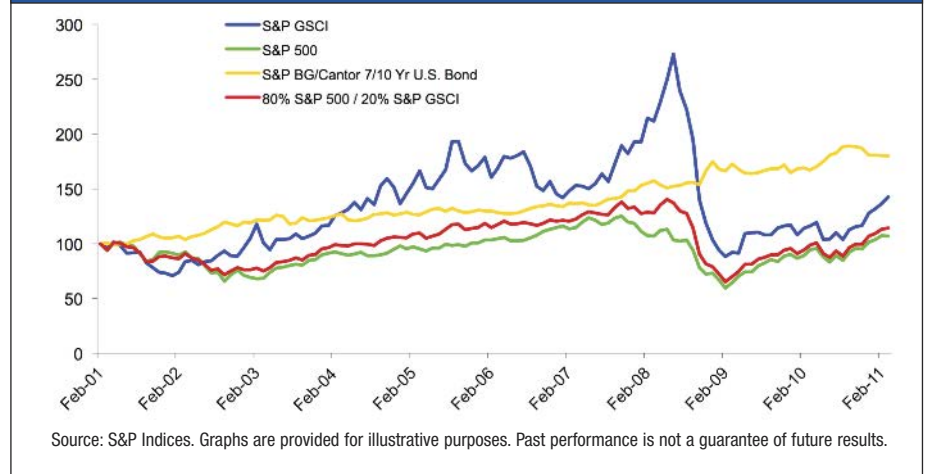


Table 1: Improving Portfolio Efficiency

Monthly Data from Jan 2000 – Dec 2010	Portfolio 1	Portfolio 2	Portfolio 3
Stocks (%)	100	50	30
Bonds (%)	0	50	50
Commodities (%)	0	0	20
Annualized Return (%)	0.41	3.71	4.71
Annualized Risk (%)	16.47	8.00	7.79
Sharpe Ratio	-0.14	0.13	0.27

Source: S&P Indices. Charts are provided for illustrative purposes. Past performance is not a guarantee of future results.
 Note: S&P 500®, S&P BG/Cantor 7/10 Yr. U.S. Bond, and S&P GSCI represent stocks, bonds, and commodities, respectively.
 Citigroup BIG and three-month Treasury bill @ 2.65% used to calculate the Sharpe ratio.

As shown in Table 1 below, an investor may increase her/his portfolio return while reducing risk, as s/he moves from an all equity portfolio (Portfolio 1) to a portfolio containing stocks and bonds (Portfolio 2), and finally to a portfolio containing stocks, bonds and commodities (Portfolio 3.)

Chart 1 above, shows how a stock portfolio, with a 20% allocation to commodities, would have outperformed on a cumulative basis, from March 2001 – March 2011, despite the large drawdown that occurred in 2008.

Commodities are also considered to be a strong hedge against inflation and the U.S. dollar as depicted in Charts 2 and 3 below.

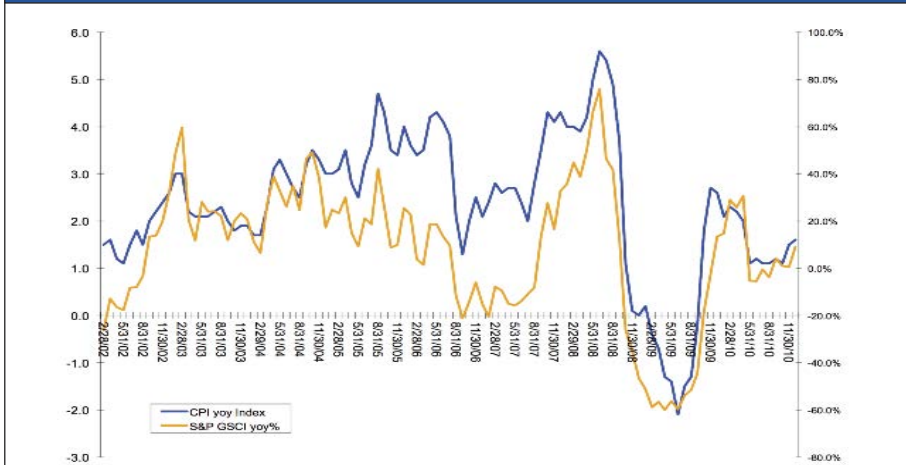
CONCLUSION

All of the examples discussed above use the most basic beta of the commodities market as depicted by the

S&P GSCI[®]. However, as investors have become more sophisticated, there has been an evolution of commodity index offerings to provide solutions to investors seeking exposure to commodities with less volatility.

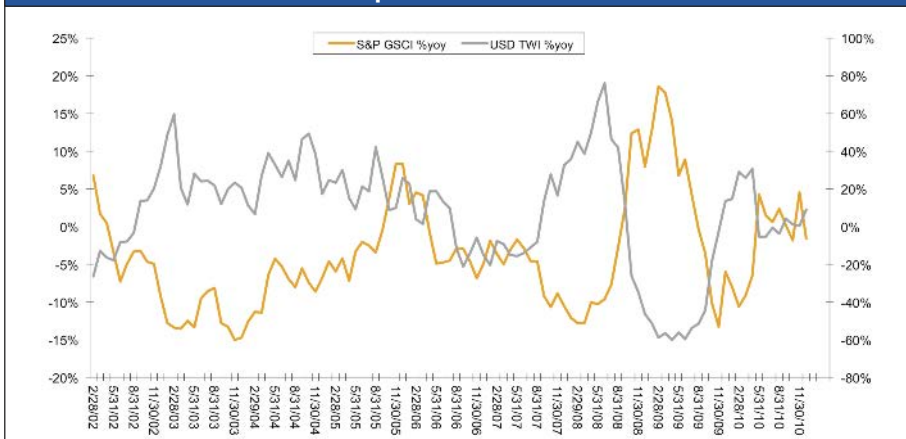
As the evolution progresses to reduce volatility, some indices modify the energy exposure while others modify the roll, or the contract expiration of choice. Additionally, some indices may include a broader set of commodities or an even more expansive set of futures all together, including not only commodities but also currencies, equity indices, fixed income indices, and short term interest rates that capture broad global trends. ♦

Chart 2: Commodities and Inflation A Natural Hedge



Source: S&P Indices. Monthly Data from Feb 2002 - Dec 2010. Graphs are provided for illustrative purposes. Past performance is not a guarantee of future results.

Chart 3: Inverse Relationship Between Commodities and the US Dollar



Source: S&P Indices. Monthly Data from Feb 2002 - Dec 2010. Graphs are provided for illustrative purposes. Past performance is not a guarantee of future results.

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cised that right, in effect, she did not receive final notice of denial of her benefits until the Supreme Court's June 2009 decision [affirming the denial of her disability benefits]."

Ultimately, the court held that the Board improperly engaged in rulemaking by setting an arbitrary 30-day deadline to convert a disability application to an application for normal retirement.

BUENO V. BD. OF TRUSTEES, 2011 WL 4482503 (N.J. SUPER. CT. APP. DIV. 2011) SETTLEMENT PAYMENT FROM CLASS ACTION REGARDING UNPAID WAGES QUALIFY AS PENSIONABLE EARNINGS.

A county and retirement system appealed a lower court's ruling that class action settlement payments are "compensation earnable." The class action case at issue involved allegations of underpayment by the county. Under the retirement plan, "compensation earnable" is defined as "salaries or wages earned during a payroll period for personal services." The court concluded that because "the awards were paid in lieu of wages and salary that the plaintiffs claimed should have been paid in the past[,]" the settlement payment properly constitute compensation earnable.

This article is a regular feature of PER-SIST. Robert D. Klausner, a well-known lawyer specializing in public pension law throughout the United States, is General Counsel of NCPERS as well as a lecturer and law professor. While all efforts have been made to insure the accuracy of this section, the materials presented here are for the education of NCPERS members and are not intended as specific legal advice. For more information go to www.robertdklausner.com

SERRES V. WASHINGTON DEPT. OF RET. SYS., 2011 WL 4090414 (WASH. CT. APP. SEPT. 12, 2011) ❖



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