Statement of Mr. Gary A. Amelio, Executive Director
Federal Retirement Thrift Investment Board
Before the House Subcommittee on the Federal Workforce and Agency Organization
April 19, 2005

Mr. Chairman and members of the Subcommittee, my name is Gary Amelio. Since June 1, 2003, I have served as Executive Director of the Federal Retirement Thrift Investment Board. Before coming to the Board, I had 23 years of private-sector experience in the employee benefits, tax, and fiduciary industry. I appear before the Subcommittee today with extensive professional experience.

My mission is to apprise the Subcommittee of the unanimous position of the Thrift Savings Plan fiduciaries, being the five Board members and myself, to oppose legislation which would add a REIT fund to the Plan. Our position is neither a commentary on the investment worthiness of REITs, nor a permanent edict.

A fiduciary must exercise the highest degree of skill and care when considering changes to the Plan's investment options. First, the universe of available investment options should be evaluated to determine whether any alternatives might be added. At the same time, the fiduciary must review current Plan options to determine if removal of any existing fund is appropriate. This "in-total" review is a necessary fiduciary function.

Examples of options to be considered in a comprehensive review include: a) whether to split the existing C and S Funds to provide for growth and value equity management styles, b) replacing the existing S Fund with separate small-capitalization and mid-capitalization funds, or c) adding other asset classes such as international emerging markets equity, hedge funds, high-yield debt, inflation protected bonds (TIPS), and commodities.

The analysis must also consider the existing TSP Plan design. For example, our enabling statute requires the Plan to be administered at a low cost. After reviewing current industry products, I believe that any REIT fund, even if acquired through competitive bidding, could cost the TSP participants many times more than the existing Plan menu. Moreover, there could be other significant costs of investment in these funds, such as market impact and other transaction costs.

Furthermore, adding a fund to the Plan is not a “freebie.” It could increase expenses for the participants by as much as 10 percent ($8-10 million) to engage contractors to modify the TSP Website, record keeping and participant statement systems, as well as to create new brochures and forms, while destroying the existing ones.

The fiduciaries have determined that the cost of the Lifecycle Funds rollout which is currently underway is money well spent, since it educates participants about the importance of asset allocation. Even those who choose not to utilize Lifecycle Funds will benefit from the educational materials. There is no commensurate benefit in communicating a narrow, industry specific product.

The fiduciaries’ fund selection process is, of course, based upon need and demand. The Thrift Savings Plan participants already hold over a billion dollars in REITs through the C and S Funds, making our Plan the thirteenth or so largest holder of REITs in the country, i.e., the need is already met. As for demand, there is no use adding a fund that no one wants. I receive many letters, e-mails and calls from the 3.4 million participants who are quite willing to share their thoughts with me. In my nearly two-year tenure, I have received only one letter concerning REITs.

As the Subcommittee is aware, the administration has held the Thrift Savings Plan up as a model in terms of structuring investment options for individual retirement savings. Many reputable national financial reporters and virtually all of the major news and trade publications have written about the TSP and specifically its menu of investment options in laudatory terms. Our simple five fund structure, low costs, broad-based index investment approach and long-term performance have generated high confidence levels and unequalled participation rates.

In deciding whether to offer Lifecycle Funds for the TSP, we first issued a Request for Information, seeking input from major investment consultants, banks, and mutual fund managers. We asked all of these organizations the same question: whether the current TSP fund lineup offered our participants adequate opportunities for diversification in their accounts and, by extension, in the Lifecycle Funds. Every organization affirmed that the current TSP fund menu offered such diversification and that additional funds were not required. Several of the organizations affirmed that the current TSP fund options offered not only adequate but ideal diversification.

Moreover, the Agency has already received an expert opinion concerning the need for additional funds at the present time to achieve diversification within the TSP. We specifically tasked Mercer Investment Consulting, Inc., the expert we selected to develop our asset allocation models for the Lifecycle Funds, with examining the current TSP fund options to determine if they provided adequate diversification to TSP participants. They affirmed that the current funds provided such diversification and that no other funds were needed.

The Board members and I have decided to engage a reputable investment consulting firm to assist in analyzing various investment-related Plan issues. A review of investment options, securities lending, risk management controls and next year's competitive bidding of the existing funds' management are all considerations in this discussion. I request that any consideration of legislation be delayed at least until after the appropriate review by the fiduciaries.

Proponents argue that REITs (as a proxy for real estate investment) offer diversification benefits that merit an overweighting of REITs in investor portfolios relative to their market capitalization (which weighting already exists in the C and S Funds). Without the inclusion of a stand-alone REIT securities fund, such an overweighting cannot be achieved in the TSP structure; however, the addition of a REIT securities fund, or any other new investment fund, should not be considered based on possible diversification benefits alone. In deciding whether or not to endorse the inclusion of a REIT securities investment fund at this time, we considered not only the possible benefits, but also TSP investor profiles, the added Plan complexity, the cost to participants and the investor education challenges that would ensue.

The professional staff analysis of the numbers used to justify the overweighting in REITs found that the potential benefits of doing so were overstated. In fact, the additional returns that the REIT industry cited as being achievable assumed a 40 percent allocation in REITs, and were based entirely on investment hindsight. No investment professional would recommend such a weighting. Further, conclusions about fund performance cannot be based on hindsight, but rather upon assumptions about future economic performance.

Furthermore, some TSP participants have demonstrated a tendency to chase returns, which could likely result in higher turnover rates for such a fund and higher transaction costs. Education efforts to counter such behavior are costly and ineffective. Restrictions on the size and/or frequency of interfund transfers complicate administration of the Plan and would negatively affect all TSP participants, even those who do not invest in a REIT fund.

The policy of adding a fund with higher asset management costs because it offers the potential for a premium on returns is a course that the Congressional authors of the TSP decided -- wisely in my view -- not to pursue. The TSP design, which calls for tracking broad-based indexes while adding value through low costs, has been embraced by participants and recognized by many impartial observers as an optimum approach. We do not recommend a change in this successful formula at this time.

It must be noted that although participants can always decide not to invest in a new fund, adding one always generates costs that all participants must pay. Consequently, the fiduciaries must exercise prudence in determining which, if any, additional funds they would recommend.

In an extensive training session conducted this February for all six TSP fiduciaries and the senior staff, the expert from the Center for Fiduciary Studies was asked by a Board member whether he believed that additional funds should be sought, and if so, which ones. He responded negatively and further stated, without any prompting, that if some were to be considered, REITs would not be at the top of the list.

I do not cite this response to suggest that third party views, or even our own analysis at a given point in time, resolves a question for all time. Rather, I raise it only to demonstrate that as fiduciaries, we are constantly seeking information from all sources on ways to improve the Plan. Indeed, this is why I met with the industry association representatives who were promoting REIT investments. The Board’s responsibility under our statute is to develop investment policies. Obtaining and analyzing new information is an ongoing process and a fiduciary responsibility.

Thus, although the view we have expressed on this matter is shared by me, the Board members, the professional staff, our asset allocation consultant, and our fiduciary trainer, it could change over time. We intend to obtain additional information and conduct careful and ongoing analysis. We would be especially interested in any data the industry has collected regarding REIT investments in other participant-directed, daily-valued defined contribution plans with a large and diverse participant base.

Finally, I ask the Subcommittee's support to help ensure that this issue not be allowed to distract participant attention from the rollout of the Lifecycle Funds this summer. The Board members and I are convinced that these asset allocation models would be highly valuable for most participants. However, experience shows that when Lifecycle Funds are offered, many participants do not take advantage of them as a result of confusion or insecurity by overwhelming volumes of information. To counter this, we are developing an education effort that is both focused and sustained. It would really be a shame if some TSP participants decide not to look at TSP Lifecycle Funds when they become available because they heard that additional funds might be coming later.