

**TESTIMONY OF EDWARD M. SWAN, JR., CFA
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Before the

**SUBCOMMITTEE ON FEDERAL WORKFORCE, POSTAL SERVICE, AND
THE DISTRICT OF COLUMBIA
HON. DANNY K DAVIS, CHAIRMAN**

**COMMITTEE ON OVERSIGHT AND GOVERNMENT REFORM
U. S. HOUSE OF REPRESENTATIVES**

**“INVESTING IN THE FUTURE: MINORITY OPPORTUNITIES AND THE
FEDERAL RETIREMENT THRIFT SAVINGS PLAN (TSP)”**

JULY 10, 2008

BACKGROUND

I am Edward M. Swan, Jr., CFA. I attended Tufts University and received my MBA from the Wharton School. I recently retired from daily participation in the financial services industry after over 33 years as an analyst, portfolio manager, marketing professional and executive. I have worked for very large firms, such as Prudential, UBS and MFS. My experience also included playing an important role at several smaller firms, such as WR Lazard and FIS Group. I also was a graduate business school faculty member developing and teaching advanced investment courses. Currently, I serve on the investment committees for several universities and a foundation. My career has given me perspective on a wide range of investment strategies and some great firms.

I attended as a potential bidder what I believe to have been the first (or at least a very early) bidders conference for the Thrift Savings Plan (‘TSP’) in the mid to late 1980’s. I remember being struck at that time how the RFP seemed to have been written with such high barriers to qualification that only a very few investment management firms could participate. The most critical barrier about which I speak involves assets under management (‘AUM’). Literally, the AUM requirement was so high that I remember thinking there could not be more than 5 firms in the country ‘qualified’ to bid. While time distorts the memory a bit, I don’t believe the very small number of ‘qualified’ bidders is exaggerated. Please remember that ‘qualified’ to bid is quite different from capable of rendering the requested service. Today we are talking about how to enhance an important retirement benefit program by opening it up to more firms capable of rendering a broad range of investment related services.

THE KEY POINTS IN MY TESTIMONY ARE -

1. Passive (normally referring to indexing during my testimony) management has an important, but limited role in managing portfolios.
2. Active management can add value.
3. DC plan participants deserve to have a broad range of investment choices. This point is important to make, but will be covered more fully by other presenters.

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IMPORTANT DEFINITIONS

The first set of important definitions has to do with different investment approaches.

- Active management is the effort to provide investment returns greater than a specified benchmark or index, such as the S&P 500 or the Russell 3000 ('R3000'). This is the classic beat the benchmark approach. It almost always involves an effort to pick the securities most likely, in aggregate, to provide performance over a reasonable time period ahead of the benchmark of index. These portfolio construction efforts can be
 - top down i.e. where you try to determine the direction of the economy and its implication for specific industries and or companies or
 - bottom up i.e. where you look for various company financial characteristics.
 - Most active managers use various combinations of both approaches.
- Passive management is a second major approach. The objective of passive management is to produce returns nearly identical to a specified benchmark or index, generally at a low fee.

The second set of important definitions has to do with the characteristics of the retirement program itself.

- Defined benefit ('DB') plans are the classic pension fund where the plan sponsor 'guarantees' some benefit based on years of participation and salary levels.

- Defined contribution ('DC') plans are based on the amount the employee contributes, often with some sort of employer match. A 401(k) would be an example of a DC program. The most common format is that the employee has a range of investment options representing various expected risk/return tradeoffs and other preferences. We will come back these choices the employee should be allowed to make because that is a critical point.

GENERAL COMMENTS

What are the arguments for and against active and passive management? In summary, the proponents of passive management claim that over time most active managers won't beat the benchmark anyway, so why bother paying higher fees and enduring the risk. Active managers make two key points. First, many if not always a majority of managers do beat their benchmarks. Second, the compounded effect on the growth in a portfolio's value from beating the benchmark over time is so great that it is worth the effort.

What do the data say about active versus passive management? The most important conclusion to draw is that many, if not always a majority, of active managers do perform better than their benchmark. How much better is a function of several factors –

1. manager skill
2. level of market efficiency – the most efficient market would be US Treasury issues (where almost all information is known by almost all participants) through inefficient markets, such as non-US developing equity markets (where the information is much more limited and less widely distributed). Managers operating in less efficient markets have a greater opportunity to outperform their benchmark(s).
3. market direction – it is generally easier to outperform in falling markets because of cash holdings

We looked at five basic sectors, four of which are in the TSP. They were domestic fixed income (Attachment 1), domestic large cap core equity (Attachment 2), domestic small cap core equity (Attachment 3), non-US developed equity markets (Attachment 4) and non-US developing equity markets (Attachment 5). What were the important conclusions?

1. Active managers in certain asset classes over time seem to have a higher likelihood of performing better than their benchmark (i.e. providing 'excess return'). Domestic fixed income seems to be most difficult to add significant value above the benchmark. Large cap core equity tends to add more excess return, but still less than the non-US developed market managers and small cap

core equity managers. This phenomenon exists largely because of the different levels of information available about securities in different markets (i.e. 'market efficiency'). For example, almost every institutional investor has the same information available to them about US Treasury issues or IBM as every other institutional investor. The differences in portfolio performance are largely determined by the manager's skill. Conversely, each small cap core company may be covered by only a few analysts. Information about these companies, beyond annual reports, other regulatory filings and online data sources, may be limited. Therefore, investment managers have an opportunity to discover 'hidden gems' in this sector.

2. You will also note that over time the difference between the best performing managers (shown as the 5th percentile at the top of each column on Attachments 1 through 5) and the worst performing manager (shown as the 95th percentile at the bottom of each column) tends to narrow over time. This phenomena is called 'mean reversion' and occurs because over time managers make some good decisions and some not so good decisions. Skilled managers, those providing excess return over time, simply tend to make more good decisions than bad decisions. Conversely, managers failing to provide 'excess return' tend to make more poor decisions than good ones.

Manager fee levels are another important consideration. As an example, if an active investment firm provides performance 0.90% ('90 basis points') above their benchmark, yet charges the client 1.00% ('100 basis points') and an index investment firm charges 0.10% ('10 basis points') to achieve benchmark level performance then little has been accomplished in terms of wealth accumulation for the client. Obviously, this construct ignores issue of relative risk for the sake of simplicity. The lowest fees tend to be charged in -

- The most efficient market sectors. In our case that would be for domestic fixed income.
- The lowest risk strategies. In our case that would be for indexing rather than active management.

The critical decision factor is whether the expected return from an active investment strategy, net of the fee, will be greater than the expected return from an index strategy, net of fee. Again, relative risk has been ignored for simplicity's sake. The TSP has very large plan assets and hence has the bargaining power to demand extraordinarily low fees. As an example, if we were to assume that the TSP were to select active managers performing only at the median manager level for the past 20 years, then there would have been a significant enough spread between the benchmark performance and the manager performance to more than accommodate active management fees. **REMEMBER**, this example is based on the assumption that the TSP staff and their consultants could do no better selecting the median manager. One would certainly hope that well paid investment consulting professionals could do better than select median performers, since median

performance could be achieved at no cost by random selection of managers within each sector. The following data are drawn from Attachments 1 through 5.

<u>Sector</u>	<u>Median Mgr</u>	<u>Benchmark</u>	<u>Spread</u>
Core Bond	7.33%	7.48%	(0.15%)
Large Cap Equity	11.45%	10.92%	0.53%
Small Cap Equity	12.82%	9.79%	3.03%
Int'l Equity (Dev.)	9.56%	6.54%	3.02%
Int'l Equity (Emerg.)	17.64%	14.53%	3.11%

As you can see from the preceding data, all of the equity sectors could have sustained active management. Certainly, small cap and international equity have very significant spreads. Again, these spreads were generated by a process equivalent to random selection of managers. One would hope that staff and consultants could provide better than random results.

It is reasonable to question whether small differences in performance will make a meaningful difference in wealth accumulation for the average TSP participant. Despite the importance of asset allocation, the following example shows that over time performance even slightly exceeding the benchmark is a powerful tool for building retirement assets. The data shown below provides an indication of the final asset accumulation for a participant depositing \$10,000 at the end of each year for 20 years, assuming no withdrawals.

<u>Avg. Annual Return</u>	<u>Total Accumulation</u>
5%	\$255,406
6%	\$268,704
7%	\$282,797

8%

\$297,781

While on the surface the differences in accumulation may not seem major, they are of considerable importance if these accumulations represent a significant percent of the assets upon which a retiree must live. If active management can help increase returns above those provided by indexing, then that is of value.

Given that our primary focus is on improving the overall retirement program, what are the most critical factors impacting asset growth? The most important factor is getting plan participants to make the maximum possible deposit into the plan each year. The item having the second most impact is the allocation of assets between the various investment sectors. The old adage of a 'rising tide raising all ships' is true for asset allocation decisions. It is generally agreed that 90% to 95% of a portfolio's total return will come from asset allocation. If the stock market is going up, it is important to be in the market, since all managers will benefit, albeit some more than others.

Another way to enhance the Plan is to make additional investment options available that are expected to increase diversification and/or improve performance. Attachment 6 provides a correlation matrix listing asset classes expected to perform well over time. The point of the matrix is that while all of the asset classes in the attachment are expected to add value over time not all will perform well at the same time. This is the basic principle underlying the rationale for diversification. Thus, when domestic all cap equities (R3000) are performing well, approximately 63% of the time non-US developed equity markets will not be performing as well. Conversely, if non-US developed equity markets are performing well then 63% of the time domestic all cap equities sell. These asynchronous ups and downs reduce risk and smooth performance over time.

Attachments 7 through 9 show the risk return trade-offs for each of the asset classes for 7, 10 and 20 year periods. While there are only three years of private equity/venture capital data from the proxy benchmark, it does seem clear the addition of these two sectors has the distinct prospect of improving returns and reducing risk.

Several of these sectors – venture capital/ private equity and real estate – are very powerful producers of future return and have low correlations to more traditional asset classes. Hence, they can be important additions to a portfolio, yet they do not lend themselves to passive/index management. These types of investments have traditionally been used by DB plans and high net worth programs. While this is not the forum for discussion how they might be included as limited participation options, I suggest such exploration could be of immense benefit to Plan participants.

Over the past 20 years there have been two important changes that allow very large plan sponsors to successfully use the services of smaller financial service vendors –

1. The cost of powerful technology used for investment management, brokerage and other financial services has been lowered to the point that firm size should not be a limiting factor as to whether services can be effectively rendered

2. The very successful advent of manager of manager programs allow smaller specialized investment management firms to be combined to compete very effectively with the largest firms in our business

At this point smaller, minority minority and/or women owned firms should have the opportunity to offer their services to the participants of the Thrift Savings Plan. Conversely, the participants of the TSP should have the opportunity to select from a broader range of investment management providers. Others among my associates testifying today will address this topic in greater depth.

SUMMARY

There are two central questions.

The first is whether there is a reasonable possibility of selecting active managers with the capacity to outperform the benchmark over reasonable time periods. The answer yes it is very possible to improve overall plan performance through the addition of carefully selected active managers. The TPA either currently has or should have the resources to assist it with the manager selection process. The industry is served by a number of consultants with the skill to pick managers capable of adding value above their benchmark. This does not mean that each manager will provide above benchmark performance in all periods! Managers have to be monitored and at times replaced.

The second is whether smaller investment managers (hopefully with a focus on minority owned and women owned firms) can provide competitive services. Again, the answer is yes. The very competitive record provided by a number of manager of emerging manager programs discussed by my associates should serve a proof statement that smaller firms can indeed compete. Further, focusing only on very large service providers and not aggressively pursuing smaller, innovative providers may well be detrimental to the interests of the Thrift Savings Plan participants.