COUNCIL OF INSTITUTIONAL INVESTORS
LIST OF ATTENDEES
ANNUAL MEETING

The Grand Hotel
April 2-3, 1990

Abraham, John - American Federation of Teachers
Andersen, Maryellen - Connecticut Retirement & Trust Funds
Anderson, Adrian - District of Columbia Retirement Board
Arthur, Dellene - Fire and Police Pension Systems, City of LA
Ashe, Peter - San Francisco City and County Employees System
Baladi, Andrè - Baladi & Company
Ball, David - Department of Labor
Bardwell, Jerry - City Employees' Retirement System of the City of LA
Bartlett, Sarah - The New York Times
Birch, Robert - Central Pension Fund of Intl. Union of Operating Engineers
Breeden, Richard - Chairman, SEC
Briggs, Joseph - Equitable Capital Management Corporation
Brosius, John - Pennsylvania State Employes' Retirement System
Brown, Cathy - Iowa Public Employees Retirement System
Burton, James - California Public Employees' Retirement System
Cabral, Richard - Contra Costa County Employees' Retirement Association
Calabrese, Mike - AFL-CIO
Carlson, Robert - CalPERS
Chernoff, Joel - Pensions and Investments
Ciriello, Paul - Fidelity Investments
Ciszek, Judith - Pennsylvania State Treasury
Cobb, Joe - Legislative Assistant to Senator Steve Symms
Codlin, Kenneth - State Universities Retirement System of Illinois
Cohen, Marilyn - Capital Insight Brokerage
Cones, George - Houston Firemen's Relief and Retirement Fund
Coyne, Ken - Annuity Reserve Fund of the Los Angeles Unified School District
Crist, Bill - CalPERS
Crystal, Graef - University of CA Haas School of Business
Cullins, Jeanna - District of Columbia Retirement Board
Davis, Gray - California State Controller
Deer, Joe - Washington State Investment Board
Diddi, Rahul - International Center for Fiduciary Research
Dixon, Cathy - Securities & Exchange Commission
Dole, Robert - Senator (R) Kansas
Drapeau, Jene - Fidelity Investments
Dunphy, Robert - Prudential Asset Management Company
Durgin, Hillary - Pensions and Investments
Durkin, Edward - United Brotherhood of Carpenters Local Unions
Ellis, Bill - CalPERS
Ellison, Ernest - Trust Company of the West
Elmore, Heather - Council of Institutional Investors
Figueroa, Jose - City Employees' Retirement System of the City of LA
Fleming, Ed - Contra Costa County Employees' Retirement Association
Forand, Edward - Connecticut Retirement and Trust Funds
Foust, Dean - Business Week
Fowler, Ralph - California State Teachers' Retirement System
Fritz, Cyril - California State Teachers' Retirement System
Gadarowski, Chris - Simon School
Gaigelas, Paul - HealthCare Investment Advisors
Gitlitz, David - United Shareholders Association
Glen, Rob - Prudential Asset Management Company
Gmach, David - New York City Comptroller's Office
Goldin, Jay - Goldin and Associates
Goodman, Amy - Insights
Gordon, Lilli - Analysis Group, Inc.

Grant, Richard - AFL-CIO
Hales, Edward - State of Wisconsin Investment Board
Hamilton, Beverly - New York City Comptrollers Office
Hanson, Dale - California Public Employees' Retirement System
Heard, Jamie - Analysis Group, Inc.
Henrichsen, Susan - CA Attorney General's Office
Henricks, Daryl - Analysis Group, Inc.
Hewitt, Carol - Oregon State Treasury
Hofer, Charles - J.P. Morgan Investment Management
Holder, Dennis - Houston Firemen's Relief and Retirement Fund
Holtzman, Elizabeth - New York City Comptroller
Hrubes, Marv - United Food and Commercial Workers' Intl. Union
Ikenberry, Nancy - State Universities Retirement System of Illinois
Iwashita, Tadashi - Embassy of Japan
Jacobs, Dennis - Iowa Public Employees Retirement System
Jarrell, Gregg - Managerial Economics & Research Center
Jefferson, Antwine - New England Investment Companies, Inc.
Johnson, Jack - Central Pension Fund of Intl. Union of Operating Engineers
Johnson, George Kim - Louisiana State Employees
Johnson, Elmer - Kirkland & Ellis
Johnson, Susan - Pennsylvania State Treasury
Jones, Luther - Florida State Board of Administration
Kallos, Bruce - State of Delaware Employees Retirement Fund
Kampel, Daniel - Daniel S. Kampel Associates, Inc.
Kellock, Susan - Marco Consulting Group
Kelly, Dan - WorldInvest
Klinsky, Steven - Forstmann Little & Company
Knoll, Catherine Baker - Pennsylvania Treasurer
Koppes, Richard - California Public Employees' Retirement System
Korn, Donald - International Center for Fiduciary Research
Lacey, Jim - U.S. Army
Lanoff, Ian - Bredhoff & Kaiser
Lashine, Nancy - J.W. O'Connor & Co., Inc.
Leban, Abbott - Pennsylvania Public School Employees Retirement System
Lesavoy, Nina - Chancellor Capital Management
Lilly, Frank - Bear Stearns
Lipsey, Robert - Air Line Pilots Association
Lipton, Patricia - State of Wisconsin Investment Board
Loescher, Sam - New Jersey Division of Investment
Lorsch, Jay - Harvard Business School
Lowe, Judy - Council of Institutional Investors
Machold, Roland - New Jersey Division of Investment
MacLellan, Ed - Massachusetts Bay Transportation Authority Retirement Fund
Madden, Jack - Florida State Board of Administration
Mann, Maurice - San Francisco City and County Employees Retirement System
Manning, Catherine - John Hancock Financial Services
Martin, Eugene - State of Wisconsin Investment Board
Martin, David - Hogan & Hartson
McCarty, Patrick - Pennsylvania Treasury
McDonald, Stephen - Trust Company of the West
Meeker, Tony - Oregon State Treasurer
Mercado-Llorens, Segundo - United Food & Commercial Workers' Intl. Union
Mertz, Kenneth - Pennsylvania State Employees' Retirement System
Moloznik, Terry - Teamster Affiliates Pension Fund
Mosman, James - California State Teachers' Retirement System
Myers, Teresa - Heitman Advisory Corporation
Nairne, Michael - New York City Comptrollers Office
Nugent, Mike - Trust for the International Brotherhood of Electrical Workers' Pension Benefit Fund
O'Brien, Jim - Beacon Hill Financial Corporation
O'Cleireacain, Carol - New York City Commissioner of Finance
O'Donnell, Thomas - One Federal Asset Management
Parker, Henry - Atalanta Sosnoff Capital Corporation
Parrish, Alex - Council of Institutional Investors

Pandick, Thomas - New York State Comptroller's Office
Peabody, Jr., Endicott - John Hancock Financial Services
Phelen, Patty - Massachusetts Pension Reserves Investment Mgmt. Board
Poitevien, Tina - Philadelphia City Fund
Quirk, Paul - Massachusetts Pension Reserves Investment Mgmt. Board
Ramseyer, William - JMB Institutional Realty Corporation
Reedy, Gerald - Annuity Reserve Fund of the Los Angeles Unified School District
Regan, Richard - Association of British Insurers
Rowes, Hugh - City of Flint Employees Retirement System
Rowett, Lillian - CalPERS
Ryan, Michael - Oregon Public Employees' Retirement System
Salisbury, Charles - T. Rowe Price
Sammis, Kathleen - New England Investment Cos.
Seeger, Charles - Chicago Mercantile Exchange
Shaffer, David - New York Business Council
Shimada, Kurato - CalPERS
Shrader, Linda - Equitable Capital Management Corporation
Slattery, Terry - Missouri State Employees' Retirement System
Smith, Steve - Oregon Public Employees' Retirement System
Sterling, Craig - Council of Institutional Investors
Straeten, Carla - New England Investment Companies, Inc.
Sullivan, Austin - General Mills
Sullivan, Ellen - Schroder Capital Management International
Sweeney, Ray - Sheet Metal Workers' National Pension Fund
Symms, Steve - Senator, (R) - Idaho
Taylor, Bill - Harvard Law Review
Teslik, Sarah - Council of Institutional Investors
Tilton, James - Trust Company of the West
Tropin, Mitchell - Bureau of National Affairs
Tydings, George - Montgomery County Employees Retirement System
Valdes, Charles - CalPERS
VanBuren, Ariane - Transnational Institute
Vance, David - Air Line Pilots Association
Vandemark, Donald - CNBC
Walsh, Tom - Murphy & Walsh Associates
Ward, Lorrie - CalPERS
Watson, Theresa - District of Columbia Retirement Board
Watson, Madale - CalPERS
Weber, Polly - J. & W. Seligman & Co., Inc.
White, Jim - Wall Street Journal
Wilcox, Art - United Brotherhood of Carpenters
Winchester, Judy - Shearson Lehman Hutton
Wyatt, Joe - CalPERS
Zinn, Ken - International Union of Mine Workers

MARCH 30, 1990

TO: SENATOR DOLE

FROM: CAROLYN SEELY Carolyn

SUBJECT: TALKING POINTS ON SHORT-TERM TRADING BILL (FOR INSTITUTIONAL INVESTORS SPEECH, IF ASKED)

- THIS IS (IN THE WORDS OF WARREN BUFFETT) "A NON-TAX TAX". NO FUND NEEDS TO PAY A DIME. IT IS DESIGNED TO CHANGE INVESTMENT BEHAVIOR.

- WHILE PENSION FUNDS ARE NOT SOLELY, OR EVEN PRIMARILY, TO BLAME FOR OUR SHORT-TERM INVESTMENT BIAS, THEY DO HAVE A SPECIAL RESPONSIBILITY TO AMERICA'S WORKERS TO LOOK OUT FOR THEIR LONG-TERM BEST INTEREST. CLEARLY, THE LONG-TERM BEST INTEREST OF ANY EMPLOYEE IS DIRECTLY TIED TO THE INTEREST OF THE INSTITUTION FOR WHICH HE WORKS AND WHICH CONTRIBUTES TOWARD HIS RETIREMENT.

- WHILE PUBLIC PENSION FUNDS CHURN LESS THAN PRIVATE FUNDS ON AVERAGE, THEY DO A SUBSTANTIAL AMOUNT OF TRADING. MOREOVER, SOME PORTFOLIO INDEXING STRATEGIES EMPLOYED BY PUBLIC PENSION FUNDS HAVE THE POTENTIAL TO EXACERBATE MARKET VOLATILITY, SOMEWHAT LIKE PORTFOLIO INSURANCE.

MARCH 27, 1990

TO: SENATOR DOLE

FROM: CAROLYN SEELY

SUBJECT: SPEECH TO COUNCIL OF INSTITUTIONAL INVESTORS

On Monday April 2, 1990, you are scheduled to speak to the annual meeting of the Council of Institutional Investors. This is an organization of 60 large public (primarily) and private pension funds that manage over $300 billion in assets. The meeting topic is the impact of institutional investors on corporate time horizons, competitiveness, governance and "other public policy matters". The group will be interested in the short-term trading bill.

Following you on the program, SEC Chairman Breeden will speak on the above-cited topic. Senator Symms will speak on his social security proposals. David Ball, Assistant Secretary of Labor for Pension and Welfare Benefits, Tadashi Iwashita from the Japanese, several economists and industry professionals are also on the program.

The Council on Institutional Investors has been cited in the press for organizing and coordinating the activities of public pension funds in corporate governance matters, such as the Exxon oil spill. (The Council was instrumental in promoting the nomination of an environmentalist to Exxon's Board.) Public funds have also sought Board representation and have been active on shareholder rights issues, executive compensation and greenmail. Since pension funds now control one-fourth of all equities and their share is growing, they are a potentially powerful force.

You were asked to speak on "The impact upon pension funds of government's search for revenues". I said you would speak on the Congressional agenda and pension funds. Your appearance is scheduled to last only 15 minutes.

The public pension funds argue that they invest differently from private pension funds. They were net buyers in 1987 when the private funds were net sellers. Nevertheless, these funds do churn, it's just, as Andy Sigler says, that the "privates churn more". (Private plans had turnover rates of 62% in 1986, and 64% in 1987. There is no data for 1987, but given the use of portfolio insurance by many funds before the October crash, the rate should have increased dramatically.)

In addition, many public funds are indexed. As the attached article suggests, although indexed portfolios are designed to mimic, not beat, market performance, trading is necessary to continuously rebalance the portfolio. This trading necessarily exacerbates any market trend, making it more volatile. Moreover, indexing strategies are developing which attempt to mimic the market plus a premium -- in other words, to do <u>at least</u> as well as the market. This sounds too much like portfolio insurance and very bad for the market in a downturn.

Council of Institutional Investors
1420 16th Street, N.W.
Suite 405
Washington, D.C. 20036
Telephone: (202) 745-0800

COUNCIL OF INSTITUTIONAL INVESTORS

ANNUAL MEETING AGENDA

April 2–3, 1990
The Grand Hotel

Washington, D.C.

MONDAY, APRIL 2

8:30-9:30 **REGISTRATION** (Ballroom – Continental Breakfast)

9:30-10:00 **MR. RICHARD C. BREEDEN**
Chairman, Securities and Exchange Commission

How the growth of institutional investors affects corporate time horizons, corporate competitiveness, corporate governance and other public policy matters.

10:00-10:30 **ELMER W. JOHNSON, ESQ.**
Partner, Kirkland & Ellis
Former Executive Vice President and Director of General Motors Corporation

Proxy reform proposals.

10:30-10:45 **BREAK**

10:45-11:15 **PROFESSOR GRAEF S. CRYSTAL**
University of California
Haas School of Business

Discussion of significant new executive compensation information and potential Council policies concerning it.

11:15-12:00 **THE HONORABLE STEVE SYMMS**
U.S. Senator (R)-Idaho

Pension funds and proposed Social Security legislation.

12:00-1:30 **LUNCHEON** (Mayfair Restaurant - Grand Hotel)

1:30 - 2:00 **PROFESSOR JAY W. LORSCH**
Harvard Business School
Author of recently published book: "Pawns or Potentates: The Reality of America's Corporate Boards."

How institutional investors can work to improve board performance.

MONDAY, APRIL 2 continued

2:00-2:30 **PROFESSOR GREGG A. JARRELL**
Director, Managerial Economics & Research Center
Former Chief Economist of the Securities and Exchange Commission

More on institutional investors and board performance.

2:30-2:45 **BREAK**

2:45-3:15 **ASSISTANT SECRETARY DAVID G. BALL**
Assistant Secretary for Pension and Welfare Benefits, Department of Labor

Application of the Willie Sutton principle to pension plans.

3:15-3:45 **TO BE ANNOUNCED**

3:45-4:30 **MR. ANDRÉ BALADI**
Managing Partner, Baladi & Company

Discussion of European corporate governance issues.

ADJOURN

TUESDAY, APRIL 3

8:30-10:00 **Executive Committee Meeting** (Continental Breakfast)

10:00-12:00 **General Members Meeting** (Ballroom – Continental Breakfast)

ADJOURN

COUNCIL OF
INSTITUTIONAL
INVESTORS

Suite 405 • 1420 Sixteenth Street, N.W. • Washington, D.C. 20036 • (202) 745-0800 • FAX (202) 745-0801

March 23, 1990

Carolyn Seely, Esq.
Office of Senate Minority Leader
S-230
United States Capitol
Washington, D.C. 20510

Dear Ms. Seely:

As promised in our conversation yesterday, enclosed are:

1. A preliminary agenda for the Council of Institutional Investors' April 2 Annual Meeting,

2. a list of expected attendees at the annual meeting, and

3. pertinent background materials.

Also enclosed for your review and approval is a draft of a revised agenda for the April 2 meeting that reflects the addition of Senator Dole to the program. We propose to distribute this version at the meeting. I will need your comments and approval by next Wednesday, as well as a copy of his bio, so that we can get the materials to the printer.

A member of our staff will meet Senator Dole at the entrance to the Grand Hotel (at the corner of 24th Street and M Street, N.W.) on the morning of April 2 to escort him to the ballroom for his 9:15 a.m. presentation.

Having been born and raised in Kansas, I am especially pleased that we will have the privilege of Senator Dole's appearance at our meeting. All of us at CII extend our sincere thanks to Senator Dole, Betty Meyer, and you for making that appearance possible.

If you would like any additional information, please give us a call.

Sincerely,

Judy Lowe

Judy Lowe

Enclosures

Speak

April 2
Mon
9:15 - 9:30

COUNCIL OF INSTITUTIONAL INVESTORS

Suite 405 • 1420 Sixteenth Street, N.W. • Washington, D.C. 20036 • (202) 745-0800 • FAX (202) 745-0801

Joyce

Grand Hotel

March 22, 1990

Ms. Betty Meyer
Office of the
Honorable Robert Dole
United States Senate
Washington, D.C. 20510

Dear Betty:

This is to confirm our conversation this morning, regarding Senator Doles' speaking engagement before the Council of Institutional Investors at the Grand Hotel, 2350 M Street, N.W. in the main Ballroom on April 2 from 9:15 a.m. - 9:30 a.m.

I have placed a call to Carolyn Seeley for followup information on the specific topic and a copy of Senator Dole's bio.

Hopefully, the confusion has been resolved between our April 2 conference and the May conference of Institutional Investor organization. If you have any questions, please do not hesitate to contact me at 745-0800. Thank you so much for your assistance and best wishes in the future.

Sincerely,

Judy Lowe

Judy Lowe

Speak

April 2 Mon.
9:15-9:30
~~1:30-1:15~~ ~~SD 419~~
~~SDH 18-419~~

COUNCIL OF
INSTITUTIONAL
INVESTORS

Suite 405 • 1420 Sixteenth Street, N.W. • Washington, D.C. 20036 • (202) 745-0800 • FAX (202) 745-0801

~~at Grand Hotel 2350 M St, NW.~~
at. Grand Hotel
2350 M St.
Ballroom
Ph: 429-0100

November 20, 1989

The Honorable Robert Dole
United States Senate
Washington, D.C. 20510

Dear Senator Dole:

The Council of Institutional Investors, an organization of 60 large public and private pension funds that manage $300 billion on behalf of over 8 million beneficiaries, invites you to address its members at its annual meeting in Washington, D.C., at the Grand Hotel, 2350 M Street, N.W. on April 2nd. The meeting will address how the growth of institutional investors affects corporate time horizons, corporate competitiveness, corporate governance and other public policy matters.

At previous meetings Council members have heard from leaders of government (e.g., SEC Chairmen Shad, Ruder and Hills, Senators Proxmire, Durenberger and Metzenbaum, Congressmen Dingell and Markey, corporate America (e.g., Chairmen of GM, Texaco, Citicorp, General Mills, Price Waterhouse, Champion International, Phillips, Pfizer), academic America (e.g., Professors Jensen and Bradley), and leading lawyers and market participants (e.g., Marty Lipton, Joe Flom, Carl Icahn, T. Boone Pickens, Mike Milken and George Roberts). Council meetings are attended by senior representatives of the members -- state treasurers and controllers, board chairmen and chief investment officers. They receive significant press coverage.

Materials on the Council are enclosed. We hope you will be able to attend this meeting and share your insights with our members. We look forward to speaking with you and would be happy to answer any questions you may have.

Judy Lowe

Sincerely,

S. A. B. Teslik

Sarah A.B. Teslik

David Ballon
212/303-3641

Hon?? $2,000

 Called 3/19/90 - to Sarah - ok

ANNUAL MEETING
April 2-3, 1990
D R A F T
COUNCIL OF INSTITUTIONAL INVESTORS
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Valdes, Charles - CalPERS
Vance, David - Air Line Pilots Association
Vandemark, Donald - CNBC
Ward, Lorrie - CalPERS
Watson, Madale - CalPERS
Wells, Milton - National Association of State Treasurers
White, Jim - Wall Street Journal
Winchester, Judy - Shearson Lehman Hutton
Wyatt, Joe - CalPERS
Zinn, Ken - International Union of Mine Workers

APRIL 2, 1990

TALKING POINTS

COUNCIL OF INSTITUTIONAL INVESTORS

- GOOD MORNING.

- THIS IS CERTAINLY AN EXCITING TIME FOR AMERICA.

  THE PACE OF CHANGE AROUND THE WORLD HAS BEEN BREATH-TAKING -- INSIDE THE SOVIET UNION IN EASTERN EUROPE AND IN LATIN AMERICA.

- BUT TO BE CANDID: I'M NOT SURE IT'S A WORLD WE'RE ENTIRELY PREPARED TO DEAL WITH.

- IF THE DEMOCRACY MOVEMENTS PREVAIL -- AND IT IS IN OUR INTEREST TO HELP THEM SUCCEED -- WE WILL HAVE ENORMOUS OPPORTUNITIES, BOTH POLITICAL AND ECONOMIC. BUT WE WILL ALSO NEED SOUND POLICIES WHICH RECOGNIZE THE BEST LONG-TERM INVESTMENTS AT HOME AND ABROAD.

- WE NEED TO SPUR THE DEVELOPMENT OF STRONG PRIVATE SECTORS IN EACH NEW DEMOCRACY. AND WE NEED TO MAINTAIN THE COMPETITIVENESS OF OUR OWN ECONOMY SO THAT WE CAN ESTABLISH MUTUALLY BENEFICIAL TRADE RELATIONS WITH THESE COUNTRIES AND SO THAT WE CAN PROVIDE THE "JUMP START" OF INVESTMENT AND TECHNOLOGY THAT THEY MOST NEED.

CLEAN AIR

- NEVERTHELESS, TOMORROW THE SENATE WILL PASS MAJOR NEW CLEAN AIR LEGISLATION. THIS IS IMPORTANT LEGISLATION -- THE FIRST REVISION OF OUR CLEAN AIR LAWS IN TWELVE YEARS.

- BUT IT IS LEGISLATION THAT WILL COST AMERICAN BUSINESS $20, $30, $40 BILLION PER YEAR -- NO ONE IS QUITE SURE OF THE PRICE TAG.

- AND THESE ARE ONLY THE KNOWN COSTS. THIS BILL WILL AFFECT HOSPITALS WITH INCINERATORS, FARMERS WHO USE AMMONIA, MARGINAL OIL PRODUCERS, AS WELL AS AMERICAN INDUSTRY.

- SO WHILE I AGREE THAT THIS LEGISLATION IS NEEDED, I HOPE THAT WE WILL KEEP SOME PERSPECTIVE. IF IT COSTS $20 BILLION TO DO 90% OF THE JOB, HOW MUCH MORE SHOULD WE SPEND TO REACH 91% OR 92%? HOW MANY JOBS CAN WE

AFFORD TO LOSE TO CHEAPER IMPORTS WHICH ARE NOT PRODUCED USING ENVIRONMENTALLY SAFE TECHNIQUES.

O MOREOVER, AS LONG AS WE ARE BURDENED BY THE NEED TO REDUCE OUR FEDERAL BUDGET DEFICIT, BUSINESS WILL BE ASKED TO BEAR AN INCREASING SHARE OF THE BURDEN OF NEW FEDERAL PROGRAMS, SUCH AS HEALTH INSURANCE AND LONG-TERM CARE. CLEAN AIR MAY BE ONLY THE FIRST STEP.

THE BUDGET PROCESS

- I HAVE ALWAYS BELIEVED THAT A PRESIDENT HAS ONE CHANCE EVERY FOUR YEARS -- THE FIRST YEAR OF EACH TERM -- TO ENACT TOUGH PROGRAMS, LIKE THE FLEXIBLE FREEZE, TO DEAL WITH OUR BUDGET DEFICIT.

- UNFORTUNATELY, AS YOU KNOW, LAST YEAR WE BASICALLY TOOK A WALK ON THE DEFICIT. WE SPENT 10 MONTHS AND DEVOTED OVER 60% OF OUR ROLL CALL VOTES IN THE SENATE TO REDUCE THE DEFICIT BY ONLY $16 BILLION.

- O THESE WERE NOT TOUGH VOTES. WE FOUND $500 MILLION IN LOST FOOD STAMPS; WE ACCELERATED MILITARY PAY DATES -- AND WE NEEDED FOUR MONTHS OF SEQUESTER ON TOP OF EVERYTHING ELSE.

- O THIS YEAR WE NEED $36 BILLION -- MORE THAN TWICE AS MUCH -- TO MEET OUR GRAMM-RUDMAN DEFICIT TARGET, EVEN UNDER OMB'S OPTIMISTIC ASSUMPTIONS. AND THE CONGRESSIONAL BUDGET OFFICE NOW SAYS WE NEED $60 BILLION MORE!

THE ROSTENKOWSKI PLAN

- O THAT IS WHY I THINK CHAIRMAN ROSTENKOWSKI HAS ISSUED THE WAKE-UP CALL WE'VE BEEN WAITING FOR.

- O I DON'T AGREE WITH EVERYTHING CHAIRMAN ROSTENKOWSKI HAS RECOMMENDED. BUT HE IS RIGHT IN INSISTING THAT ANY "PEACE DIVIDEND" BE USED FOR DEFICIT REDUCTION AND THAT ANY NEW SPENDING BE ON A PAY-AS-YOU-GO BASIS. WE MUST

EITHER MAKE NEW PROGRAMS FINANCIALLY SELF-SUFFICIENT OR SCALE BACK EXISTING PROGRAMS TO PAY FOR NEW INITIATIVES. THIS IS WHAT I PROPOSED WHEN I CALLED FOR A 5% REDUCTION IN FOREIGN AID SET ASIDES.

THE FREEZE

- O CHAIRMAN ROSTENKOWSKI IS PROBABLY ALSO RIGHT, POLITICALLY, IN REVIVING CANDIDATE BUSH'S PROPOSAL FOR A ONE-YEAR FREEZE IN FEDERAL SPENDING WITH THE EXCEPTION OF MEANS-TESTED POVERTY PROGRAMS.

- O A FREEZE IS NOT THE BEST POSSIBLE POLICY; IT IS SIMPLE CRUISE CONTROL. IT DOES NOT DISTINGUISH AMONG PROGRAMS ACCORDING TO

CHANGING NEEDS. IT PERPETUATES SOME OBSOLETE PROGRAMS WHICH SHOULD BE CUT SIGNIFICANTLY OR EVEN ELIMINATED TO PAY FOR NEW PRIORITIES, LIKE EDUCATION AND THE DRUG WAR. AND IT DOES NOT FACE UP TO NEEDED STRUCTURAL REFORMS, SUCH AS THE PRESIDENT'S MEDICARE PROPOSALS.

- MOREOVER, IT DOES NOT EVEN FREEZE CONGRESSIONAL PAY. IF A FREEZE IS TO SUCCEED, WE MUST ALL SHARE EQUALLY.

- O HOWEVER, UNLIKE MOST BUDGET SOLUTIONS, A FREEZE IS EASILY UNDERSTOOD -- AT LEAST OUTSIDE THE BELTWAY WHERE YOU ARE NOT AUTOMATICALLY ENTITLED TO YOUR INFLATION ADJUSTMENT. AND IT DEMANDS THE SAME SACRIFICE FROM EVERYONE.

COMPETITIVENESS

O CERTAINLY, A MULTI-YEAR BUDGET PACT WOULD HELP AMERICAN COMPETITIVENESS. WE ALSO NEED TO IMPROVE OUR EDUCATION SYSTEM AND PROVIDE INCENTIVES FOR RESEARCH AND FOR THE APPLICATION OF THOSE DISCOVERIES TO NEW PRODUCTS AND SERVICES.

- AND PASSAGE OF THE PRESIDENT'S CAPITAL GAINS RATE REDUCTION WOULD REDUCE THE HIGH COST OF CAPITAL NOW CONFRONTING AMERICAN BUSINESS AND INCREASE SAVING AND INVESTMENT.

- HOWEVER, WE NEED MORE THAN ADDITIONAL INVESTMENT DOLLARS. AMERICA ALSO NEEDS LONG-TERM, "PATIENT" EQUITY CAPITAL THAT WILL ALLOW OUR BUSINESSES TO ENGAGE IN PROJECTS, SUCH AS RESEARCH, PRODUCT DEVELOPMENT OR

THE MODERNIZATION OF PLANT AND EQUIPMENT, THAT WOULD ENHANCE FUTURE PRODUCTIVITY, EVEN AT THE EXPENSE OF CURRENT EARNINGS.

- MOREOVER, THE SHORT-TERM INVESTMENT STRATEGIES PREVAILING IN OUR CAPITAL MARKETS ARE HURTING AMERICAN INVESTORS AS MUCH AS THEY ARE HURTING AMERICAN BUSINESS AND AMERICAN WORKERS. STUDY AFTER STUDY SHOWS THAT LONG-TERM HOLDING IS MORE PROFITABLE THAN FREQUENT CHURNING.

PENSION FUNDS

- O A CAPITAL GAINS RATE REDUCTION WILL HELP TO LENGTHEN HOLDING PERIODS FOR INDIVIDUAL INVESTORS. HOWEVER, IT IS IMPORTANT THAT ALL STOCKHOLDERS, INCLUDING PENSION FUNDS, BEHAVE MORE AS OWNERS THAN INVESTORS IN THE COMPANIES WHOSE STOCH THEY BUY.

- I CONGRATULATE ALL OF YOU YOU ON YOUR EFFORTS TO BECOME ACTIVE AND RESPONSIBLE STOCKHOLDERS. YOU ARE UNIQUELY QUALIFIED TO DEMAND THAT COMPANIES CARE FOR THE ENVIRONMENT, RESPECT THE RIGHTS OF ALL SHAREHOLDERS REFRAIN FROM EXCESSIVE COMPENSATION AWARDS TO ENTRENCHED MANAGEMENT. AND YOU ARE DOING THIS.

- BUT I ALSO CHALLENGE YOU TO CONSIDER THE VIABILITY OF AMERICA'S EMPLOYERS AS WELL AS THE RETIREMENT OF AMERICA'S EMPLOYEES. AFTER ALL, YOUR BENEFICIARIES ARE NOT WELL SERVED IF AMERICAN BUSINESS AND AMERICAN LIVING STANDARDS DECLINE WHILE YOU OUT-PERFORM A FALLING STOCK MARKET.

CONCLUSION

- O BECAUSE THIS IS AN ELECTION YEAR, BI-PARTISAN COOPERATION IN THE CONGRESS MAY BECOME MORE AND MORE DIFFICULT. NEVERTHELESS, I BELIEVE THAT WE WILL FINALLY AGREE ON WHAT I HAVE CALLED THE FIVE C's: CLEAN AIR, CHILD CARE, CAMPAIGN FINANCE REFORM, A CRIME PACKAGE, AND SOME FORM OF CAPITAL GAINS RELIEF. HOWEVER, AS ALWAYS, THE SERIOUS DEBATE ON

THE DEFICIT AND THE BUDGET PROCESS WILL CONTINUE TO DOMINATE OUR AGENDA UNTIL BOTH CONGRESS AND THE PRESIDENT FACE UP TO THE TOUGH CHOICES.

- THANK YOU.

By William G. Shepherd Jr.

Tracking Indexes

The fear is that indexing, a controversial US style of stock market investing, will sweep the globe and, in the hands of computer-mad quants, turn the world's markets into wild arenas where values have no meaning and only the largest corporations can raise capital.

That fear may, over time, prove to be unfounded. Indexed investment—also called passive investment—involves structuring portfolios to move in line with a particular market average, such as America's S&P 500 or Tokyo's TOPIX. This is usually done by buying all, or at least the largest, stocks that make up the index. In pure indexing, no attempt is made to pick winners or to outperform the average; the object is to keep from underperforming it—a kind of surrender to mediocrity.

If everyone invested in this fashion, so the argument runs, a misallocation of capital would occur. Capital would become concentrated in the world's biggest companies—whose stocks would forever be whiplashed by arbitrage against index futures. Since pure indexers don't care whether stocks are expensive or cheap and don't pick stocks for their growth potential, innovative smaller companies would go begging. "Once you start putting money into an index," says Mike Crivelli, who heads client services for Bankers Trust Australia in Sydney, "you move away from the concept of rewarding success."

But managers of indexed portfolios are now adopting so many different strategies to capture a few more percentage points of return that they are turning themselves into a new breed of active managers. In the process, they are rediscovering the principles of valuing securities. The trend amounts to a pluralizing of investment philosophies that should lead to broader, more stable equity markets in the future.

Indexed investing has indeed caught on globally. Within the United States, where the indexing vogue began 15 years ago, the consulting firm Greenwich Associates estimates that in the two years since the 1987 crash, indexed stock investment has grown by 52%, to $257 billion. That represents an increase from a quarter to a third of US institutions' domestic stock holdings.

Internationally, the increase has been even more dramatic. In the same two years equity indexing outside the United States has quadrupled, to some $105 billion—with perhaps another $100 billion being managed by so-called closet indexers, who use indexing techniques but don't admit it. Two-thirds of the growth has come in Japan, where institutions have caught indexing fever in a big way—and where Japan's Ministry of Finance is concerned that indexing and its companion strategy, index arbitrage, are increasing market volatility and encouraging market manipulation.

London is another hotbed of indexing, as is Sydney to a lesser extent. But the index philosophy has made little headway against old-guard money managers in Edinburgh or Mel-

RICHARD OSAKA

bourne. And indexing has been slow to catch on in smaller, less efficient markets in Europe, Canada and the Far East. Many stocks that constitute local indexes cannot be purchased easily, if at all, and local portfolio managers, often a small inside clique, can frequently beat their market indexes with old-fashioned rumor-mongering and stock-picking. In such cases, the big future for indexed portfolios will be as vehicles for outsiders—cross-border investors unfamiliar with the local games.

More important, the nature of indexed investment is changing even as its popularity spreads. To differentiate themselves competitively, international managers of indexed portfolios are experimenting with so many new wrinkles that indexing is losing its "passive" character. What once appeared to be a monolithic movement is now fracturing into many different investment approaches employing new types of market averages, different ways of constructing portfolios and a wide range of stratagems to improve performance—even including putting money into shares of small companies on the ground, of all things, that they are undervalued.

In a sense, the quants—the architects of indexing who rely on highly sophisticated mathematics to structure portfolios—are rediscovering the wheel. To get a leg up on rivals, they are succumbing to the gambling instinct and are turning more and more to that once-shunned quality, human judgment. "Active indexing," "quantitative stock selection" and "index plus alpha" have become the new buzz phrases, and they all translate, in one way or another, to "Let's take some risks and pick some stocks." The computer, once the totem of a new quantitative discipline, is becoming more of an everyday tool to augment intuition and common sense, not to replace them. Passive investment is looking more like active investment every day.

> The MOF has spotted unusual moves in the Nikkei 225 just before index futures expire. In fact, the Nikkei is being manipulated.

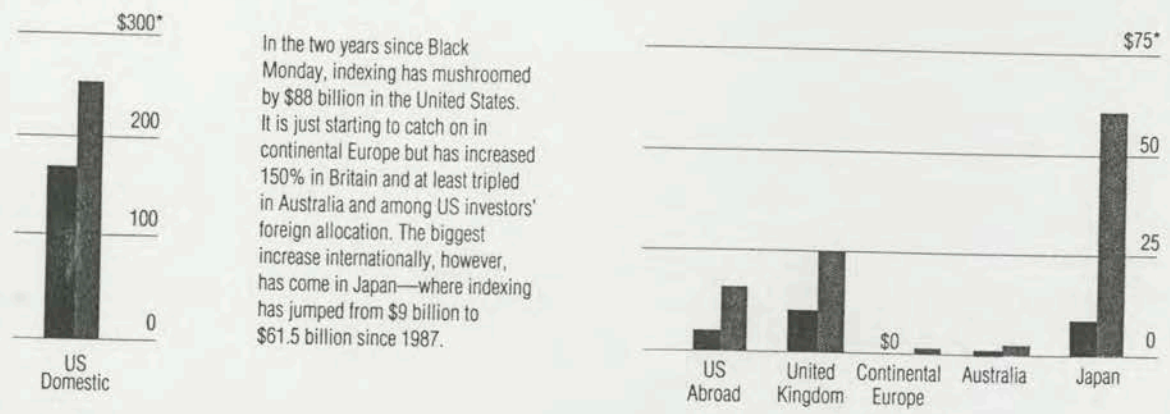
"We may be coming full circle," says Ron Gould, who manages Tokyo investments for the biggest UK indexer, Barclays de Zoete Wedd (BZW) Investment Management. Purely passive investing distorts the market in new ways that create new opportunities, "and people exploit opportunities," says Larry Martin, vice president of Boston's State Street Bank & Trust, the largest international indexer. "Indexing is never going to replace active management." State Street itself is exploiting some of those opportunities. It's about to introduce index funds for small companies and for emerging markets.

Another case in point involves forecasting. Using abstruse mathematics to forecast market and economic trends, once considered heresy by staunch indexers, has become the new quantitative frontier. France's Crédit Lyonnais recently pirated five top quant researchers from Nikko Capital Management, an important Japanese indexer, and from NB Investment Technologies, Nikko's joint venture in Tokyo with BARRA, a prestigious US quant research firm, to start a London-based asset management group that will forecast industrial trends and stock prices. "People are moving from pure indexing to more active ways of using quantitative techniques," explains Simon Green, senior manager of the new Crédit Lyonnais venture.

New York's Chase Investors Management, one of the more experimental indexers in international investment, recently began forecasting expected returns on securities—a supposedly impossible task. "We changed our minds," says Chase managing director Eric Seff. "We came to the conclusion that you actually can forecast. I wouldn't call what we're doing passive at all. The fact that we start with an indexed portfolio is a matter of convenience. This is the new generation of active investment management."

In continental Europe, which has few big pension funds, indexing is still in its infancy. A slew of indexed open-end (mutual) funds has popped up in recent months—at least seven of them

HOW EQUITY INDEXING IS GROWING



In the two years since Black Monday, indexing has mushroomed by $88 billion in the United States. It is just starting to catch on in continental Europe but has increased 150% in Britain and at least tripled in Australia and among US investors' foreign allocation. The biggest increase internationally, however, has come in Japan—where indexing has jumped from $9 billion to $61.5 billion since 1987.

Sources: Greenwich Associates, WM Company, Frank Russell Associates, Japan Pension Fund Association, Barclays de Zoete Wedd Investment Management, MLC (Mutual Life Citizens), Global Finance estimates.

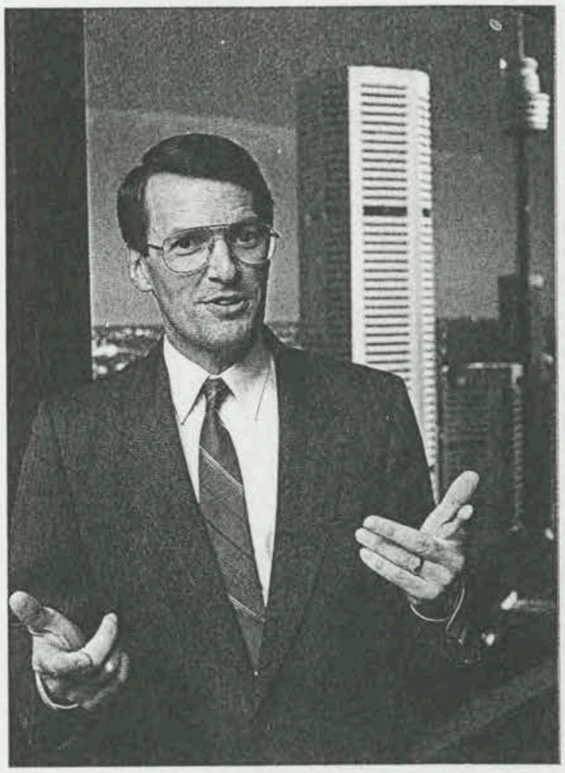
in France, managed by such banks as Crédit Lyonnais, Banque Paribas and Crédit Chemique. Single-country portfolios have also been started in West Germany, the Netherlands, Belgium, Italy and Spain, while Austria's Länderbank has introduced a euro-index fund.

But most of these funds have been marketed to individuals more than to institutions, and it's not yet clear that the public is interested merely in approximating a market average, at least in their home market. Swiss Bank early this year introduced a mutual fund, called the SBC 100 Index Fund, that tracks Switzerland's stock markets. "It has frankly not caught on among many investors," says Rudolf Lörtscher, SBC's indexing chief in Basel. "Most portfolio managers in Switzerland honestly believe they can outperform the market."

Crédit Lyonnais's first indexed mutual fund, Lion Indice, was strictly passive and was designed to track the French market's index, the CAC 40. Its second effort, Lion France Plus, is an "active" index fund. Launched in January, it will try to beat the CAC 40 by stressing stocks that benefit from industrial trends or from interest and inflation rates.

The chief market for index funds in Europe appears to be investors from other countries. Frankfurt's Deutsche Bank found that its year-old db-25 portfolio, designed to track the West German market, attracted greatest interest among Far East and Swiss institutions. To capitalize on West Germany's bull market since the fall of the Berlin Wall, Deutsche Bank in January started a 30-stock portfolio, called db-DAX, to represent West Germany's DAX index. Also aimed at institutions, the db-DAX is not structured as a fund. Instead, each investor will have his own subcustody account. "You keep the rights to dividends and subscriptions, as does a normal shareholder" explains Fritz Diehl, a researcher with Deutsche Bank's trading group. "You also are free to sell stocks out of the portfolio," he adds, but then you cannot trade the basket back to Deutsche Bank.

Indexing for cross-border investors within Europe will undoubtedly surge as 1992 approaches. Major European institutions have long been constrained by exchange controls and political pressures to keep capital at home. "One of the corollaries of 1992 is that those barriers are coming down," says Philip Winder, director of international business development at London's Bankers Trust International. "A lot of the major European funds are just now getting permission from their boards to invest outside their home countries."



JOHN MARMARAS/ WOODFIN CAMP

ENHANCING RETURNS

Bill Webster, head of investment for Australia's largest indexer, Lend Lease property group, says spreads are huge because execution is difficult in that market.

British money managers have been the most aggressive in offering index funds for cross-border investment in Europe and the Far East—both to the public and to institutions. BZW Investment Management has been setting up tax-advantaged, indexed SICAVs in Luxembourg that it is retailing around Europe and in the Arab Emirates. SICAV (for Société d'Investissement à Capital Variable) is a French type of pooled fund similar to a unit trust. The firm is also hunting for new quantitative stock selection tools. According to BZW director James Woodlock, research is under way in such far-out mathematical fields as chaos theory, catastrophe theory and Eigenvectors, used in advanced regression models.

BZW's biggest indexing rival, County NatWest Investment Management, just started a $180 million fund for Japan's Nomura Securities to invest in Europe. Called Star 1992, the fund is 46% invested in Britain and 54% on the Continent. "Continental funds are a very exciting new trend, both in New York and in Japan," says Bruce Pullman, County NatWest's top quant.

London money managers are also successfully retailing cross-border index funds to the public. UK brokerage firm James Capel has attracted considerable attention and some £112 million ($190 million) with four indexed unit trusts (mutual funds) introduced during the past 15 months. The first three invest in the United States, continental Europe and Japan. The most recent, the Tiger Fund, concentrates in smaller Asian markets, including Hongkong, Singapore, Malaysia, Taiwan, Thailand, South Korea and the Philippines. James Capel also helps institutions devise portfolios based on specialized indexes. According to Namdar Mossaheb, who runs the firm's quant research department in Edinburgh, his group has constructed an index for portfolios of smaller companies, particularly those that might be acquired or taken private in a leveraged buyout. If that doesn't entail forecasting and stock evaluation, nothing does.

Nowhere, though, has indexing been hotter than in Japan, which has suffered from a shortage of professional investment management. For years Japanese fund managers have underperformed the popular Nikkei 225 index and the newer TOPIX, a broader index of 1,163 stocks, by embarrassingly wide margins. Japan's Pension Fund Association established benchmarks several years ago to encourage better performance but to little avail. Noboru Terada, the association's executive adviser, says bluntly: "Active management cannot beat the benchmarks."

Consequently, Japanese investment managers are adopting indexing techniques with a passion. Indexed mutual funds for the public have attracted nearly ¥4 trillion ($27 billion) in the past four years, and institutional indexing has soared from zero to perhaps ¥5 trillion—about 8% of institutional assets—in a mere two years.

Competition is the spur. Japan gradually is deregulating its institutional money management business. Management of pension assets was long limited by law to a small oligarchy of 12 life insurance companies and eight trust banks, which in turn were encumbered by regulations about how to deploy the assets—no more than 30% of a pension portfolio, for instance, could be socked into equities or invested abroad. In Japan's don't-rock-the-boat society, their terrible investment record was tolerated because they also lent money to pension plan sponsors and assured a stable shareholder base.

The first competition appeared four years ago, when the government granted trust licenses to nine foreign banks. Now the competition is about to become more serious. Starting next month, 138 licensed discretionary investment managers, both domestic and foreign, will be able to run pension portfolios too. "For the first time," says BZW's Gould, "pension plan sponsors can look at the relative strengths of managers and say, 'We want to hire those strengths.'"

Brambles of regulation will assure that the change does not result in a free-for-all, however. In some instances, pension fund managers will be free to invest as much as 50% in stocks or outside Japan. But only certain types of pension funds (the *koseinenkin*, or private plans that augment state benefits) will be allowed to hire managers from the new group, and only to run the new-money portions of pension assets; that is, new managers won't be able to swipe existing assets from the old guard.

Because more deregulation is likely in the future, the insurance companies and trust banks as well as investment managers are seizing on all the indexing and quantitative techniques they are able to find. The asset management arms of Japan's Big Four securities firms have been the most aggressive at cutting deals with American quant experts.

Until Crédit Lyonnais raided some of its top quants, Nikko Securities was believed to be in the lead, thanks not only to its joint venture with BARRA but also to a close tie to Wells Fargo Investment Advisers, the largest indexer in US markets. Nikko bought 50% of Wells Fargo last autumn, and next month Wells Fargo is due to take a minority position in Tokyo's Nikko International Capital Management. Nomura Securities, biggest of the Big Four, set up a joint venture last summer with Rosenberg Institutional Equity Management, whose quant-minded boss, Barr Rosenberg, was the founder of BARRA. Daiwa Securities, meanwhile, has hooked up with another quant firm, Roll & Ross Asset Management, and Yamaichi Securities has been working with Global Advanced Technology on a trading system and a stock selection system that draw on an exotic tool of artificial intelligence known as "fuzzy" logic.

Japan's indexing craze has led to the sort of problems that troubled American markets two years ago—volatile price swings. When indexers gang up on a market, the big stocks that dominate the index can soar while other stocks languish. Naturally, some speculators have been surfing on those stocks—only to find themselves capsized when index arbitragers suddenly dump their index stocks and buy index futures.

For that reason, many players are staying away from the big index stocks and playing smaller stocks in the Tokyo exchange's second section—one reason why the second section has been Japan's best performer this year. That performance has not escaped the indexers' notice. "We have begun to see interest in indexing to the second section," observes Takashi Miyawaki, head of portfolio analysis at Salomon Brothers Asia. There's even talk of starting futures contracts for the second section.

Meanwhile, Japan's Ministry of Finance has spotted unusual moves in the Nikkei 225 average just before index futures expire. In fact, the Nikkei is being manipulated. Unlike the broader TOPIX index, which is weighted by capitalization, the Nikkei is a simple average of prices without regard to how many shares a company has outstanding. So a two-point move in a company with few shares affects the average as much as a two-point move in giant Nippon Telegraph & Telephone. "The manipulation is obvious," says one Tokyo money manager. "Everybody can see it."

Index arbitrage has caught on big not only among US brokerage firms,

INDEX FUTURES AND OPTIONS

Index futures aren't used only in arbitrage. Along with index options, they encourage the growth of indexing by providing portfolio managers with ways to hedge.

According to *Futures*, a Chicago-based magazine that monitors development of derivative instruments worldwide, a dozen countries (other than the United States) now trade either futures contracts or options, or both, on local stock indexes.

Britain, Canada and Australia all have well-established futures and options, while Hongkong and France offer just index futures. Singapore, oddly, trades futures on Japan's Nikkei 225 index but has no futures or options on its own stock market. Japan, the Netherlands, Sweden and Finland have relatively new options and futures, as does the small market in Ireland. Denmark joined the club in December by introducing futures on its KFX stock index.

Coming attractions: West Germany will introduce futures contracts on its DAX stock index this summer on the Deutsche Terminbörse. SOFFEX, the Swiss Options and Financial Futures Exchange, plans to launch futures on the Swiss Market Index this year too. Spain intends to set up a computerized futures exchange in Barcelona that will feature stock index futures, but the project has been delayed.

The next wave will likely be futures and options on bond indexes. Denmark and the Netherlands already offer bond index futures, and the Netherlands trades bond index options as well.

which do it for their own account, but also among Japanese brokers and mutual funds. Because the execution of index futures and baskets of stocks has not yet been fully computerized, spreads can run 1% or more, compared with as little as 0.15% in the United States at times. But precisely because arbitrage is cumbersome, Salomon's Miyawaki points out, profits aren't quick; spreads can remain wide for a long time.

Nowhere else has index arbitrage become so prevalent. In the United Kingdom, for example, index arbitrage is inhibited by tax law. Institutions or securities firms that trade futures without owning the underlying stocks are subject to special taxes, and Inland Revenue keeps an eye on such trading. In Australia index arbitrage has gained some following, though. MLC, a large life insurer owned by the Lend Lease property group, is not only Australia's largest indexer, it may be its biggest index arbitrager too. Spreads can be enormous, as much as 3%, because execution is so cumbersome. "We've typically added 600 basis points (6%) to indexed portfolios in the past year," says Bill Webster, head of investment for both MLC and the Lend Lease group.

Indexing developed in the United States after the 1973–74 bear market for three reasons. As countless studies demonstrated, active managers as a group were not able consistently to beat, or even to match, a market average. Moreover, US pension funds had grown enormous; they were forced to buy so many different stocks that their portfolios virtually represented the market anyway. Finally, indexing offered a way for pension funds to save millions of dollars a year in commissions and management fees.

Solution: eliminate bad investment decisions by eliminating thinking entirely. Within a decade, however, managers of indexed portfolios had begun to monkey with three factors—how the portfolio is constructed, what index to use and how to add a little return here and there. All three are now turning passive managers back into active ones.

In indexing's purest form, a manager simply buys all the stocks in an index, in the same proportions in which they compose the index—an approach known as "replication." Minus initial commissions and other costs of acquiring the stocks, the portfolio should track the index exactly. The portfolio manager subsequently has little more to do than figure out how to reinvest dividends while keeping stock proportions in line with the index.

But even passive managers find it hard to sit by idly. Replication is fine for the biggest funds. But for smaller funds, why not figure out how to approximate the index closely with fewer stocks—and cut initial costs? Big-cap companies naturally account for most of an index. With an eye to industry groupings and the like, managers added some medium-size and smaller companies, an approach that became known as "stratified sampling." With a modicum of math and computer time, they calculated that they could come within a percentage point or two of tracking, say, the S&P 500 with 250 stocks or fewer. Some portfolios were set up with only 125 stocks. As indexing went international, sampling became critical because so many foreign stocks are illiquid or legally purchasable only by domestic investors.

UK money managers have been the most aggressive in offering index funds for cross-border investment in Europe and Asia.

The fewer the stocks, of course, the greater the margin for error. How might that margin be reduced? The third way of constructing an indexed portfolio is the most interesting—because it deviates wildly from the original premise of passive investing.

Instead of duplicating an index's component stocks, quants began scrutinizing an index's characteristics. What sorts of risks, in what proportions, make up the index? How do the stocks move in relation to one another? What are their price/earnings and price-to-book ratios? How much of the index is subject to interest rate changes? How much depends on export earnings? The objective was to replicate the sensitivities of the index with a small number of stocks in proportions that differed from how they might appear in the index—an approach called "optimization."

But in fact, the indexers were beginning to analyze individual companies and individual stocks. They were devising an incredibly complex mathematical approach to describe what old-style portfolio managers have always dealt in: fundamentals.

At the same time, indexers were discovering that there is no such thing as a perfect index. Broader indexes reflect the US market better than the S&P 500. Criticisms of the granddaddy of international indexes, Capital International's Europe, Australia and Far East (EAFE) index—which is marketed by US institutional broker Morgan Stanley—have varied all over the lot. The index didn't have enough stocks or had too many stocks that couldn't be purchased. It included too many countries or not enough countries. It didn't adjust for cross-shareholdings among companies. Morgan competitors, such as Goldman Sachs and Salomon Brothers, introduced competing indexes. London's *Financial Times* constructed all sorts of indexes and sub-indexes that were based on its 3,078-stock FT-Actuaries World Index.

Money managers and brokerage firms began merging country indexes into varieties of regional indexes—for southern Europe, for the Deutschemark bloc countries, for East Asia ex-Japan, to name a few—and began creating their own indexes for such groupings as global industrial sectors, world small companies, and even low p/e companies with specified growth rates. Indexes have proliferated so widely that the very act of creating a new one has become a form of active portfolio management.

Just how unorthodox are indexes becoming? Consider a Japanese warrant index that tracks Japan's stock index TOPIX and that was created by London & Bishopsgate International, a small money manager based in both New York and London. The firm uses the index to switch from stocks to warrants when the Tokyo market drops. In a market decline, warrants lose their premium; when the market rebounds, the premium is restored, which makes the warrants rise more

MARTIN MAYER/NETWORK/CONTACT

than the stocks. "We did this in Japan last year," says the firm's cofounder, Andrew Smith, "and added 11% to the return on the indexed portfolio."

Perhaps the most intriguing new index implicitly thumbs its nose at all the others. It's an international index that weights countries according to their gross domestic product (GDP)—an economic yardstick—instead of their stock prices. Conceived by Boston International Advisors, which specializes in offbeat, custom-designed indexes, the GDP index was instantly adopted by the State of Connecticut Trust Funds. "We invest in stocks to participate in the growth of economies," says Frank McDermott, Trust Funds' assistant treasurer for investments. "A 60% weighting in Japan [that market's size in the EAFE index] didn't make sense."

A GDP index, McDermott explains, provides a double-edged discipline. It makes you put money into markets that are small relative to their economies (such as West Germany) and reduce stock holdings in markets that are large (such as Japan and Britain). Says Boston International's managing director David Umstead: "A normal index is roughly two-thirds in the Pacific. The GDP index is just the opposite. It's two-thirds in Europe." Because Japan's sky-high market fared relatively poorly in 1989, the GDP index last year gained 20.6% while EAFE was up only 10.6%.

The quants' third road to apostasy is the broadest: the myriad ways they are trying to improve on the performance of pure indexing. Many strategies, such as playing the stock portfolio off against a basket of currencies to hedge against exchange rate changes or writing out-of-the-money call options to pick up extra returns, are straightforward enough. Last year State Street Bank began lending stock regularly in Japan, where stock borrowing by short sellers and arbs has mushroomed. "We achieved a return of about 25 basis points," says State Street's Martin.

More important is the way indexers are titling portfolios—that is, deviating from indexes by overweighting certain stocks. In international portfolios, country tilts were the first to become popular. Indexers started playing entire countries as if they were stocks, underweighting Japan, for example, or overweighting the United Kingdom. Decisions to reduce or increase investment in different countries entail a certain amount of prognostication or at least intuition. What is the outlook for a nation's economy? Will its stock market outperform other markets? When indexers realized that the success or failure of country tilts depended as much on currency exchange rates as on stock market moves, they started trying to predict currency moves too.

The new wave of tilting, as Roger Whittaker, a director of Bankers Trust Investment Management in London, points out, is "really stock-picking strategies" in disguise. The current fad is factor tilts, overweighting markets or individual stocks based on such fundamentals as price/earnings ratios. BZW Investment Management, for instance, is now tilting index portfolios according to yields and price-to-book ratios. State Street's experiments with stock selection based on price-to-book ratios "beat EAFE by 14% last year," says Martin.

Industry tilts—reweighting portfolios to favor specific international industries, such as banking or communications or energy companies—has not yet caught on among international indexers. The chief problem is that corporate accounting varies widely from country to country. Without common standards, it's tough to bring quantitative techniques to bear on industry tilts.

"Factor tilts will eventually grow into industry tilts," predicts Chase Investors' Seff. "But not enough work has been done yet." Nonetheless, County NatWest's assistant director Robert Brown says the firm is exploring the possibility of using quantitative stock selection to play industry sectors on a regional rather than on a global basis—autos within Europe, for example. But County assistant director Alistair Lowe concedes: "We don't know if it's going to work."

Eventually it will. As quantitative techniques become more sophisticated, portfolio managers who trumpeted a new era of passive investment are going to find themselves placing bets and risking capital in as many different ways as any speculators of old. Step by step, they're becoming stock pickers like everybody else. ■

NEW TREND

County NatWest's quant team (from left), Robert Brown, Bruce Pullman and Alistair Lowe, has started an index fund for continental Europe.

Council of Institutional Investors

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ABOUT THE COUNCIL

W**all Street Journal:** Public employee pension funds finally are talking loud enough to have their voices heard in company executive suites.

Despite the muscle bestowed on state and city pension systems by their $600 billion in assets, most companies have had to pay little heed to calls from the public funds for more say in how corporations conduct their affairs. But the perils of that tack have increased as public funds have learned winning tactics after several years of heightened shareholder activism.

Shareholder resolutions this year are attracting their greatest support ever over management objections, and, as evidenced most recently by the defeat of Honeywell Inc.'s anti-takeover proposals announced Friday, public funds are chalking up a growing list of victories in their company dealings....

Mr. [Harrison J.] Goldin, co-founder of the **Council of Institutional Investors,** which has become a lightning rod for much of the public funds' activity in the corporate governance area, scored his biggest company coup to date last week, just a day before the Honeywell vote was announced. On Thursday, Exxon Corp. said it will back Mr. Goldin's requests for an environmentalist to be added to the Exxon board, and for the company's board to set up a separate directors committee to deal with public issues, such as the environment....

Another oil company, Texaco, Inc., provided a significant advance for activist public funds earlier this year when it agreed to nominate a director from a list of 15 names suggested by Calpers [the California Public Employees Retirement System]. New York University President John Brademas, an ex-congressman, was elected to the Texaco board earlier this month....

Though still uneven and sporadic, the ability to get their concerns heard by top management is building steadily among institutional investors, according to experts. "They've recognized their power and they've begun to broker it," says money-management consultant Michael Stolper.

Wall Street Journal, May 15, 1989.

F**ortune:** Don't expect directors, no matter how highly paid, to grow fat and lazy. The new group of activist shareholders will make sure they stay alert... These supershareholders viewed the greenmail, golden parachutes, poison pills, and expensive legal maneuvering [of takeover battles] as nothing more than executives' attempts to keep their jobs, while denying the owners a higher price for their stock. Now institutions... are testing to see how far they can push managements.

In 1985 a group of pension funds created the **Council of Institutional Investors,** whose members now control assets of over $200 billion. It is promoting a "bill of rights," which calls for equal voting rights for all shareholders, among other things. Demanding more control over the enterprises they own, aggressive institutions such as the New York City Retirement Funds ($28.2 billion in stocks) have called upon managers to account for their actions. Disappointed by the performance of General Motors, for example, **the Council** invited GM chief Roger Smith to a face-to-face session with institutional investors. After the meeting in January, 1987 he pleased the investors by announcing a stock buyback and the reform of a management-bonus plan they had found objectionable....

"Pushing Corporate Boards To Be Better," *FORTUNE,* July 18, 1988.

N**ew York Times:** The influence of institutional investors has never been stronger. Led by the giant state and city pension funds, they challenged company officials with record levels of votes against them in the proxy season that is now ending....

At the same time, in what could be considered the most far-reaching development of all, Texaco Inc. is said to be considering a place on its board for one or more of these funds....

"Companies will find it in their interest to invite us on the board," said Harrison J. Goldin, Comptroller of the City of New York and co-chairman of the **Council of Institutional Investors,** a group of 60 pension funds with more than $250 billion in assets formed several years ago. The council is a nonprofit forum for fund leaders to discuss shareholder issues and to meet with corporate management to voice their opinions. ...

The new activism is a sharp change from previous years, when fund managers who did not like a company's management simply voted with their feet by selling their shares. But the funds have generated so much cash flow from new contributions and the market value of their stock and bond holdings have risen so high that their assets have ballooned to an estimated total of $2 trillion. It has become much harder to unload their huge blocks of stock and move the money into other companies.

"We don't have the luxury of withdrawing and going somewhere else," said Richard H. Koppes, chief counsel for the California Public Employees Retirement System in Sacramento, one of the largest funds in the country with $46 billion in assets [and a founding member of **CII**].

As a result, some of the funds are now eager to use the power that goes along with large ownership positions. Pension funds own almost one-half of the stock of companies that make up the Standard & Poor's 500 Index and 23.2 percent of all corporate equities. By comparison, in 1970 their stake was 9.4 percent of all equity and in 1960 it was only 4 percent, according to the Employee Benefit Research Institute in Washington.

"We want to be viewed as partners," said California's Mr. Koppes....

"Institutions' Proxy Power Grows," *New York Times,* July 5, 1988.

R**egardies:** Less than a week after the Perot buyout, Roger Smith received a telephone call inviting him to address the **Council of Institutional Investors,** the most powerful group of investment managers in America. The Council's membership included 40

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pension fund managers who collectively controlled assets of $160 billion (38 percent of the pension assets in America). Members of the council held 6 million GM shares and more than a million Class-E shares.

Albert Lee, "Call Me Roger," *Regardies*, May 1988.

Barron's:
There's no doubt that pension managers have the muscle to influence the way corporations are run. The funds now own 40% of the publicly traded firms and are expected to own half by the year 2000....

Anti-takeover devices, especially "poison pills," promise a protracted fight between the funds and corporate managers....Waging an all-out proxy contest through a professional solicitor is costly.... But Sarah Teslik, executive director of the **Council of Institutional Investors**, suggests that a group of funds might split the costs of a proxy fight. Among her council's members she counts 40 public pension funds.

"Meeting Resistance: It's Proxy Season, and Pension Funds Grow Assertive," *Barron's*, April 18, 1988.

Business Week:
More than ever, pension funds...are the kingpins on Wall Street. Their assets have mushroomed from $548 billion in 1970 to more than $1.5 trillion now—and more than a third of that is invested in equities. In 1965, pension funds held only 6% of all corporate equity. They now own about a quarter of it. By the year 2000 that share could climb close to 50%, according to the Federal Reserve Board....

The enormity of their holdings is leading to a major change in the way many institutions perceive entrenched management. The old "Wall Street Walk"—simply selling investments in a company whose performance is under par—doesn't work anymore.

The increasingly powerful public institutional owners who banded together in the **Council of Institutional Investors** are spearheading a movement for change. With more than 50 pension fund members controlling $200 billion worth of investments, the **CII** is leading the proxy fight against antitakeover measures in about 40 shareholder meetings this spring....

Above all, **CII** says it seeks a dialogue with managers. Members want to meet with management—as they did with GM—to make sure their opinions are considered and that management is accountable to someone.

"The Battle for Corporate Control," *Business Week*, May 18, 1987.

Institutional Investor:
Leaders of the shareholder crusade...say their cause will continue to thrive even if takeovers do not... [and] insist that shareholders have much more to do, that they should lean on managements generally— prodding them, especially, to become globally competitive....

It was the takeover epidemic that spawned what has been the most vociferous group focusing on shareholder issues, the **CII**....the clear pacesetter in the pursuit of shareholder rights.

"The Revolt of the Institutional Shareholders," *Institutional Investor*, May 1987.

John S.R. Shad:
"The **Council of Institutional Investors** may prove to be one of the most important developments in investor representation since the creation of the SEC."

John S.R. Shad, Chairman, Securities and Exchange Commission, October 30, 1985.

COMMONWEALTH OF PENNSYLVANIA
STATE EMPLOYES' RETIREMENT SYSTEM
BOAS SCHOOL BUILDING
909 GREEN STREET
HARRISBURG, PENNSYLVANIA 17102-2999
TELEPHONE: 717-787-6293

November 22, 1989

Mr. David Bronner CEO
Retirement Systems of Alabama
135 South Union Street
Montgomery, AL 36130

Dear Mr. Bronner:

As a member of the Council of Institutional Investors I would like to invite your fund to join us as members concerned with long term pension fund investing. Initial activity of the Council included creating a Shareholder Bill of Rights. Corporate governance issues continue to be a major focus of the Council as well as providing information for members concerning federal pension taxation (S. 1654 Bill, taxation of pension fund assets.)

Individual assistance is also provided. In particular, the Council is currently helping the Pennsylvania funds examine a Pennsylvania State Bill 1310 amending the Business Corporation Law. By combining the strengths of the individual funds the Council and its members are positioned to effectively improve the pension fund industry.

For additional information please give me a call at (717) 783-9705 or Council personnel at (202) 745-0800.

Sincerely,

Kenneth G. Mertz, II
Chief Investment Officer

KGM:tel

cc: Tina Poitevien, Philadelphia City Fund
Laura Wallace, Nevada Public Employees' Retirement System
Howard France, Maryland State Retirement & Pension Systems
Chuck Conrad, Los Angeles County Employees' Retirement Association
Gerald Gilbert, Georgia Teachers Retirement System
Stanley Siu, Hawaii Employees' Retirement System
Edwin Gallison, Arizona State Retirement System

bcc: Judy Lowe, CII

BEAR STEARNS

THOMAS E. MEADE
SENIOR MANAGING DIRECTOR

BEAR, STEARNS & CO. INC.
245 PARK AVENUE
NEW YORK, NEW YORK 10167
(212) 272-3406

August 30, 1989

Ms. Sarah A.B. Teslik
Council of Institutional Investors
1420 16th Street, N.W.
Suite 405
Washington, D.C. 20036

Dear Sarah:

On behalf of Bear Stearns, we thank you and the Council for providing us access to the senior policy-making personnel of the nations largest pension funds and allowing us access of mutual concern.

Again, accept my deepest thanks, and I look forward to seeing you at the Council's November meeting in New York.

Sincerely,

Thomas F. Meade

Thomas F. Meade

TFM:pm

American Federation of Labor and Congress of Industrial Organizations

815 Sixteenth Street, N.W.
Washington, D.C. 20006
(202) 637-5000

September 8, 1989

Ms. Sarah Teslik
Executive Director
Council of Institutional Investors
1420 16th St., N. W.
Washington, D.C. 20036

Dear Sarah:

On behalf of the pension funds we represent on the Council of Institutional Investors, I'd like to thank you and your staff for all the valuable service, information and representation you have provided over the past year.

Without the Council's excellent conferences, newsletters and steady stream of "member alerts" arriving by FAX, there would be no other economical way we could keep abreast of important developments that shape the increasingly complex investment, regulatory and corporate governance environment confronting pension funds today.

I hope the Council will continue to function as <u>both</u> an informational and an advocacy organization for public and union pension funds. CII has managed to create a niche that is very different from information services, such as IRRC, or the more expensive consulting services.

The Department of Labor is certainly correct that shareholder voting rights have actual and potential economic value. Surprisingly, CII is, to my knowledge, the first and only association of pension funds dedicated to collective action to use those voting rights effectively to help maximize long-term portfolio value. I certainly hope that more of the institutional investors which get a free ride off Council efforts will join up and realize fully the increasing dividends of coordinated shareholder activism.

Sincerely,

Michael Calabrese

Michael Calabrese, Director
AFL-CIO Pension Invest. Project

MC:mb

Pensions & Investment Age, April 17, 1989

Corporations need motherhood lesson

By Sarah Teslik

The experience of the past few years has confirmed what common sense had long suggested: most corporate executives view corporate governance as about as appealing and appropriate as taking your mother along on a date. A good mother, we all know, should care about her children, but be very careful not to meddle.

A good institutional investor, according to corporate America, should behave similarly. Quietly and cheerfully buying and selling apparently is OK, although the etiquette sometimes gets tricky.

- You must not buy and sell too much, or you are a short-term churner who destroys corporations, communities and marriages.
- You must not buy and sell too little.
- You must not invest broadly and passively — the equivalent of indexing whether or not such vehicles are used — because then you are a cruel and heartless beast who does not care about individual companies or the long term.
- You must buy and sell for your beneficiaries, except when a deviation from that purpose is in corporations' interests.

Voting is a gray area: voting for management slates and for management proposals is OK; a rare and passive 'no' vote may be OK at someone else's corporation. Anything else is meddling.

It is widely assumed institutional investors who do "anything else" do so because they want to act like managements. They want to make widgets. If they can't do that, they at least want to second-guess whether the right widgets were made in the right quantity for the right price.

Even those who recognize this is not only untrue but impossible, assume institutional investors want special treatment with regard to the selection of directors: Like "a chicken in every pot," they want "a shareholder on every board."

Fortunately, the sides are not as far apart as they think.

The mother analogy is apt. Even a consummate party-animal mother cannot go on all her children's dates if she has 1,000 children in her portfolio. She can neither manage nor oversee their adult lives, yet she wants them to [illegible]

The appropriate approach should be as obvious in the corporate governance world as it is in the nursery. Working to get the system right is the best (and probably the only) effective way to maximize the likelihood that each of many children will do well.

In childrearing, of course, this is done by imparting values, knowledge and drive before adulthood. In corporate governance this is done through the ongoing review of the structure of the system, not to second-guess specific board or management decisions but to see if the system minimizes conflicts of interests and maximizes the capacity and motivation of boards to oversee corporations in a way that protects such shareholder interests.

The ongoing review of the corporate governance system should include such structure-related questions as the following:

- Before identifying potential board members, should a board or nominating committee identify the kinds of expertise a board should have and the kinds it needs to strengthen?
- What criteria should be used to judge the independence of "independent" directors? Should they include: the absence of employment in an executive capacity by the company within the past five years; avoidance of persons who are among the company's regular professional advisers (or are a member of a firm that is); avoidance of persons connected to entities that are significant customers or suppliers of the company?
- Should the board only accept as candidates persons who do not serve on more than a specified number of other boards?
- Should management directors serve on nomination and compensation committees?
- Should the chief executive officer and chairman of the board be the same person?
- What information — in what form — is given to board members? How much before a meeting do they receive it? Who prepares it? Who reviews it?
- What staff support is made available to independent directors? Should they, at company expense, be able to seek the advice of attorneys, bankers, auditors?
- Should there be a maximum number of years an independent director can serve?
- Should the board establish a shareholder advisory committee that would have periodic meetings with the board to review questions such as these?

Engaging in such a review does not suggest shareholders think the current system is awful or that large numbers of directors are incompetent, lazy or dishonest.

Good boards constantly review their own systems, and pension fund fiduciaries use the same kind of diligence in reviewing the selection, compensation, and monitoring systems they use for their money managers.

A number of senior corporate executives have responded to a discussion such as this with the question, "What makes you think you know enough to ask even these structural questions?" There are two answers to this.

First, one does not have to be a plasma physicist to discuss the pluses and minuses of limiting the number of boards on which individuals can serve or whether independent directors should be given access to independent consultants. No one suggests the answers are simple or uniform, but shareholders can do their homework and know their limitations like anyone else. Indeed, it is precisely because they recognize their limitations that members of the Council of Institutional Investors have approached individual corporations about discussing these issues.

Second, even if shareholders don't measure up to managements' views of what they should do or think, it takes a truly extraordinary redefinition of shareholder rights to deny them the right to ask these questions. Politicians get annoyed with the press and the voters for asking awkward or stupid questions, and trade association executives, I am told, sometimes get annoyed with their members. But politicians and trade association executives have to take their voters and members the way they find them, knowing no matter how much they would like it otherwise, they are ultimately accountable to them.

Secure and competent managements and boards should welcome a constructive dialogue with shareholders regarding the structure of corporate governance. That shareholders desire such a discussion is recognition of the need to avoid meddling in management and the desirability of working together and avoiding mutually destructive confrontation. It is not, however, an invitation for unending discussion, no matter how polite or friendly. The invitation is for constructive discussion leading, when appropriate, to action. The favor of a reply is requested. ■

Ms. Teslik is executive director of the Council of Institutional Investors, Washington.