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U.S. House of Representatives

Hearing on Investing in the Future: Minority Opportunities and the Thrift Savings Plan

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Chairman Davis, Ranking Member Marchant, and Members of the Subcommittee, thank you for this opportunity to testify on this matter of great importance to millions of federal workers. My name is Jarvis Hollingsworth and I am a partner in the Houston office of the international law firm of Bracewell & Giuliani. While I am a former Board Chair of the Teacher Retirement System of Texas, the views I am expressing today are my own and do not reflect either the position of the System or my firm.

The Teacher Retirement System of Texas ("TRS") is a state agency that manages a \$112 billion-plus pension trust fund and administers an array of benefits, including healthcare programs, for over 1.2 million retirees and active teachers. TRS is the sixth largest public pension plan in the United States. The System pays out over \$5.5 billion in annual benefit payments. As trustees of the system, the board is actively involved in hiring investment advisors, determining asset allocation and formulating investment-benefit policies for the fund which invests in domestic and international securities, private equity, real estate and hedge funds. As fiduciaries, the board, with advice from staff and external consultants, sets policy and asset allocation that it collectively determines is in the best interest of the constituents. I also served on the board of directors of the Texas Growth fund, a private equity fund focused on investing in Texas-based companies.

Pursuant to the June 26, 2008 letter from Subcommittee Chairman Davis, my discussion today will address three main issues:

1. Recent changes in investment asset allocation at TRS;
2. The use of external managers moving TRS from a passively-managed strategy to some active management; and
3. Exploring ways to increase minority participation in the management of the TSP.

ASSET ALLOCATION

During fiscal year 2006, the TRS board instituted a review of the investment program. The objective was to increase the returns without an increase in risk, and to enhance the competitiveness of the fund. The board, in cooperation with the staff and external consultants, conducted a comprehensive review of TRS policies and practices. The review centered on four key initiatives:

1. Establishing a more efficient and holistic asset allocation;
2. Accessing external managers where appropriate;
3. Using derivative instruments to manage risk and increase efficiency; and
4. Establishing risk management principals and practices.

The board determined that these initiatives would help the fund meet its future pension obligations, be more cost-effective and manage risk in a proactive manner.

In recent years, the portfolio was concentrated in large domestic equities. Hence, a majority of the fund's returns were traditionally driven by the performance of these publicly-traded instruments. In August 31, 2006, the proportions of TRS' total investment assets were 65% equities, 26.8% fixed income, 4.3% spread across the various alternative assets (private equity, real estate and hedge funds) and 3.9% in cash instruments. Over 90% of the fund was essentially invested in an enhanced index or passive management approach.

In order to achieve a more efficient allocation policy and lessen the fund's exposure to dramatic swings in the stock market, TRS conducted a comprehensive asset allocation study that included both public and private markets implemented through both traditional and alternative investment markets. This study resulted in the definition of three major asset categories: global equities (60% of the portfolio), which includes all public and private equity; stable value (20% of the portfolio), which includes all fixed income credit U.S. treasuries, hedge funds and cash; and real return (20% of the portfolio), which includes real estate, real assets, commodities and global inflation-linked bonds. This reallocation moved the fund away from the traditional model of being highly weighted in publicly traded stocks and bonds and allowed the fund to guard against the downturns in certain markets and better capitalize on the strong returns of less traditional asset classes. In addition to being a better balanced portfolio, it offered greater diversification, the opportunity for more robust returns and took advantage of the fund's competitive advantages – long investment time horizon (ten years) and very limited short-term liquidity requirements. This asset reallocation also decreased the fund's downside risk, lowered the volatility in the portfolio and lowered the correlation among the portfolio's asset classes.

ACTIVE v. PASSIVE MANAGEMENT AND EXTERNAL MANAGERS

TRS has a long-standing tradition of managing the assets of the trust internally in a cost-effective manner. As indicated earlier, the vast majority of the assets as of October, 2006, were internally managed by TRS investment professionals. This strategy resembled what many described as an enhanced index or a passive management approach, and was not unlike the structure of many large pension plans. As a matter of fact, 70% of pension plan assets are managed by plan investment professionals. While this resulted in an effective, low-cost implementation of policy that produced consistent returns over time by a highly professional and competent group of TRS investment professionals, staff, in conjunction with the board and its advisors, determined that a combination of both internal and external management would allow for a more effective portfolio design that diversifies risk across managers and investment strategies.

As reported to the board by TRS investment staff, external managers can be beneficial to the performance of the fund in many ways. First, external managers give the fund access to unique strategies not available from in-house resources. External managers often specialize in specific strategies that have been refined over time after incurring significant development and implementation costs. While there are clear benefits to having a variety of strategies available for investing fund assets, in many cases it may not be economically feasible to internally identify and develop additional strategies with above-average returns or desirable diversification characteristics. This is especially true for investment in areas such as emerging markets, private issues, or non-financial assets. Engaging external managers that already have these capabilities can be an effective way to take advantage of the attractive returns and diversification effects of these unique strategies without incurring prohibitive development costs or refining new strategies through trial and error.

External managers can also assist in improved risk management for higher risk or high yield strategies. These strategies require more sophisticated risk management efforts to insure that they reflect an appropriate level of risk. External managers that have successfully implemented higher risk and/or high yield strategies to enhance earnings have already developed the necessary infrastructure to measure, monitor, and manage the unique risks associated with these strategies. There is strong support throughout the investment industry that the use of external managers is an appropriate strategy when used in conjunction with suitable controls and risk management resources. They can be used to improve investment returns, manage existing risk exposures, and achieve significant efficiencies in the administration of pension assets. A significant number of large pension funds currently use external managers to assist in achieving their investment goals. In the 2007 legislative session, the Texas legislature authorized TRS to use external managers to manage up to 30% of the fund's assets. TRS is currently undergoing a process to structure a due diligence program to review and select its external managers.

External managers, however, are not without their costs. There are obviously management and performance fees associated with the engagement of external managers and this factor weighed heavily in the decision by the TRS board to engage external managers. As a bit of background, prior to the implementation of this investment process in October 2006, TRS had one of the lowest per-member costs among U.S. public pension plans. However, after much consultation

with TRS' internal staff and external consultants, the board concluded that given the opportunity to improve investment returns gained by the engagement of external managers, combined with the diversification that would result from the added expertise in specific strategies not available from the TRS staff, and the improved risk management, the increased costs were worth the engagement of external managers in certain asset classes. As discussed earlier, the external manager program has not yet been implemented as TRS is currently undergoing a process to structure the due diligence program to review and select its external managers.

All in all, a more diverse combination of market exposures gained through a balanced asset allocation, active management strategies, where appropriate, combined with the inclusion of highly skilled external managers selected through a prudent process, can improve the overall results of a fund by boosting returns and diversifying risks.

SMALL AND EMERGING MANAGERS AND MINORITY AND WOMAN-OWNED FUND PARTICIPATION

As fiduciaries of public funds, trustees have a duty to seek superior, risk-adjusted returns for their annuitants, and the case has been made that young, talented small and emerging managers have out performed their large counterparts in both up and down markets. While these young managers generally have shorter track records and less experience, they can have a very strong competitive advantage due to the absence of a legacy portfolio and the ability to devote more time and resources to the investment process. Also, in the area of private equity, for example, the continued upward trend in fund and deal size creates opportunities for outsized returns for these small and emerging players who can take advantage of a relatively lower level of competition and more favorable valuations. They can also diversify a portfolio as they typically target sectors, strategies and geographies, and allow limited partners the opportunity to gain meaningful allocations in their fund.

TRS launched a small and emerging manager program in 2004 as part of a broader effort to diversify the private equity investment portfolio. One of the primary objectives of the program was to identify less-established private equity funds viewed to possess the requisite underwriting skill and discipline to provide top-quartile investment returns. Prior to establishing the program, TRS invested primarily in the nation's largest private equity funds.

Diversity of investment professionals is also important and is very complimentary to the risk/return goals at TRS. Minority and woman-owned managers are more likely to be in the small and emerging manager space and give pension plans a means to develop meaningful relationships with such businesses. TRS is committed to increasing the number and size of its relationships with minority and woman-owned firms having the qualifications to assist in fulfilling the TRS mission, in accordance with TRS' fiduciary responsibilities to plan participants. In addition, the reallocation of the plan's assets in October 2006 also provides additional opportunities for TRS to increase the number of relationships it has with minority and woman-owned managers. Currently, small and emerging manager programs have been implemented in the TRS private equity and hedge fund programs through the use of fund of funds, and TRS is currently evaluating fund of fund managers for the implementation of small and emerging manager programs in the global equities and real estate portfolios.

In addition, in 2006 TRS launched a minority and woman-owned brokerage program to increase the fund's relationships with these businesses. It is a six month pilot program in which these firms are allowed to execute trades for a six month period, after which their execution and/or research is evaluated for inclusion on the system's approved list of brokers. TRS has been very pleased with the results of this program.

In light of the projected demographic changes in the U.S. and abroad, investing in funds targeting under-served markets offer attractive opportunities to pension plans to potentially enhance returns that opportunistically target high-growth ethnic and economic sectors. This risk/reward appeal of minority and woman-owned firms to institutional investors mirrors the attractive demographics among minority groups who are projected to account for a vast majority of the overall U.S. population growth in the very near future. In addition, minority purchasing power and businesses owned by minorities continue to grow by increments vastly exceeding the U.S. average. Moreover, according to the U.S. Census Bureau, women currently account for 51% of the total U.S. population and have significant influence on consumer behavior. As such, businesses that are successfully catering to the female market are also well positioned for growth and profitability. Minority and woman-owned funds are uniquely positioned to find and take advantage of these attractive opportunities for targeting high-growth ethnic and economic sectors, and are, therefore, very complimentary to the risk/return goals of plan fiduciaries.

As pension obligations continue to increase and the global investment marketplace continues to rapidly change, plan fiduciaries must search for ways to invest more efficiently and effectively and to boost investment returns while reducing long-term risks. We are confident that the investment changes made at TRS will best serve the interests of the members, the retirees and the pension fund.

I hope this review of recent TRS activities has been of assistance to the Subcommittee as it carries out its vital oversight of the federal TSP. Thank you.