

ALASKA LEGISLATURE COMMITTEE FILES 1987-1988 8672

5076 HSTA HB 215 - HB 217

648

HB

215



Official Business

# Alaska State Legislature

## House

P.O. BOX V  
State Capitol  
Juneau, Alaska 99811

April 21, 1987

Barry L. Haight, President  
Fairbanks Central Labor Council  
A. F. of L. - C. I. O.  
819 First Avenue  
Fairbanks, AK 99701

Dear Barry:

On April 8, the House State Affairs Committee passed out House Bill 215. The committee report is attached. Its next referral is to the Finance Committee.

I agree with your position that the bill addresses an unfair situation and I believe the proposed remedy is appropriate. Thank you for writing to share your concerns.

Sincerely,

*It's a good bill!*

*Fran*  
Fran Ulmer, Chair  
House State Affairs Committee

HB 215

# FAIRBANKS CENTRAL LABOR COUNCIL

## A. F. of L. - C. I. O.

819 FIRST AVENUE  
FAIRBANKS, ALASKA



April 6, 1987

Representative Fran Ulmer, Chairwoman  
House State Affairs Committee  
P.O. Box V  
Juneau, Alaska 99811

RECEIVED

Dear Fran:

The Fairbanks Central Labor Council supports passage of H.B. 215. Enactment of this legislation will resolve a longstanding problem in the public employee workplace.

A number of AFL-CIO members in the Fairbanks area have recently discovered that they have service not credited for retirement just as they were ready to retire. The problem of uncredited service tends to be worse with public safety employees who are more likely to suffer from occupational injuries or illness than other workers.

Because of contract language many City of Fairbanks employees continue to pay into the Public Employee retirement system even when they are on workmen's compensation. House Bill 215 will resolve this unfair situation.

Sincerely,

A handwritten signature in cursive script that reads "Barry".

Barry L. Haight, President  
Fairbanks Central Labor Council

cc: Representative Mark Boyer  
Representative Niilo Koponen

BL:jb

**DEPARTMENT OF ADMINISTRATION**

**DIVISION OF RETIREMENT & BENEFITS**

PLEASE REPLY TO:

P.O. BOX CR  
JUNEAU, ALASKA 99811-0203  
PHONE: (907)465-4460

2600 DENALI ST. SUITE 401  
ANCHORAGE, ALASKA 99503  
PHONE (907) 277-7504

Public Employees Retirement System  
Teachers Retirement System  
Judicial Retirement System  
Elected Public Officers Retirement System  
National Guard Retirement System  
Territorial Retirement System  
Retirees Voluntary Dental Vision-Audio Plan  
Supplemental Benefits System  
Group Health Life Insurance Benefits  
Deferred Compensation Plan  
Public Employers Social Security Contributions

**STEVE COWPER, GOVERNOR**

April 7 1987

The Honorable Fran Ulmer  
Chairman  
House State Affairs Committee  
P.O. Box V  
Juneau, AK 99811

Dear Madam Chair:

Re: House Bill 215

In accordance with Alaska Statute 24.08.036, I am providing the analysis below on House Bill 215. The analysis includes the long-term and short-term costs to the State if the bill is adopted and the impact the bill will have on the actuarial soundness of the Public Employees' Retirement System (PERS) and the Teachers' Retirement System (TRS) funds. Required changes to the appropriation for the Division of Retirement and Benefits are discussed in a separate fiscal note.

This bill would allow PERS members to receive credit for periods of leave without pay for which they receive workers' compensation payments. They would only have to pay the employee's contribution for that equivalent service. It is estimated to result in a .02% increase in PERS employer contribution rates in FY 88 and level thereafter. The State PERS payroll is estimated to be \$521,290,584.00 in FY 88 and remain level each year thereafter. This would result in an annual State cost of \$104.3 in FY 88 and in succeeding years (the PERS contribution rate increase of .02% times the State PERS estimated payroll of \$521,290,584.00).

In addition to the State costs above, there would also be an increase in political subdivisions FY 88 contribution rate of .02%. This would result in an increase in their annual costs by \$65.9 (rate increase of .02% times the estimated political subdivision payroll of \$329,282,769.00).

6

Rep. Fran Ulmer  
House Bill 215  
PO Box V  
Juneau, AK 99811

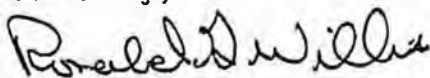
Dear Ms. Ulmer:

I have been employed with the City of Fairbanks Fire Dept. since 1970. In the 17 years I have been employed I have been hospitalized twice for smoke inhalation and sustained a neck and shoulder injury in 1975 after falling through a roof in the line of duty. Subsequently, I have had three surgeries for this injury for which I am currently recuperating from the third surgery in February 1987. I should be able to return to work by the end of April.

As a result of the job related injuries sustained over the years I have been off work for approximately 7 to 9 months cumulatively. In the past we were all under the understanding that time off for on the job injuries were for full credited services. Under the new APERS system any on the job injuries under 10 days is full credited service while injuries or illness requiring more than 10 days is considered LWOP non-credited service from date of injury.

I have given you a brief outline of my work and medical background to give you an idea although I'm sure you are already aware of the hazards of this line of work. I feel we are penalized under the current APERS laws system for job related injuries and would like your support for House Bill 215.

Sincerely,



Ronald G. Willis

cc: Nilo Koponen  
Mark Boyer

Ron Willis  
1716 Southern Ave  
Fairbanks, AK 99701

907 456 7554

4/7/87

STATE OF ALASKA  
Interdepartmental Route Slip

TO: Mail Station 3100	Department House State Affairs 102
--------------------------	---------------------------------------

Attention

- |  |   |
|--|---|
| <input type="checkbox"/> Approval      | <input type="checkbox"/> Note & Return        |
| <input type="checkbox"/> Signature     | <input type="checkbox"/> Initial & Return     |
| <input type="checkbox"/> Comment       | <input type="checkbox"/> Return as Requested  |
| <input type="checkbox"/> Contact Me    | <input type="checkbox"/> Return for Approval  |
| <input type="checkbox"/> Prepare Reply | <input type="checkbox"/> Necessary Action     |
| <input type="checkbox"/> For Your File | <input type="checkbox"/> For Your Information |

Remarks:

Replacement for Position  
Paper on HB 215

FROM: Mail Station 0200	Department Administration
By Mike McMullen/Comm.'s Office	Date 4-9

POSITION PAPER

HB 215

This bill would allow Public Employees' Retirement System (PERS) members who take more than ten days leave of absence without pay (LWOP) in a calendar year because of an on-the-job injury or work-related illness and who are receiving workers' compensation benefits to receive service credit in the PERS. The members could establish an indebtedness for that LWOP service in an amount equal to their employee contributions which would have been paid had they been working.

Because the department is sympathetic to the concerns represented, its position is neutral even though the bill has a cost of \$104.3 in FY 88 during a time when the administration is struggling with holding personal services costs down. If it is determined to address these concerns with service credit in the PERS, it could be addressed at approximately one-half the cost if treated as in the Teachers' Retirement System (TRS). In the TRS, the member can receive credit for LWOP service by paying both the employee and employer contributions. Even though this would still result in a cost, this would help to offset the cost to the employers and thereby make this bill more fiscally conservative.

The department is neutral on this bill due to the cost. However, the department would support the bill if it were amended as described above.

*J. K. Humphreys*  
for J. K. Humphreys, Director  
Division of Retirement and Benefits

4-9-87  
Date

*Garrey Peska*  
Commissioner Garrey Peska  
Department of Administration

4/9/87  
Date



Official Business

# Alaska State Legislature

## House

P.O. BOX V  
State Capitol  
Juneau, Alaska 99811

COMMITTEE ON STATE AFFAIRS

April 13, 1987

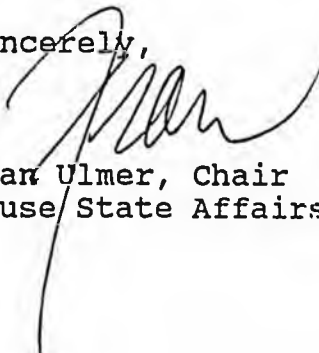
Barry L. Haight, Chairman  
Fire Fighters Legislation Action Committee  
P.O. Box 784  
Fairbanks, AK 99707

Dear Mr. Haight:

Thank you for your letter on House Bill 215. The State Affairs Committee considered this bill on Wednesday, April 8, and passed it on to the Finance Committee. I have enclosed a copy of the State Affairs Committee report for your information and will send your letter on to the Finance Committee.

Thank you, again, for writing.

Sincerely,

  
Fran Ulmer, Chair  
House State Affairs Committee

Enc.

# Fire Fighters Legislative Action Committee

P.O. Box 784 Barry L. Haight, Chairman

Fairbanks, Alaska 99707

April 6, 1987

Representative Fran Ulmer, Chairwoman  
House State Affairs Committee  
Post Office Box "V"  
Juneau, Alaska 99811

A Chronology - Workers' Compensation payments as Creditable Service under the Public Employees Retirement System

1960- The Public Employees Retirement System (PERS) is created. Later review by an Alaska Court and the Alaska Public Employees Retirement Board determined that legislative intent was for Workers' Compensation payment to be included as creditable service. The Department of Administration followed this practice until 1979.

1977- Statutory definition was changed, dropping "subsistence and maintenance" language.

1979- The Department of Administration decided to change its interpretation of A.S. 39.35.680(8) to find that "compensation" and therefore, creditable service under A.S. 39.35.300 should no longer include payments for Workers' Compensation.

It is interesting to note that in 1979, the department requested an opinion from the Attorney General regarding the 1977 statutory amendment to "compensation" under the PERS Act; the Attorney General, relying on rules of statutory construction, ruled that Workers' Compensation payments were included within the definition of "compensation". A month later, at the request of the department, a second opinion was issued without any legal citations. The Attorney General revised his opinion to state that the portion of an employee's salary paid through Workers' Compensation payments should not be included as "compensation". Thereafter, the department revised its policy. A Board of Review at a later date described this maneuver as a "self-serving rationalization".

1982- The legislature passed a statutory change to the PERS Act and Workers' Compensation was expressly added to a list of itemized exclusions.

Thus, we have three classes of employees:

- 1) Those hired previous to 1979 with whom not only are Workers' Compensation payments creditable service, but also unused leave payments.
- 2) Those employees hired between July 1, 1979 and July 1, 1982, who receive Workers' Compensation payments as creditable service, but not unused leave.
- 3) Employees hired after July 1, 1982, to whom neither Workers' Compensation payments nor unused leave is creditable service under PERS.

Therefore, current law dictates that an employee injured on the job is penalized by having his retirement benefits reduced. The more severe the injury and the greater the length of time out of work, the greater the penalty.

The Fire Fighters Legislative Action Committee supports passage of House Bill 215 as a reasonable method of solving inequities of Workers' Compensation under the Public Employees Retirement System.

xc: Representative Niilo Koponen  
Representative Mark Boyer

# HOUSE COMMITTEE REPORT

(7)

Date referred: 3/25/87

FURTHER REFERRALS: Finance

DATE: 4-8-87

The State Affairs Committee has considered HB 215

"An Act relating to credited service under the Public Employees' Retirement System for certain periods of leave of absence without pay; and providing for an effective date."

**RECOMMENDS:**

- replace with \_\_\_\_\_  the same title
- attached amendment(s)  a new title
- do pass
- do not pass
- no recommendation
- individual recommendations
- additional referral to the \_\_\_\_\_ Committee

**ADOPTS:**  \_\_\_\_\_ letter of intent

**ATTACHES NEW FISCAL NOTE(s):**

- fiscal impact  same as previous fiscal note published \_\_\_\_\_
- zero fiscal note  same as previous zero fiscal note published \_\_\_\_\_
- zero with analysis

**SIGNING DO PASS:**

[Signature]

Cliff Davidson

[Signature]

[Signature]

\_\_\_\_\_

\_\_\_\_\_

\_\_\_\_\_

\_\_\_\_\_

\_\_\_\_\_

\_\_\_\_\_

**SIGNING OTHER RECOMMENDATIONS:**

[Signature] NO REC.

[Signature] NO REC.

[Signature] No rec.

\_\_\_\_\_

\_\_\_\_\_

\_\_\_\_\_

\_\_\_\_\_

\_\_\_\_\_

[Signature]  
Chairman's signature



Official Business

# Alaska State Legislature

## House

P.O. BOX V  
State Capitol  
Juneau, Alaska 99811

### COMMITTEE ON STATE AFFAIRS

#### FILE CONTENTS

1. HB 215: AN ACT RELATING TO CREDITED SERVICE UNDER THE PUBLIC EMPLOYEES' RETIREMENT SYSTEM FOR CERTAIN PERIODS OF LEAVE OF ABSENCE WITHOUT PAY; AND PROVIDING FOR AN EFFECTIVE DATE.
2. LETTER FROM J.K. HUMPHREYS TO REPRESENTATIVE ULMER, DATED APRIL 7, 1987
3. POSITION PAPER, DEPARTMENT OF ADMINISTRATION
4. MEMO FROM CHERIE SHELLEY TO REPRESENTATIVE ULMER, DATED APRIL 6, 1987
5. LETTER FROM FIRE FIGHTERS LEGISLATIVE ACTION COMMITTEE
6. LETTER FROM RONALD WILLIS TO REPRESENTATIVE ULMER. DATED APRIL 7, 1987

#### FISCAL NOTE

- A. DEPARTMENT OF ADMINISTRATION, DIVISION OF RETIREMENT AND BENEFITS: -0-

A

STATE OF ALASKA 1987 LEGISLATIVE SESSION  
FISCAL NOTE

Bill Version: HB 215  
Publish Date: \_\_\_\_\_

REQUEST \_\_\_\_\_

Revision Date: \_\_\_\_\_  
Title: An Act relating to credited service under the PERS.  
Sponsor: Boyer  
Requestor: \_\_\_\_\_

Agency Affected: Administration  
BRU: Retirement and Benefits  
Components: Retirement and Benefits

EXPENDITURES/REVENUES: (Thousands of Dollars)

	FY 87	FY 88	FY 89	FY 90	FY 91	FY 92
<b>OPERATING</b>						
PERSONAL SERVICES	0	0	0	0	0	0
TRAVEL	0	0	0	0	0	0
CONTRACTUAL	0	0	0	0	0	0
SUPPLIES	0	0	0	0	0	0
EQUIPMENT	0	0	0	0	0	0
LAND & STRUCTURES	0	0	0	0	0	0
GRANTS, CLAIMS	0	0	0	0	0	0
MISCELLANEOUS	0	0	0	0	0	0
<b>TOTAL OPERATING</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>0</b>
<b>CAPITAL</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>0</b>
<b>REVENUE</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>0</b>

FUNDING: (Thousands of Dollars)

GENERAL FUND	0	0	0	0	0	0
FEDERAL FUNDS	0	0	0	0	0	0
OTHER	0	0	0	0	0	0
<b>TOTAL</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>0</b>

POSITIONS:

FULL-TIME	0	0	0	0	0	0
PART-TIME	0	0	0	0	0	0
TEMPORARY	0	0	0	0	0	0

ANALYSIS: Attach a separate page if necessary

An analysis of the impact of this bill on the actuarial soundness of the Public Employees' Retirement System (PERS) is provided in the attached letter to Representative Ulmer.

Prepared By: J.K. Humphreys *J.K. Humphreys* Phone: 465-4460  
Division: Retirement and Benefits Date: April 6, 1987

Approved by Commissioner: Garrey Peska *Garrey Peska* Date: 4/8/87  
Agency: Department of Administration

Distribution (by preparer):  
Legislative Finance  
Legislative Sponsor  
Requestor  
Office of Management and Budget  
Impacted Agency(ies)  
Senate Secretary

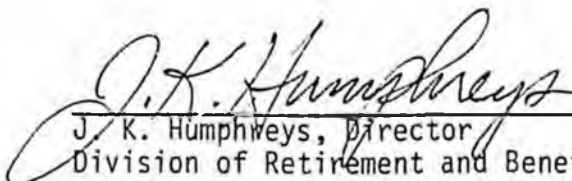
POSITION PAPER

HB 215

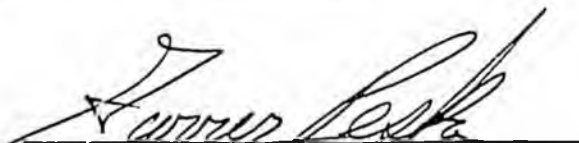
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Although the department is sympathetic to the concerns represented by this bill, it does not support a bill with a cost of \$104.3 in FY 88 during a time when the administration is struggling with holding personal services costs down. In addition, it has always been the department's position to oppose service credit for any form of LWOP in any of the systems. Allowing this type of LWOP would only serve to open the door to allow credited service for other forms of LWOP. If it is determined to address these concerns with service credit in the PERS, it could be addressed at approximately one-half the cost if treated as in the Teachers' Retirement System (TRS). In the TRS, the member can receive credit for LWOP service by paying both the employee and employer contributions. Even though this would still result in a cost, this would help to offset the cost to the employers and thereby make this bill more fiscally conservative.

The department is opposed to this bill.

  
\_\_\_\_\_  
J. K. Humphreys, Director  
Division of Retirement and Benefits

4/8/87  
Date

  
\_\_\_\_\_  
Commissioner Garrey Peska  
Department of Administration

4/8/87  
Date

**DEPARTMENT OF ADMINISTRATION**  
**DIVISION OF RETIREMENT & BENEFITS**

PLEASE REPLY TO:

P.O. BOX CR  
JUNEAU, ALASKA 99811-0203  
PHONE: (907)465-4460

2600 DENALI ST. SUITE 401  
ANCHORAGE, ALASKA 99503  
PHONE (907) 277-7504

STEVE COWPER, GOVERNOR

April 7 1987

The Honorable Fran Ulmer  
Chairman  
House State Affairs Committee  
P.O. Box V  
Juneau, AK 99811

Dear Madam Chair:

Re: House Bill 215

In accordance with Alaska Statute 24.08.036, I am providing the analysis below on House Bill 215. The analysis includes the long-term and short-term costs to the State if the bill is adopted and the impact the bill will have on the actuarial soundness of the Public Employees' Retirement System (PERS) and the Teachers' Retirement System (TRS) funds. Required changes to the appropriation for the Division of Retirement and Benefits are discussed in a separate fiscal note.

This bill would allow PERS members to receive credit for periods of leave without pay for which they receive workers' compensation payments. They would only have to pay the employee's contribution for that equivalent service. It is estimated to result in a .02% increase in PERS employer contribution rates in FY 88 and level thereafter. The State PERS payroll is estimated to be \$521,290,584.00 in FY 88 and remain level each year thereafter. This would result in an annual State cost of \$104.3 in FY 88 and in succeeding years (the PERS contribution rate increase of .02% times the State PERS estimated payroll of \$521,290,584.00).

In addition to the State costs above, there would also be an increase in political subdivisions FY 88 contribution rate of .02%. This would result in an increase in their annual costs by \$65.9 (rate increase of .02% times the estimated political subdivision payroll of \$329,282,769.00).

# Fire Fighters Legislative Action Committee

P.O. Box 784 Barry L. Haight, Chairman Fairbanks, Alaska 99707

456-2030

April 6, 1987

Representative Fran Ulmer, Chairwoman  
House State Affairs Committee  
Post Office Box 'V'  
Juneau, Alaska 99811

A Chronology - Workers' Compensation payments as Creditable Service under the Public Employees Retirement System

1960- The Public Employees Retirement System (PERS) is created. Later review by an Alaska Court and the Alaska Public Employees Retirement Board determined that legislative intent was for Workers' Compensation payment to be included as creditable service. The Department of Administration followed this practice until 1979.

1977- Statutory definition was changed, dropping "subsistence and maintenance" language.

1979- The Department of Administration decided to change its interpretation of A.S. 39.35.690(8) to find that "compensation" and therefore, creditable service under A.S. 39.35.300 should no longer include payments for Workers' Compensation.

It is interesting to note that in 1979, the department requested an opinion from the Attorney General regarding the 1977 statutory amendment to "compensation" under the PERS Act; the Attorney General, relying on rules of statutory construction, ruled that Workers' Compensation payments were included within the definition of "compensation". A month later, at the request of the department, a second opinion was issued without any legal citations. The Attorney General revised his opinion to state that the portion of an employee's salary paid through Workers' Compensation payments should not be included as "compensation". Thereafter, the department revised its policy. A Board of Review at a later date described this maneuver as a "self-serving rationalization".

1982- The legislature passed a statutory change to the PERS Act and Workers' Compensation was expressly added to a list of itemized exclusions.

Thus, we have three classes of employees:

- 1) Those hired previous to 1979 with whom not only are Workers' Compensation payments creditable service, but also unused leave payments.
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Therefore, current law dictates that an employee injured on the job is penalized by having his retirement benefits reduced. The more severe the injury and the greater the length of time out of work, the greater the penalty.

The Fire Fighters Legislative Action Committee supports passage of House Bill 215 as a reasonable method of solving inequities of Workers' Compensation under the Public Employees Retirement System.

xc: Representative Niilo Koponen  
Representative Mark Boyer

# Alaska State Legislature

REPRESENTATIVE  
MARK BOYER

HOUSE FINANCE COMMITTEE



## House of Representatives

### MEMORANDUM

FAIRBANKS

1098 LAKEVIEW TERRACE  
FAIRBANKS, ALASKA 99701  
(907) 456-6473

JUNEAU

P.O. BOX V  
STATE CAPITOL  
JUNEAU, ALASKA 99811  
(907) 465-3466

TO: Representative Fran Ulmer, Chair  
House State Affairs Committee  
Committee Members

FROM: Representative Mark Boyer

SUBJECT: HB 215 - Credited Service under PERS/  
Workers Compensation

DATE: April 6, 1987

Under current law, participants in the Public Employees Retirement System who are forced to take leave without pay due to on-the-job injury suffer a break in credited service which, upon retirement, reduces their benefit. This loss of credited service also negatively impacts date of eligibility for retirement, particularly for public safety employees eligible for the "twenty and out" provision. An employee electing to retire on the twentieth anniversary of date of hire who went on leave without pay while receiving workers compensation will be denied retirement until an additional period of time equal to that leave is worked.

Prior to 1979, certain periods of time lost due to job-related injury were considered credited service under PERS, if employees were receiving the portion of normal compensation not covered by workers compensation through sick or annual leave. When Payroll section verified an employee's service to the Division of Retirement and Benefits, Payroll reported no leave without pay for periods when the employee was on workers' compensation and was receiving payments from the state charged against leave. This practice was changed in 1979, when Retirement and Benefits directed Payroll to report periods of time attributed to workers' compensation, rather than to sick or annual leave, as leave without pay.

It is inherently unfair that public employees injured on the job should be doubly penalized by reduced income while on workers' compensation and reduced pension benefits due to loss of credited service upon retirement. HB 215 would remedy this situation by allowing employees to pay an amount equal to

their normal PERS contribution for time spent on leave without pay due to job-related injury or illness. Similar provisions are in statute allow credited service for military service, employment with a BIA school, and temporary service with the state. There will be minimal fiscal impact on public employers, since there is no cost other than the normal contribution which would have been made had the employee not been injured in the course of their employment.

# **CORRECTION**

**THIS DOCUMENT  
HAS BEEN REPHOTOGRAPHED  
TO ASSURE LEGIBILITY**

**DEPARTMENT OF ADMINISTRATION**  
**DIVISION OF RETIREMENT & BENEFITS**

PLEASE REPLY TO:

P.O. BOX CR  
JUNEAU, ALASKA 99811-0203  
PHONE: (907) 465-4460

2600 DENALI ST. SUITE 401  
ANCHORAGE, ALASKA 99503  
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**STEVE COWPER, GOVERNOR**

April 7 1987

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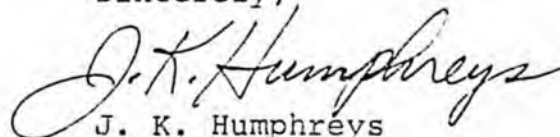
The Honorable Fran Ulmer

-2-

April 7, 1987

Although there will not be a significant adverse impact on the actuarial soundness of the PERS fund if the bill becomes law, the unfunded liability will increase by \$600,000.00 and the funding ratio will decrease by .05%.

Sincerely,

A handwritten signature in cursive script that reads "J. K. Humphreys".

J. K. Humphreys  
Director

JKH/RLS/nl

20/6D1/0406-02/1

cc: Commissioner Garrey Peska  
Department of Administration

# Fire Fighters Legislative Action Committee

P.O. Box 784 Barry L. Haight, Chairman Fairbanks, Alaska 99707

456-2030

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Thus, we have three classes of employees:

- 1) Those hired previous to 1979 with whom not only are Workers' Compensation payments creditable service, but also unused leave payments.
- 2) Those employees hired between July 1, 1979 and July 1, 1982, who receive Workers' Compensation payments as creditable service, but not unused leave.
- 3) Employees hired after July 1, 1982, to whom neither Workers' Compensation payments nor unused leave is creditable service under PERS.

Therefore, current law dictates that an employee injured on the job is penalized by having his retirement benefits reduced. The more severe the injury and the greater the length of time out of work, the greater the penalty.

The Fire Fighters Legislative Action Committee supports passage of House Bill 215 as a reasonable method of solving inequities of Workers' Compensation under the Public Employees Retirement System.

xc: Representative Niilo Koponen  
Representative Mark Boyer

# **CORRECTION**

**THIS DOCUMENT  
HAS BEEN REPHOTOGRAPHED  
TO ASSURE LEGIBILITY**

**DEPARTMENT OF ADMINISTRATION**  
**DIVISION OF RETIREMENT & BENEFITS**

PLEASE REPLY TO:

P.O. BOX CR  
JUNEAU, ALASKA 99811-0203  
PHONE: (907)465-4460

2600 DENALI ST. SUITE 401  
ANCHORAGE, ALASKA 99503  
PHONE (907) 277-7504

**STEVE COWPER, GOVERNOR**

April 7 1987

The Honorable Fran Ulmer  
Chairman  
House State Affairs Committee  
P.O. Box V  
Juneau, AK 99811

Dear Madam Chair:

Re: House Bill 215

In accordance with Alaska Statute 24.08.036, I am providing the analysis below on House Bill 215. The analysis includes the long-term and short-term costs to the State if the bill is adopted and the impact the bill will have on the actuarial soundness of the Public Employees' Retirement System (PERS) and the Teachers' Retirement System (TRS) funds. Required changes to the appropriation for the Division of Retirement and Benefits are discussed in a separate fiscal note.

This bill would allow PERS members to receive credit for periods of leave without pay for which they receive workers' compensation payments. They would only have to pay the employee's contribution for that equivalent service. It is estimated to result in a .02% increase in PERS employer contribution rates in FY 88 and level thereafter. The State PERS payroll is estimated to be \$521,290,584.00 in FY 88 and remain level each year thereafter. This would result in an annual State cost of \$104.3 in FY 88 and in succeeding years (the PERS contribution rate increase of .02% times the State PERS estimated payroll of \$521,290,584.00).

In addition to the State costs above, there would also be an increase in political subdivisions FY 88 contribution rate of .02%. This would result in an increase in their annual costs by \$65.9 (rate increase of .02% times the estimated political subdivision payroll of \$329,282,769.00).

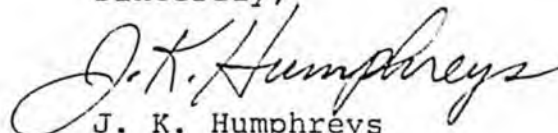
The Honorable Fran Ulmer

-2-

April 7, 1987

Although there will not be a significant adverse impact on the actuarial soundness of the PERS fund if the bill becomes law, the unfunded liability will increase by \$600,000.00 and the funding ratio will decrease by .05%.

Sincerely,



J. K. Humphreys  
Director

JKH/RLS/nl

20/6D1/0406--02/1

cc: Commissioner Garrey Peska  
Department of Administration

# Fire Fighters Legislative Action Committee

P.O. Box 784 Barry L. Haight, Chairman Fairbanks, Alaska 99707

456-2030

April 6, 1987

Representative Fran Ulmer, Chairwoman  
House State Affairs Committee  
Post Office Box 'V'  
Juneau, Alaska 99811

A Chronology - Workers' Compensation payments as Creditable Service under the Public Employees Retirement System

1960- The Public Employees Retirement System (PERS) is created. Later review by an Alaska Court and the Alaska Public Employees Retirement Board determined that legislative intent was for Workers' Compensation payment to be included as creditable service. The Department of Administration followed this practice until 1979.

1977- Statutory definition was changed, dropping "subsistence and maintenance" language.

1979- The Department of Administration decided to change its interpretation of A.S. 39.35.680(8) to find that "compensation" and therefore, creditable service under A.S. 39.35.300 should no longer include payments for Workers' Compensation.

It is interesting to note that in 1979, the department requested an opinion from the Attorney General regarding the 1977 statutory amendment to "compensation" under the PERS Act; the Attorney General, relying on rules of statutory construction, ruled that Workers' Compensation payments were included within the definition of "compensation". A month later, at the request of the department, a second opinion was issued without any legal citations. The Attorney General revised his opinion to state that the portion of an employee's salary paid through Workers' Compensation payments should not be included as "compensation". Thereafter, the department revised its policy. A Board of Review at a later date described this maneuver as a "self-serving rationalization".

1982- The legislature passed a statutory change to the PERS Act and Workers' Compensation was expressly added to a list of itemized exclusions.

Thus, we have three classes of employees:

- 1) Those hired previous to 1979 with whom not only are Workers' Compensation payments creditable service, but also unused leave payments.
- 2) Those employees hired between July 1, 1979 and July 1, 1982, who receive Workers' Compensation payments as creditable service, but not unused leave.
- 3) Employees hired after July 1, 1982, to whom neither Workers' Compensation payments nor unused leave is creditable service under PERS.

Therefore, current law dictates that an employee injured on the job is penalized by having his retirement benefits reduced. The more severe the injury and the greater the length of time out of work, the greater the penalty.

The Fire Fighters Legislative Action Committee supports passage of House Bill 215 as a reasonable method of solving inequities of Workers' Compensation under the Public Employees Retirement System.

xc: Representative Niilo Koponen  
Representative Mark Boyer

# Alaska State Legislature

REPRESENTATIVE  
MARK BOYER

HOUSE FINANCE COMMITTEE



House of Representatives

MEMORANDUM

FAIRBANKS

1098 LAKEVIEW TERRACE  
FAIRBANKS, ALASKA 99701  
(907) 456-6473

JUNEAU

P.O. BOX V  
STATE CAPITOL  
JUNEAU, ALASKA 99811  
(907) 465-3466

TO: Representative Fran Ulmer, Chair  
House State Affairs Committee  
Committee Members

FROM: Representative Mark Boyer

SUBJECT: HB 215 - Credited Service under PERS/  
Workers Compensation

DATE: April 6, 1987

Under current law, participants in the Public Employees Retirement System who are forced to take leave without pay due to on-the-job injury suffer a break in credited service which, upon retirement, reduces their benefit. This loss of credited service also negatively impacts date of eligibility for retirement, particularly for public safety employees eligible for the "twenty and out" provision. An employee electing to retire on the twentieth anniversary of date of hire who went on leave without pay while receiving workers compensation will be denied retirement until an additional period of time equal to that leave is worked.

Prior to 1979, certain periods of time lost due to job-related injury were considered credited service under PERS, if employees were receiving the portion of normal compensation not covered by workers compensation through sick or annual leave. When Payroll section verified an employee's service to the Division of Retirement and Benefits, Payroll reported no leave without pay for periods when the employee was on workers' compensation and was receiving payments from the state charged against leave. This practice was changed in 1979, when Retirement and Benefits directed Payroll to report periods of time attributed to workers' compensation, rather than to sick or annual leave, as leave without pay.

It is inherently unfair that public employees injured on the job should be doubly penalized by reduced income while on workers' compensation and reduced pension benefits due to loss of credited service upon retirement. HB 215 would remedy this situation by allowing employees to pay an amount equal to

their normal PERS contribution for time spent on leave without pay due to job-related injury or illness. Similar provisions are in statute allow credited service for military service, employment with a BIA school, and temporary service with the state. There will be minimal fiscal impact on public employers, since there is no cost other than the normal contribution which would have been made had the employee not been injured in the course of their employment.



4

Alaska Public  
Employees Association **APEA**  
State Headquarters: 340 N. Franklin, Juneau, AK 99801 (907) 586-2334

RECEIVED APR 8 1987

MEMORANDUM

TO: Representative Fran Ulmer, Chairperson  
State Affairs Committee

FROM: Cherie Shelle *CS*  
Executive Director

SUBJECT: HB 215 - Credited Service in PERS

DATE: April 6, 1987

The Alaska Public Employees Association urges the committee to recommend passage of House Bill 215. This legislation will correct an injustice suffered by employees with occupational illnesses or on-the-job injuries. HB 215 is an important addition to statutory rights and benefits guaranteed disabled workers.

This bill will allow employees to receive retirement credit for periods during which workers compensation benefits were being received. Employees would be required to pay the full amount of employee contributions for the period of disability. Employees would also be required to pay interest on the indebtedness beginning on the date the employee returns to work or terminates employment as prescribed by regulation. Retirement benefits would be actuarially reduced if there is an outstanding liability to the system at the time the employee is appointed to retirement.

This legislation conforms to a recent court decision which granted credited service under similar circumstances.

Employees disabled in the course of their employment or unable to work because of an occupational illness should not suffer the double injury of reduced retirement benefits. This legislation corrects this injustice

We urge the committee to act favorably on House Bill 215.

Fairbanks Field Office  
825-D College Road  
Fairbanks, AK 99701  
Telephone: (907) 456-5412

Anchorage Field Office  
833 Gambell Street, Suite A  
Anchorage, AK 99501  
Telephone: (907) 274-1688

Juneau Field Office  
227 4th Street  
Juneau, AK 99801  
Telephone: (907) 586-6305

HB

217



Official Business

# Alaska State Legislature

P.O. Box V  
State Capitol  
Juneau, Alaska 99811

STATE AFFAIRS COMMITTEE

HOUSE BILL 217

FILE CONTENTS

1. HB 217: AN ACT RELATING TO PURCHASE OF FOREIGN INVESTMENTS BY THE BOARD OF TRUSTEES OF THE ALASKA PERMANENT FUND
2. LETTER FROM DAVID ROSE TO REPRESENTATIVE ULMER, DATED APRIL 13, 1987, AND ATTACHMENTS
3. GOVERNOR'S TRANSMITTAL LETTER

## FISCAL NOTE

- A. PERMANENT FUND CORPORATION: \$35,000 IN FY 88; \$500,000 IN FY 89

# HOUSE COMMITTEE REPORT

(11)

Date referred: 5/4/87

FURTHER REFERRALS:

DATE: 3/8/88

The Finance Committee has considered HB 217

"An Act relating to purchase of foreign investments by the board of trustees of the Alaska permanent fund."

**RECOMMENDS:**

- replace with CS HB 217 (Fin.) [ ] the same title
- [ ] attached amendment(s) [ ] a new title
- do pass
- [ ] do not pass
- [ ] no recommendation
- [ ] individual recommendations
- [ ] additional referral to the \_\_\_\_\_ Committee

**ADOPTS:** [ ] \_\_\_\_\_ letter of intent

**ATTACHES NEW FISCAL NOTE(S):**

- fiscal impact [ ] same as previous fiscal note published \_\_\_\_\_
- [ ] zero fiscal note [ ] same as previous zero fiscal note published \_\_\_\_\_
- [ ] zero with analysis

**SIGNING DO PASS:**

LARSON Ronald J. Larson

BOYER Mark Boyer

RIEGER Steve Rieger

PRANK Frank Prank

BROWN Fay Brown

DAVIS Mike Davis

\_\_\_\_\_

\_\_\_\_\_

\_\_\_\_\_

\_\_\_\_\_

**SIGNING OTHER RECOMMENDATIONS:**

ADAMS Albert Adams

POURCHOT Ed Pourchot

SWACK-HAMMER Ed Swack-Hammer NO REC

WALLIS Key Wallis

GOLL John Goll

\_\_\_\_\_

\_\_\_\_\_

Albert Adams  
Chairman's signature

FISCAL NOTE

REQUEST:

Revision Date: \_\_\_\_\_  
Title: An Act relating to purchase of  
foreign securities by PFC.  
Sponsor: Rules  
Requestor: Governor

Agency Affected: Revenue  
BRU: Permanent Fund Corporation  
Components: \_\_\_\_\_

EXPENDITURES/REVENUES: (Thousands of Dollars)

OPERATING	FY 88	FY 89	FY 90	FY 91	FY 92	FY 93
PERSONAL SERVICES	-	-	-	-	-	-
TRAVEL	-	-	-	-	-	-
CONTRACTUAL	-	35.0	500.0	500.0	500.0	500.0
SUPPLIES	-	-	-	-	-	-
EQUIPMENT	-	-	-	-	-	-
LAND & STRUCTURES	-	-	-	-	-	-
GRANTS, CLAIMS	-	-	-	-	-	-
MISCELLANEOUS	-	-	-	-	-	-
TOTAL OPERATING	-	35.0	500.0	500.0	500.0	500.0
CAPITAL	-	-	-	-	-	-
REVENUE	-	-	-	-	-	-

FUNDING: (Thousands of Dollars)

GENERAL FUND	-	-	-	-	-	-
FEDERAL FUNDS	-	-	-	-	-	-
OTHER	-	35.0	500.0	500.0	500.0	500.0
TOTAL	-	35.0	500.0	500.0	500.0	500.0

POSITIONS:

FULL-TIME	-	-	-	-	-	-
PART-TIME	-	-	-	-	-	-
TEMPORARY	-	-	-	-	-	-

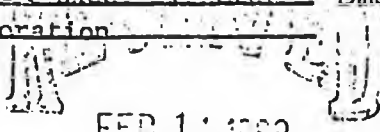
ANALYSIS : (Attach a separate page if necessary)

FY 89: Contractual services for manager search.

FY 90 - FY 93: Management fees.

Prepared by: Alaska Permanent Fund Corporation Phone: 465-2047  
Division: \_\_\_\_\_ Date: February 8, 1988  
Approved by Commissioner: David A. Rose, Exec. Director Date: February 8, 1988  
Agency: Alaska Permanent Fund Corporation

Distribution (by preparer):  
Legislative Finance  
Legislative Sponsor  
Requestor  
Office of Management and Budget  
Impacted Agency(ies)



LEGISLATIVE FINANCE

FISCAL NOTE

REQUEST:

Revision Date: \_\_\_\_\_  
Title: An Act relating to purchase of  
foreign securities by PFC.  
Sponsor: Rules  
Requestor: Governor

Agency Affected: Revenue  
BRU: Permanent Fund Corporation  
Components: \_\_\_\_\_

EXPENDITURES/REVENUES: (Thousands of Dollars)

OPERATING	FY 88	FY 89	FY 90	FY 91	FY 92	FY 93
PERSONNEL SERVICES	-	-	-	-	-	-
TRAVEL	-	-	-	-	-	-
CONTRACTUAL	-	35.0	500.0	500.0	500.0	500.0
SUPPLIES	-	-	-	-	-	-
EQUIPMENT	-	-	-	-	-	-
LAND & STRUCTURES	-	-	-	-	-	-
GRANTS, CLAIMS	-	-	-	-	-	-
MISCELLANEOUS	-	-	-	-	-	-
TOTAL OPERATING	-	35.0	500.0	500.0	500.0	500.0
CAPITAL	-	-	-	-	-	-
REVENUE	-	-	-	-	-	-

FUNDING: (Thousands of Dollars)

GENERAL FUND	-	-	-	-	-	-
FEDERAL FUNDS	-	-	-	-	-	-
OTHER	-	35.0	500.0	500.0	500.0	500.0
TOTAL	-	35.0	500.0	500.0	500.0	500.0

POSITIONS:

FULL-TIME	-	-	-	-	-	-
PART-TIME	-	-	-	-	-	-
TEMPORARY	-	-	-	-	-	-

ANALYSIS : (Attach a separate page if necessary)

FY 89: Contractual services for manager search.

FY 90 - FY 93: Management fees.

Prepared by: Alaska Permanent Fund Corporation Phone: 465-2087  
Division: \_\_\_\_\_ Date: February 8, 1988  
Approved by Commissioner: David A. Rosa, Exec. Director Date: February 8, 1988  
Agency: Alaska Permanent Fund Corporation

Distribution (by preparer):

- Legislative Finance
- Legislative Sponsor
- Requester
- Office of Management and Budget
- Impacted Agency(ies)

# HOUSE COMMITTEE REPORT

(7)

Date referred: 3/27/87

FURTHER REFERRALS: Finance

DATE: 5-1-87

The State Affairs Committee has considered HB 217

"An Act relating to purchase of foreign investments by the board of trustees of the Alaska permanent fund."

**RECOMMENDS:**

- replace with \_\_\_\_\_  the same title
- attached amendment(s)  a new title
- do pass
- do not pass
- no recommendation
- individual recommendations
- additional referral to the \_\_\_\_\_ Committee

**ADOPTS:**  \_\_\_\_\_ letter of intent

**ATTACHES NEW FISCAL NOTE(s):**

- fiscal impact  same as previous fiscal note published 3/27/87
- zero fiscal note  same as previous zero fiscal note published \_\_\_\_\_
- zero with analysis

**SIGNING TO PASS:**

[Signature]

[Signature]

\_\_\_\_\_

\_\_\_\_\_

\_\_\_\_\_

\_\_\_\_\_

\_\_\_\_\_

\_\_\_\_\_

\_\_\_\_\_

**SIGNING OTHER RECOMMENDATIONS:**

[Signature] NO REC.

[Signature] DO NOT PASS

[Signature] No Rec.

\_\_\_\_\_

\_\_\_\_\_

\_\_\_\_\_

\_\_\_\_\_

[Signature]  
Chairman's signature



ALASKA STATE CHAMBER OF COMMERCE

310 Second Street  
Juneau, Alaska 99801  
(907) 586-2323

March 4, 1988

The Honorable Al Adams, Chairman  
House Finance Committee  
Alaska State Legislature  
P.O. Box V  
Juneau, AK 99811

Dear Al:

On Monday, March 7 you will be considering HB 217 relating to foreign investment by the Alaska Permanent Fund.

We have reviewed the Bill and strongly support the legislation as set forth in the committee substitute.

The Alaska State Chamber favors passage for the following reasons:

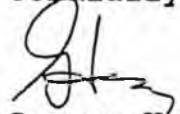
1. The Fund has developed (and earned) a reputation for conservative, careful, and deliberate investment. It clearly has the professional competence to utilize the additional proposed investment tools for the betterment of the State and its citizens.
2. The expansion of investments to the international arena provides further diversification of the Fund's stock and bond portfolios. This blending and diversifying permits the Fund to continue its investment mission at lower risk than that currently being experienced.
3. Generally, foreign investments generate higher earnings than domestic investments. This is evidenced by the performance of such investments in State PERS and TRS. While this should not be a compelling argument for foreign investment, it is clearly indicative that expected returns, over time, will be at least equal to domestic investments.
4. Finally, and perhaps most important from our viewpoint, is the by-product benefit of foreign investment. The contacts made by the Fund will be extremely valuable. As it researches foreign corporations; confers, meets, and enters into business arrangements with major nondomestic bankers and financiers; and creates dialogue with business leaders throughout the world, the Fund will bring business visitors and potential investors to our state. As these visitors

establish relationships with the Fund, they will gain firsthand exposure to Alaska and its business and economic opportunities.

The global outreach which will be facilitated by international investment is most timely in these difficult economic times for Alaska. We must do everything possible to expand our horizons and develop increased economic activity. Enactment and implementation of the Committee Substitute for House Bill 217 will help us accomplish this.

We recommend its adoption.

Cordially,

  
George Krusz  
President

STEVE COWPER  
GOVERNOR



STATE OF ALASKA  
OFFICE OF THE GOVERNOR  
JUNEAU

March 25, 1987

The Honorable Ben Grussendorf  
Speaker of the House  
Alaska State Legislature  
P.O. Box V  
Juneau, AK 99811

Dear Representative Grussendorf:

Under the authority of art. III, sec. 18, of the Alaska Constitution, I am transmitting a bill relating to the purchase of foreign investments by the board of trustees of the Alaska Permanent Fund. The bill specifically permits the purchase of foreign securities by the board.

Returns from foreign investment have exceeded those from investments in the United States over most recent 10-year periods. In addition, the United States represents less than one-half of the world's equity capitalization, and that share is declining as foreign economies experience more rapid long-term growth. No one national market consistently produces superior or inferior returns, and foreign securities markets exhibit a low correlation with the U.S. market. Consequently, the ability to invest in those foreign securities will reduce overall portfolio risk while providing an increased return when compared to a portfolio of solely U.S. equities.

In sec. 2 of the bill, capital and surplus requirements are reduced in recognition of different international accounting conventions. For example, it has been reported in Barron's National Business and Financial Weekly that, if U.S. regulators required U.S. banks to establish a modest 10 percent reserve against their loans to the six major Latin American debtors, it would cost Chase Manhattan Bank \$4.82 a share this year and Manufacturers Hanover Trust Co. more than twice that amount. On the other hand, some German banks reserve more than 30 percent against lesser-developed-country loans. If we were to require \$500,000,000 in capital and surplus of all foreign banks,

Hon. Ben Grussendorf

Page 2

we might be forced to eliminate investments in banks with smaller reported capital but very large unreported reserves, which might make them some of the safest banks in the world.

Sincerely,

A handwritten signature in black ink, appearing to read "Steve Cowper", written over the typed name and title.

Steve Cowper  
Governor

## THE IMPORTANCE OF INVESTING GLOBALLY IN A SHRINKING WORLD

Why foreign investments? This is a question which wouldn't even have arisen 20 years ago. In 1967, the United States' financial markets represented over two-thirds of the world's equity market capitalization, and the United States was the world's unquestioned financial and industrial leader. By the end of 1987, it represented only 33% of the world's equity market capitalization, and many economists predict that this percentage will continue to shrink.

The world's investable capital markets, excluding cash and real estate, totaled some \$13 trillion at the end of December 1986. The world fixed-income markets amounted to some \$7.4 trillion while the world equity markets totaled \$5.6 trillion. Some statisticians are projecting that by the year 2000, world GNP will be over \$15 trillion, with 75% outside the United States.

With the breakdown of exchange controls and rapid technological advances in communications, the internationalization of the world's financial markets has been proceeding at a rapid pace. To put into perspective the magnitude of these changes, one only has to consider that in 1973 television news in Juneau was delayed at least a day

and all scheduled programs were delayed a week. The tapes had to be flown to Juneau from Seattle, and not infrequently, bad weather delayed their arrival. The only access to current world news and the financial markets was the telephone.

Today, thanks to satellite telecommunications, the Alaska Permanent Fund Corporation has instant access not only to world news but also to the world's financial markets. In our office in Juneau, each of our investment officers has two television monitors on which we are able to obtain Reuters and Telerate financial services. We have instant access to the stock market, the U.S. Government bond market, foreign exchange quotations, commodities, financial futures, worldwide financial news, and trading in U.S. Government bonds in both London and Tokyo as well as New York.

The rapidity with which the world has been shrinking has been truly breathtaking. Worldwide global telecommunications and the integration of the world's financial markets is no longer a dream but well on the way to being an accomplished fact.

During the past 17 years, a period of explosive change, the non-U.S. markets have offered significant investment

opportunities for U.S. investors. Many of the world's fastest growing economies today are located in the Pacific Basin, and investments in this area offer some of the most attractive opportunities currently available.

Opportunities can be seen both in the form of return enhancement and risk reduction. A number of statistical studies have shown definite benefits from foreign investment, both in the level of return and the reduction of risk. It has been demonstrated that the inclusion of foreign investments in a domestic portfolio reduces the volatility (risk) of that portfolio since the world's financial markets do not all move in concert. The degree of benefit demonstrated varies from one study to another depending upon the particular time span used, the countries covered, and the types of investments, but the positive conclusions persist through all of them.

Global investing isn't restricted to only a few companies; it includes most of the world's major industries. The number one oil company in the world is Exxon. Numbers two and three are foreign companies - The Royal Dutch Shell Group and British Petroleum. The two largest food companies are European - Unilever of Dutch and British ownership; and Nestle, a Swiss concern. The number two and three chemical companies in the world behind Dupont are German - Bayer and

Hoechst. And the top four banks are Japanese - Daichi Kangyo, Fuji, Sumitomo, and Mitsubishi. Some of the most significant research for modern wonder drugs is being undertaken by a number of major Swiss and British pharmaceutical companies.

Currently the world is involved in fierce competition to determine which companies will be the winners in the fields of capital goods, consumer electronics, and telecommunications. A large number of the most rapidly growing firms are situated outside the United States, reflecting fast expanding overseas markets and abundant overseas supplies of industrial raw materials and of labor at various skill levels. In some instances, investors can only participate in certain areas of technology by investing in foreign firms.

Over the ten year period ending December 1986, the Standard & Poor's 500 Index managed a very healthy compounded return of 13.7% annually. The Capital International Europe, Australia, Far East Index returned an annual 22.3% for the same period. The next decade may be just the converse with the S&P at 22.3% and EAFE at 13.7%. Even if this is the case, one can be fairly certain that there will be countries, securities, and whole asset classes that will

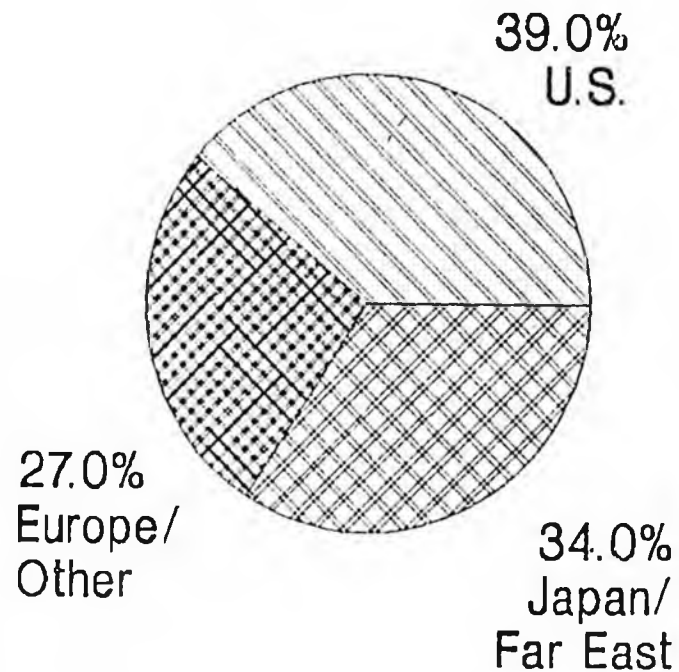
outperform the U.S. for periods of time during the next decade.

The United States' inability to stand apart from the rest of the world as an independent entity is, above all, the reason to factor international investing into investment plans. In addition, a number of analysts suggest that the prudent man rule and the prudent expert rule require investors with fiduciary responsibilities to look carefully at developments worldwide and to put in place plans for an uncertain future - a future of unpredictable global influence on investments.

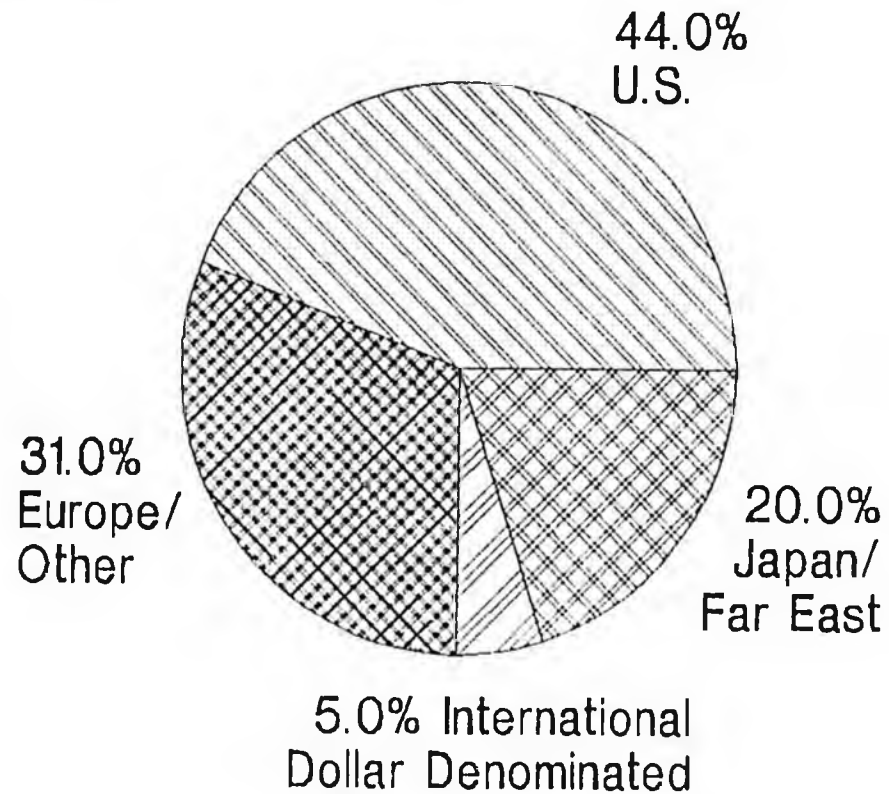
We don't know how the U.S. market will compare to foreign markets over the next twenty years. The analysis of international markets should be embraced because it can protect a securities portfolio against unforeseen dangers. Uncertainty about the future should be a compelling force leading investors to diversify as widely as possible.

# 1986 WORLD CAPITAL MARKETS

EQUITIES (\$5.6 Trillion)



BONDS (\$7.4 Trillion)



Source: J.P. Morgan Investment

## TOTAL ANNUAL RETURN (U.S. DOLLARS)

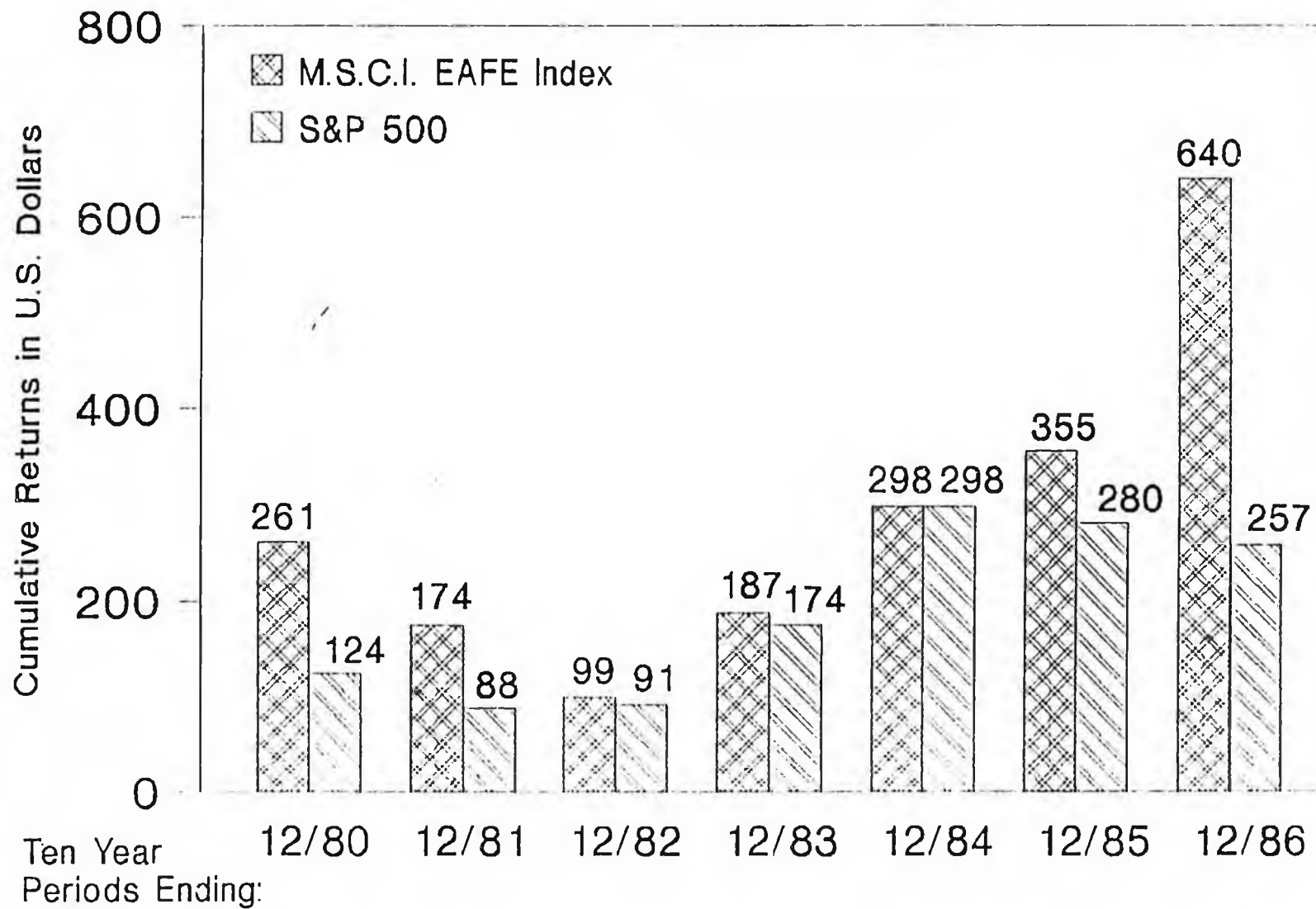
	Germany	Switzerland	U.K.	Australia	Hong Kong	Japan	Singapore	Canada	S&P 500
1977	25.8	28.7	58.0	11.9	(11.2)	15.9	5.9	(2.1)	(7.2)
1978	26.9	21.9	14.6	21.8	18.5	53.3	45.1	20.4	6.5
1979	(2.2)	12.1	22.1	43.6	83.5	(11.9)	28.5	51.8	18.5
1980	(9.1)	(7.3)	41.1	55.3	72.7	30.3	62.8	22.6	32.4
1981	(8.2)	(9.5)	(10.6)	(23.9)	(15.8)	15.8	18.3	(10.7)	(4.9)
1982	12.3	3.4	9.2	(22.6)	(44.5)	(0.5)	(16.7)	2.4	21.5
1983	25.9	19.3	17.2	56.0	(3.0)	24.9	31.7	33.4	22.4
1984	(3.8)	(11.1)	5.4	(12.6)	46.8	17.1	(26.9)	(7.6)	6.2
1985	140.9	108.9	53.4	21.0	51.6	43.9	(22.0)	16.1	31.7
1986	37.2	34.3	27.1	43.8	56.0	99.7	45.2	10.7	18.2

BEST PERFORMER

WORST PERFORMER

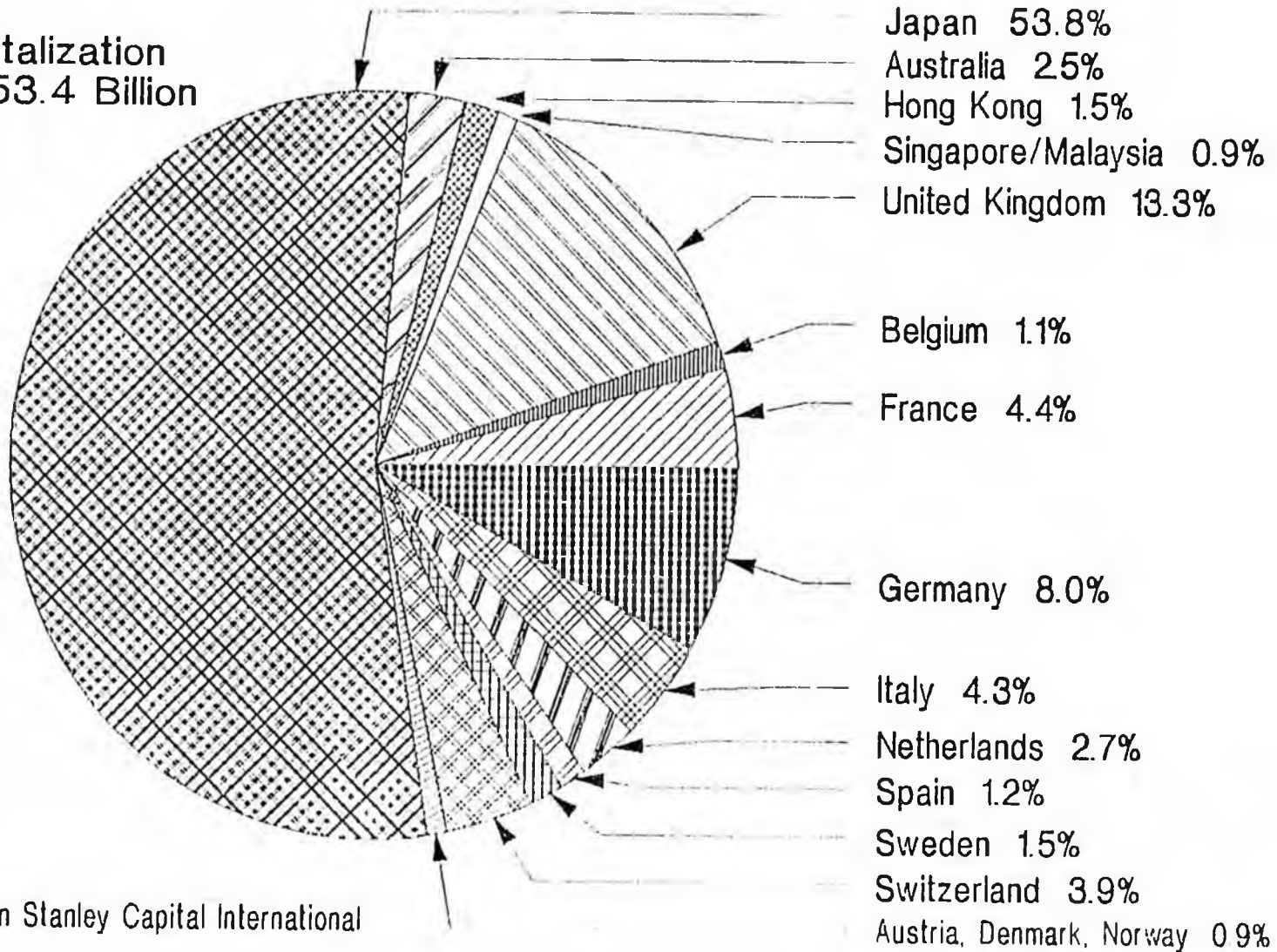
# U.S. INTERNATIONAL EQUITY MARKET PERFORMANCE COMPARISON

## M.S.C.I. EAFE INDEX vs. STANDARD & POOR'S 500



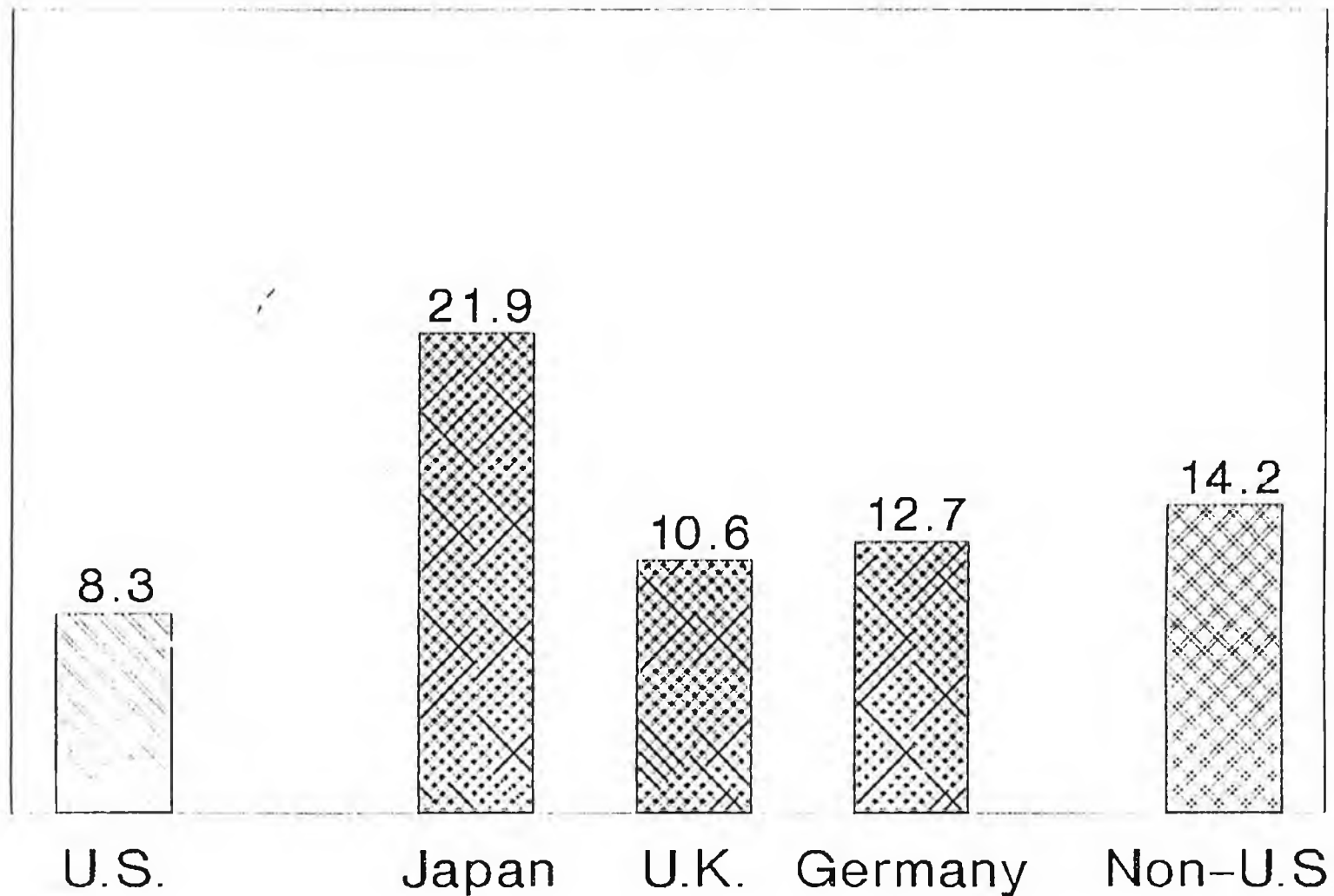
# Components of The MSCI Europe, Australia, Far East (EAFE) Index December 31, 1986

Total Capitalization  
U.S. \$2,053.4 Billion

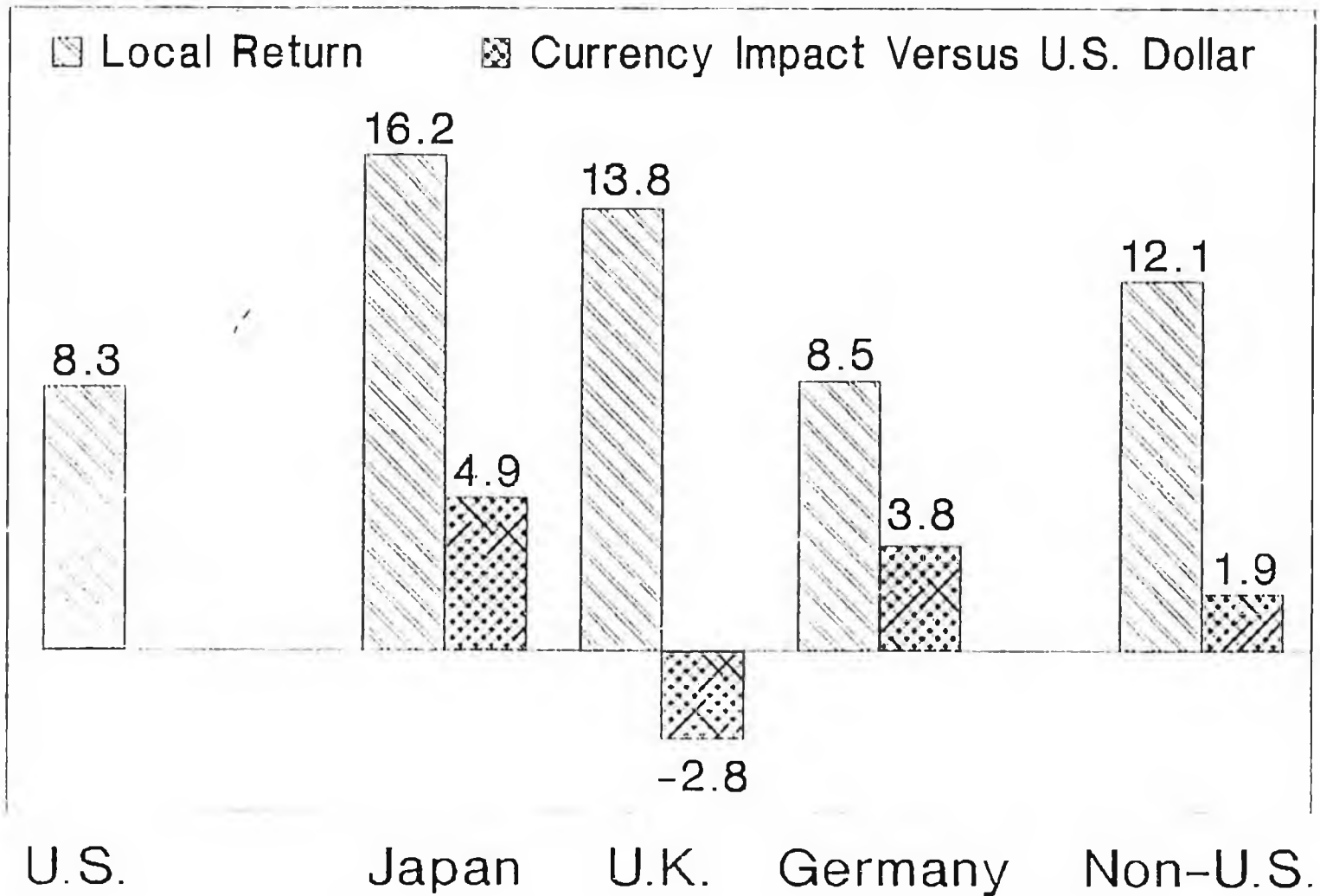


Source: Morgan Stanley Capital International

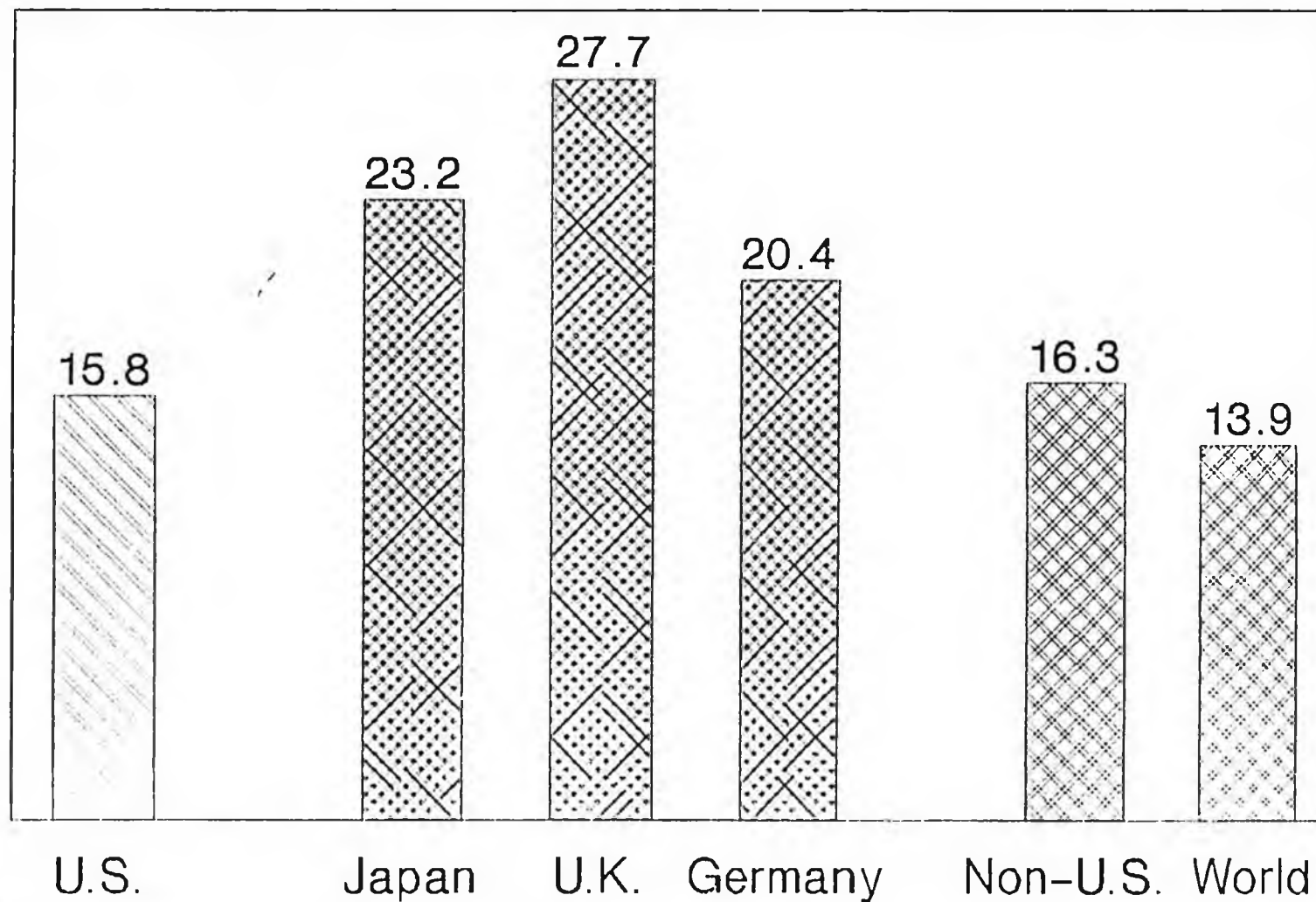
# INTERNATIONAL EQUITY MARKETS ANNUALIZED RETURNS IN U.S. DOLLARS 1970 - 1986



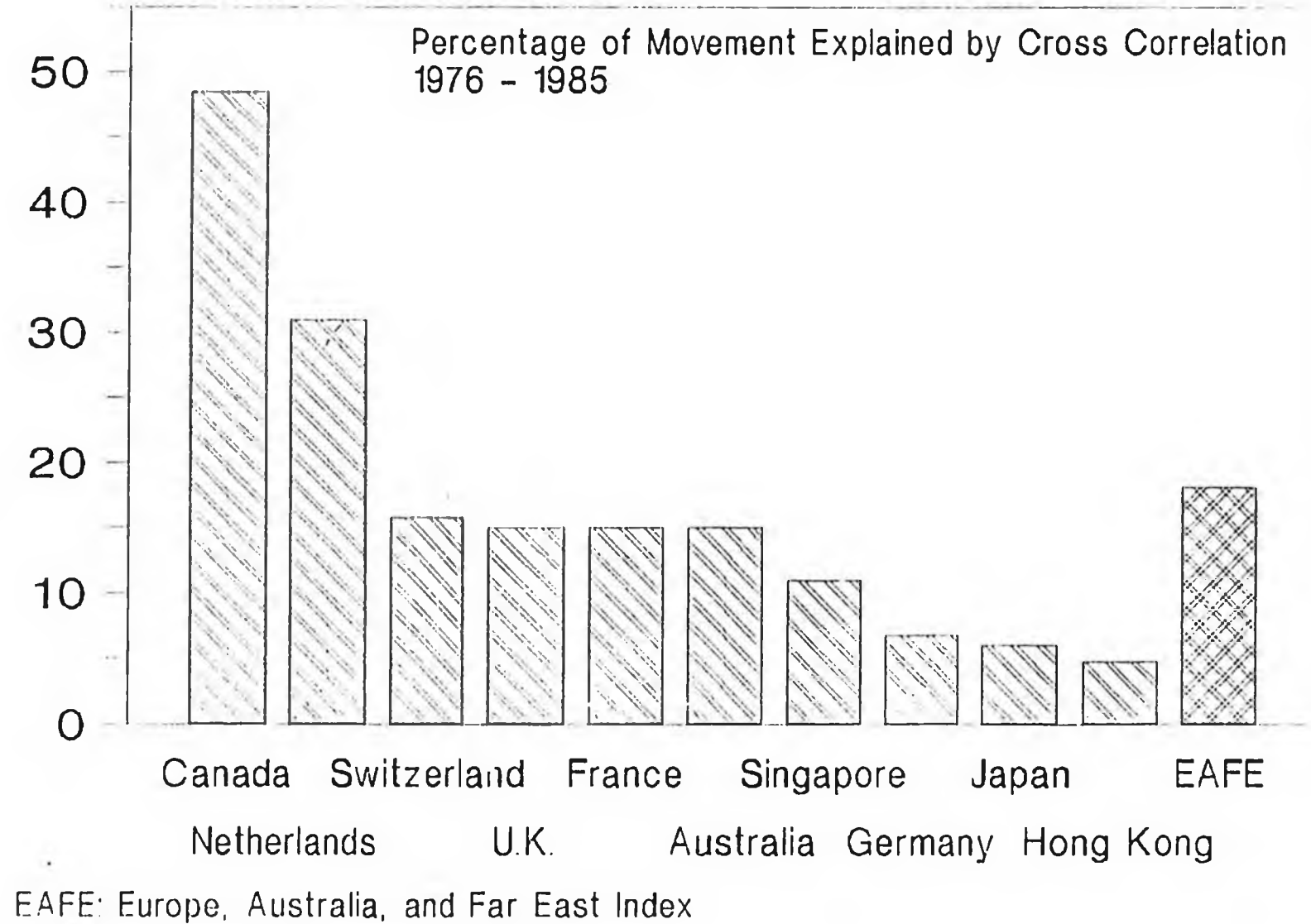
# INTERNATIONAL EQUITY MARKETS ANNUALIZED LOCAL AND CURRENCY RETURNS 1970 - 1986



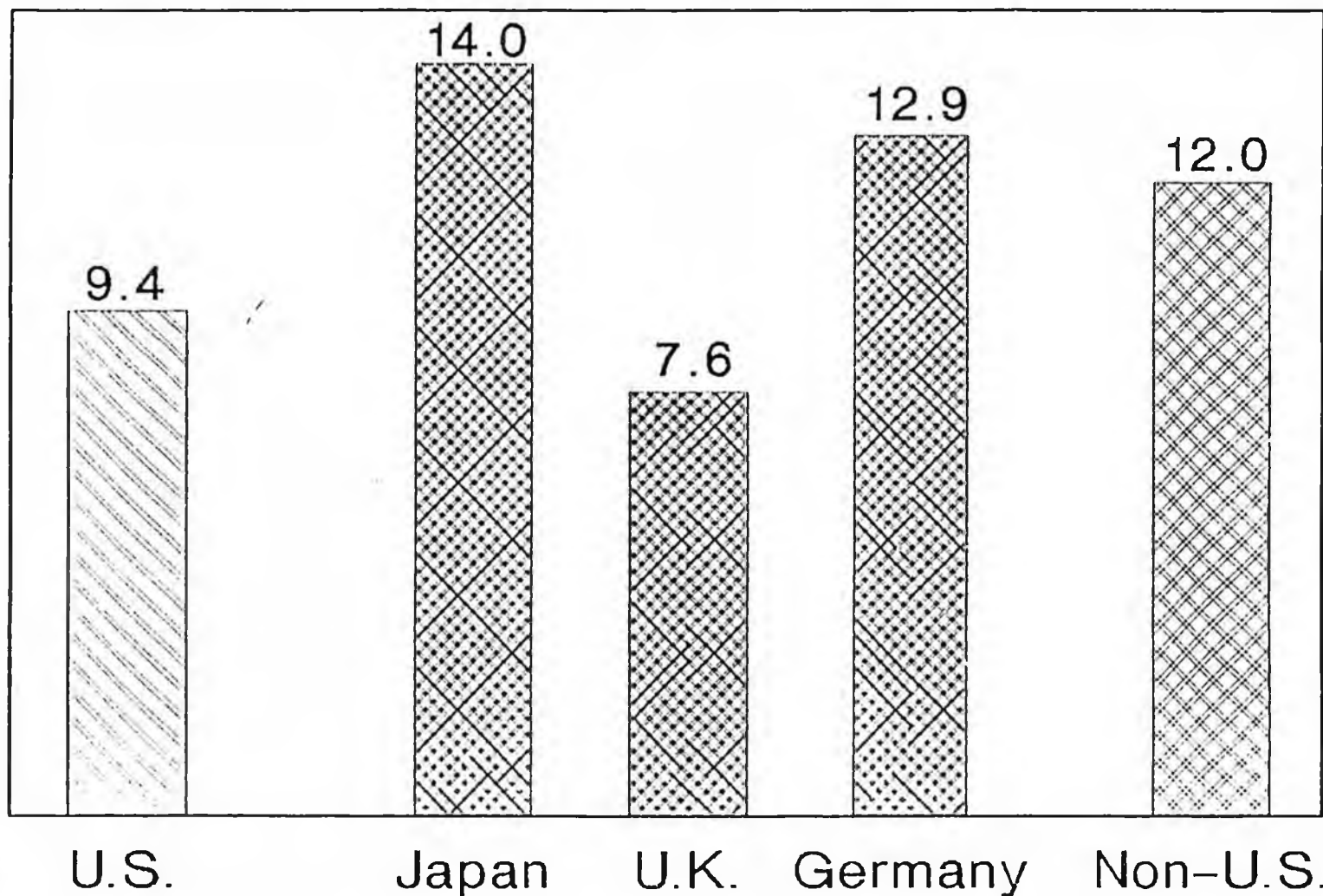
# INTERNATIONAL EQUITY MARKETS STANDARD DEVIATION OF RETURNS IN U.S. DOLLARS 1970 - 1986



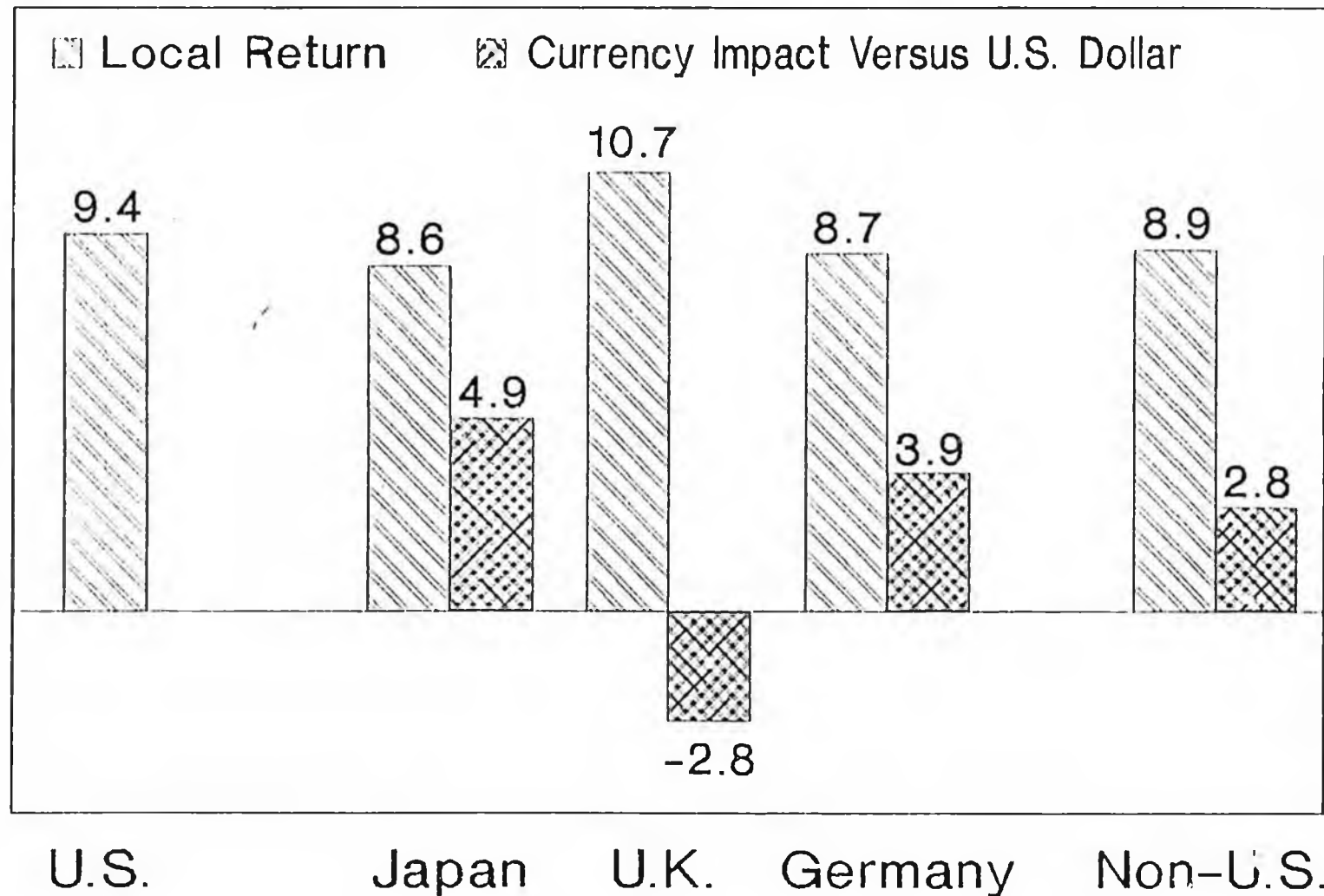
# CORRELATION OF RETURNS BETWEEN U.S. AND MAJOR FOREIGN MARKETS



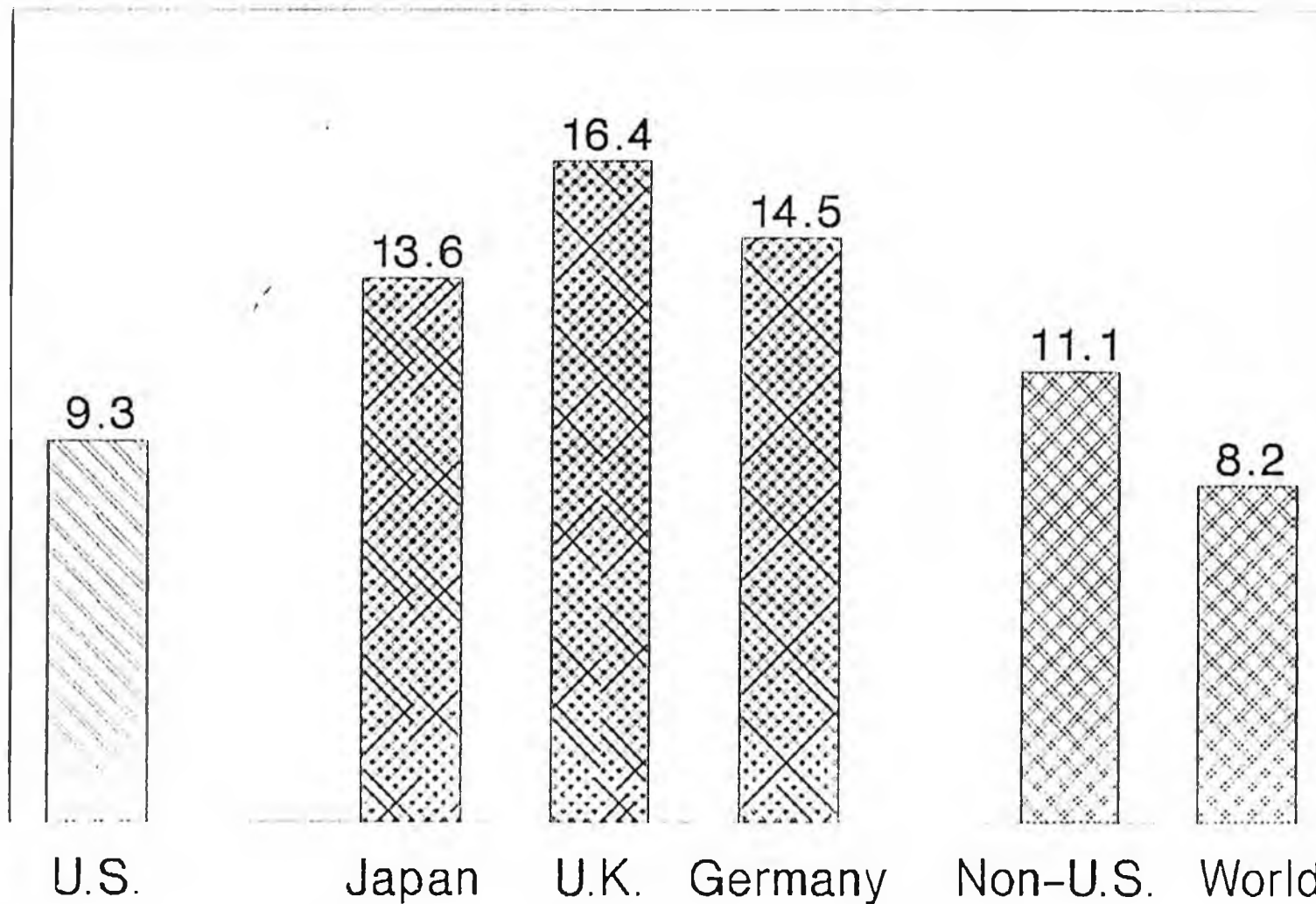
INTERNATIONAL FIXED INCOME MARKETS  
ANNUALIZED RETURNS IN U.S. DOLLARS  
1970 - 1986



# INTERNATIONAL FIXED INCOME MARKETS ANNUALIZED LOCAL AND CURRENCY RETURNS 1970 - 1986

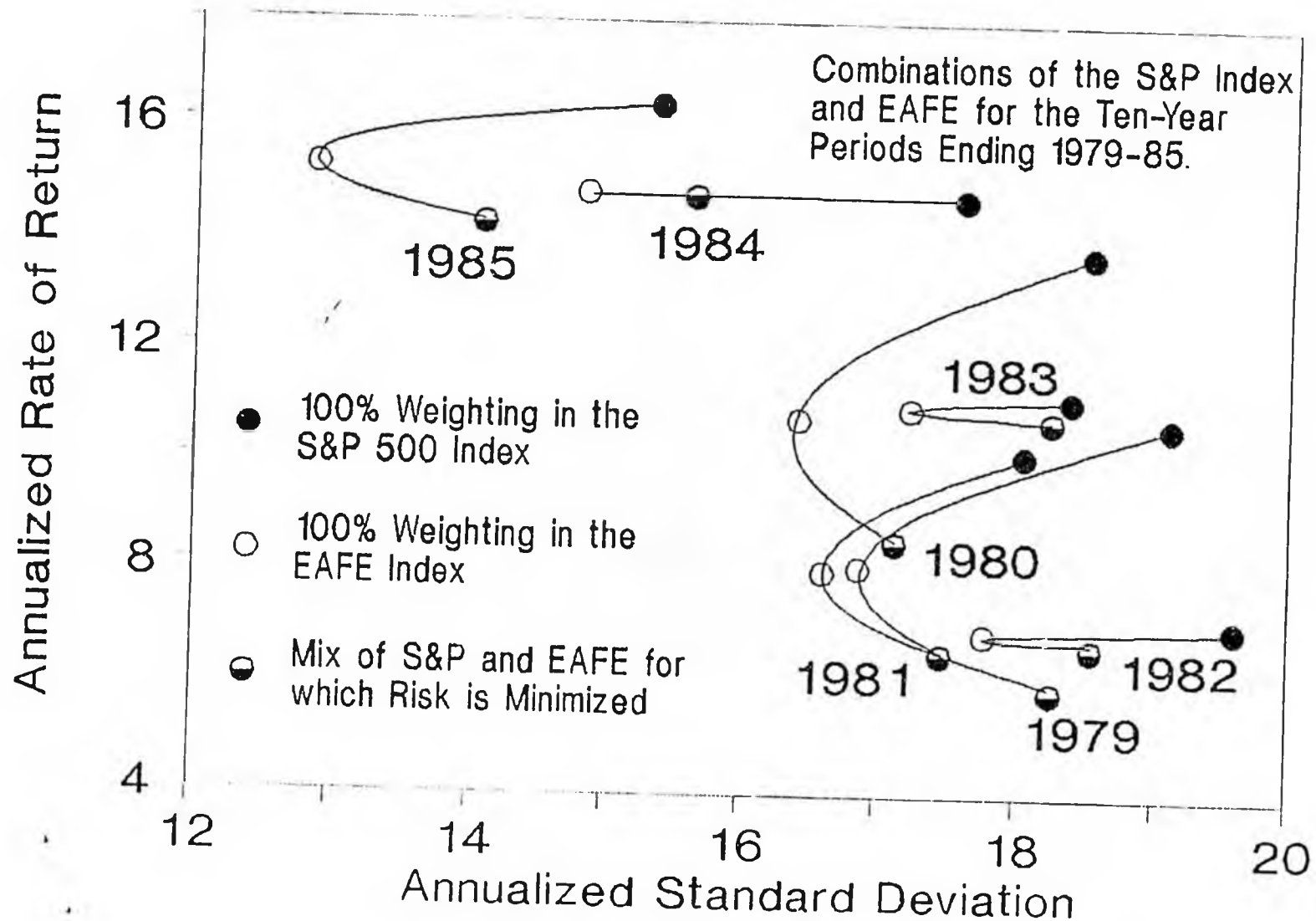


INTERNATIONAL FIXED INCOME MARKETS  
STANDARD DEVIATION OF RETURNS IN U.S. DOLLARS  
1970 - 1986



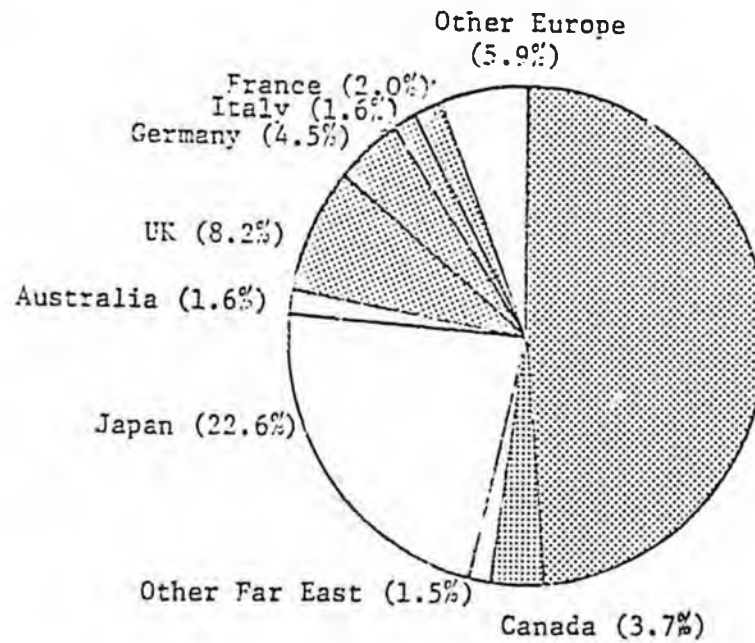
# EAFE VERSUS THE S & P 500

## RISK-RETURN ANALYSIS

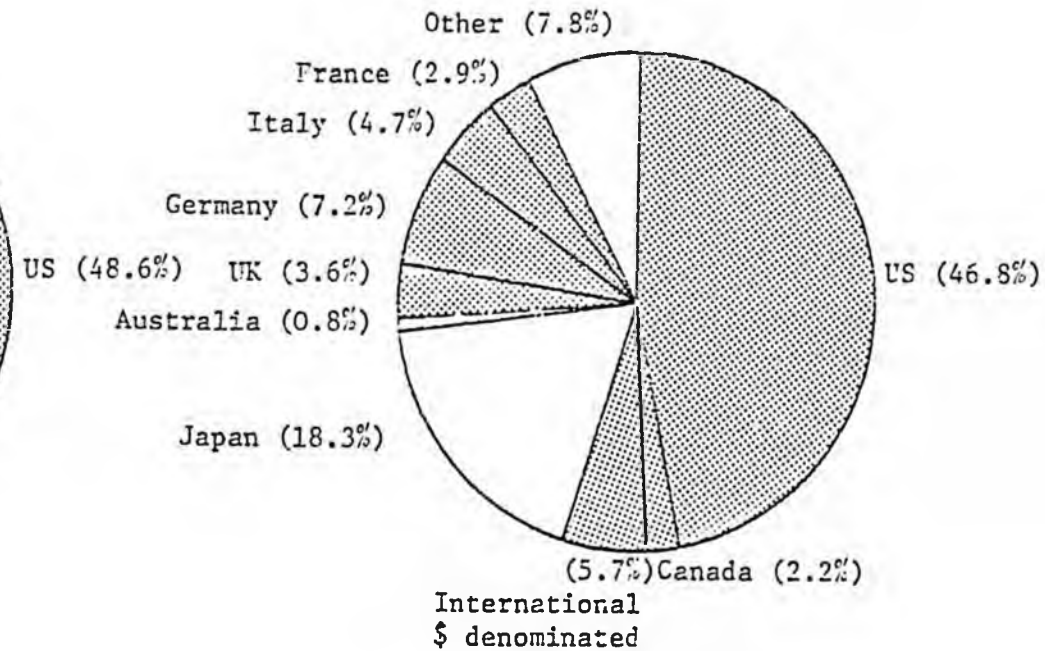


Introduction

Equities (\$4 trillion)



Bonds (\$6 trillion)

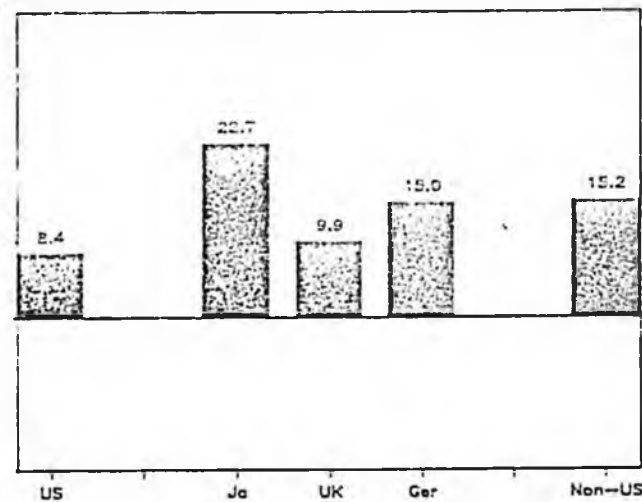


Benefits

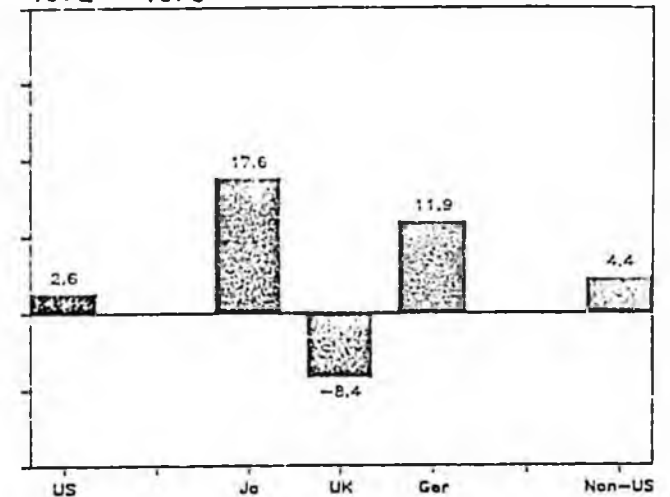
Return enhancement

International equity markets - annualised percent returns in U.S. dollars

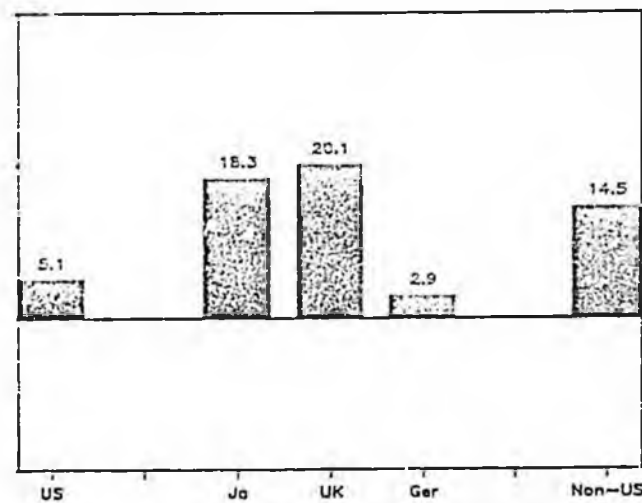
1972 - 1986



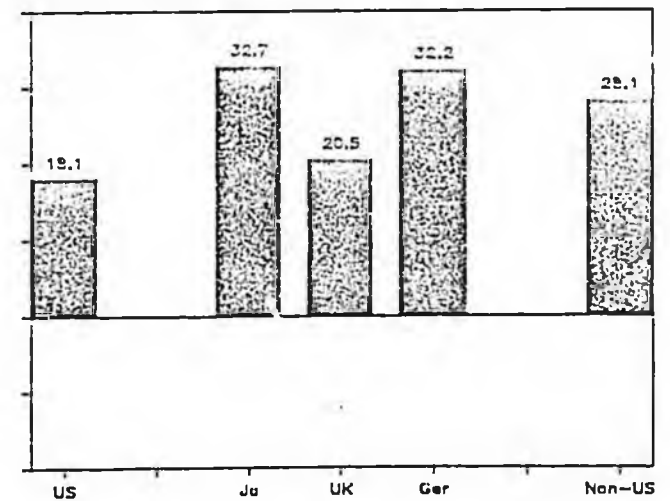
1972 - 1976



1977 - 1981



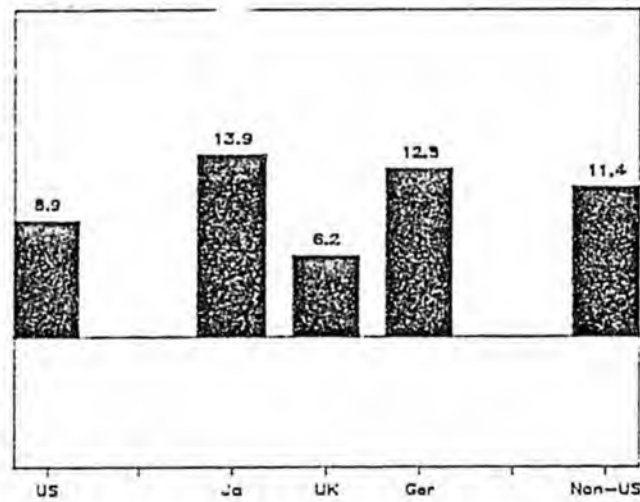
1982 - 1986



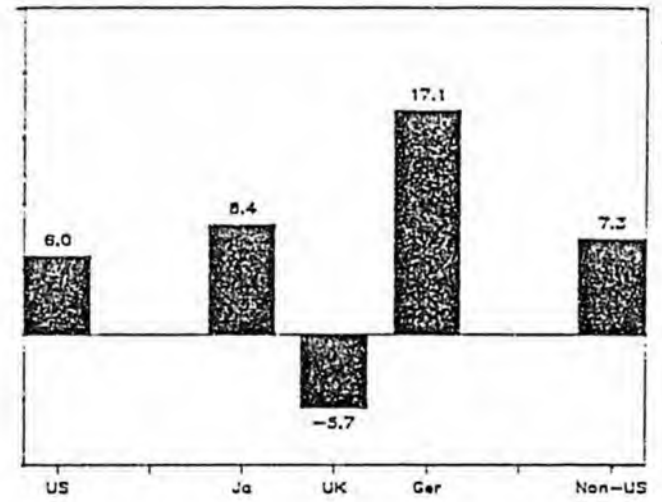
Benefits

Return enhancement

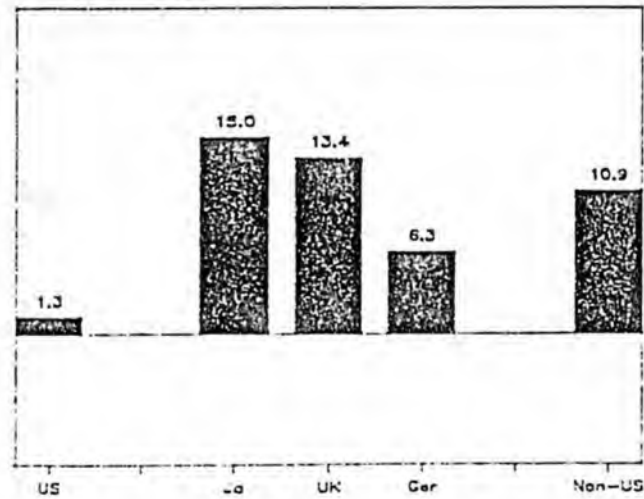
International fixed income markets - annualised percent returns in U.S. dollars  
1972 - 1986



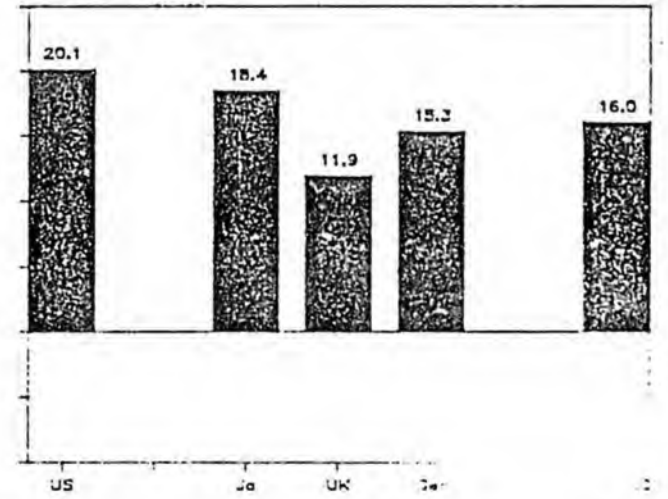
1972 - 1976



1977 - 1981



1982 - 1986

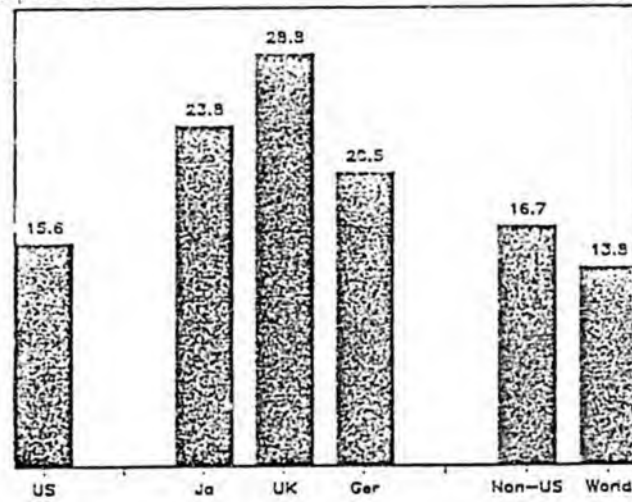


Benefits

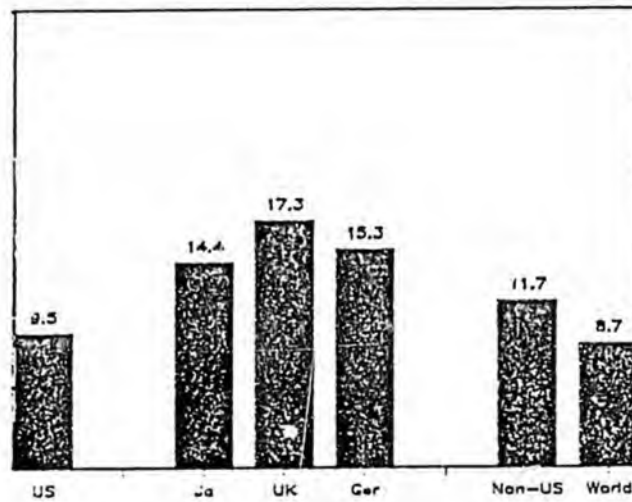
Risk reduction

Standard deviation of annual returns in U.S. dollars 1972 - 1986

Equities

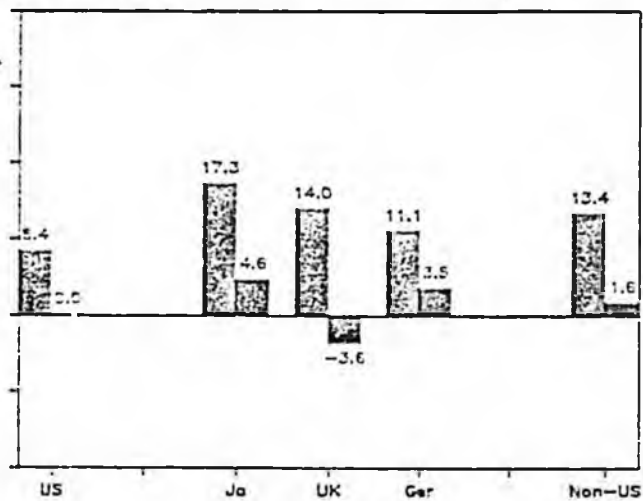


Bonds

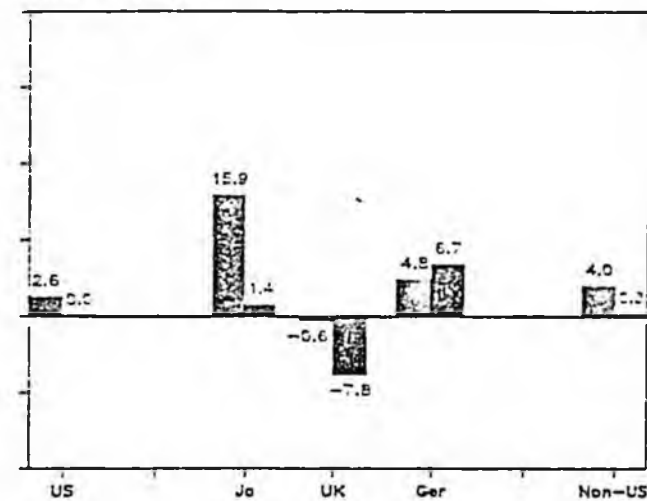


Many markets and currency movements

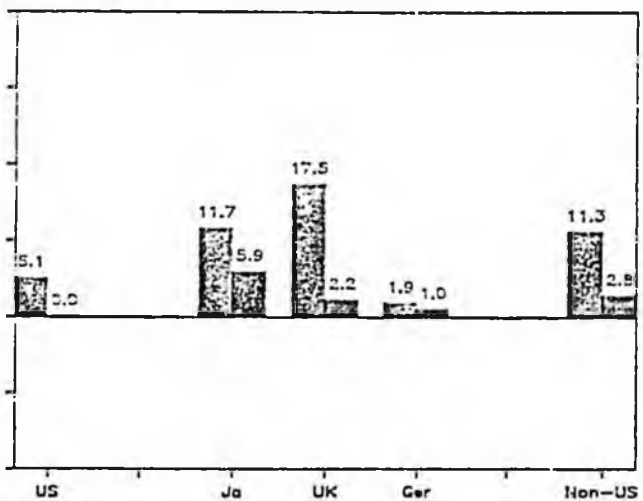
International equity markets - annualised percent returns  
1972 - 1986



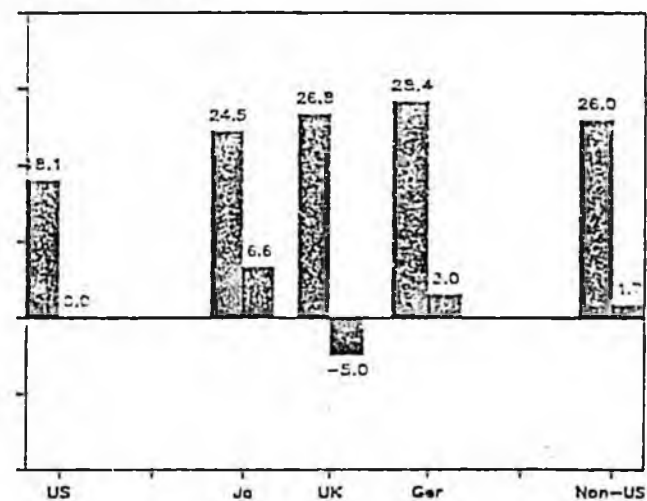
1972 - 1976



1977 - 1981



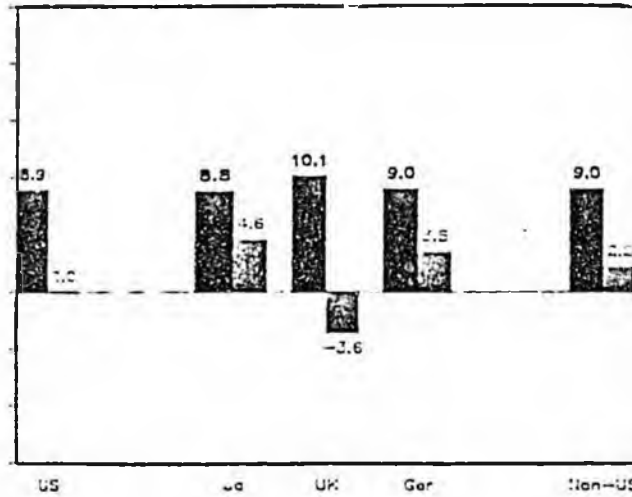
1982 - 1986



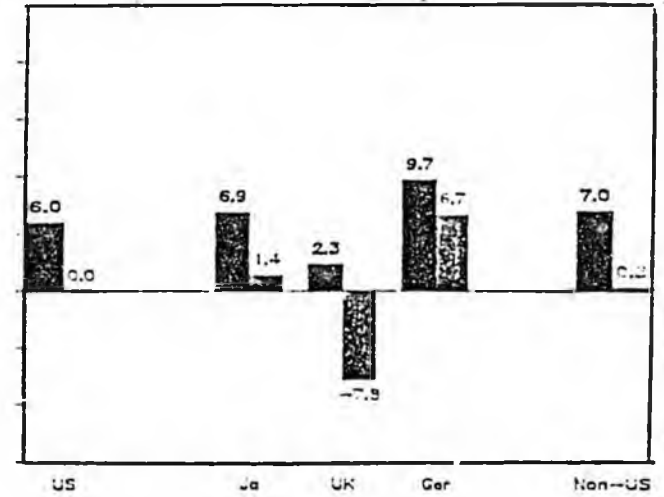
Many markets and currency movements

International bond markets - annualised percent returns

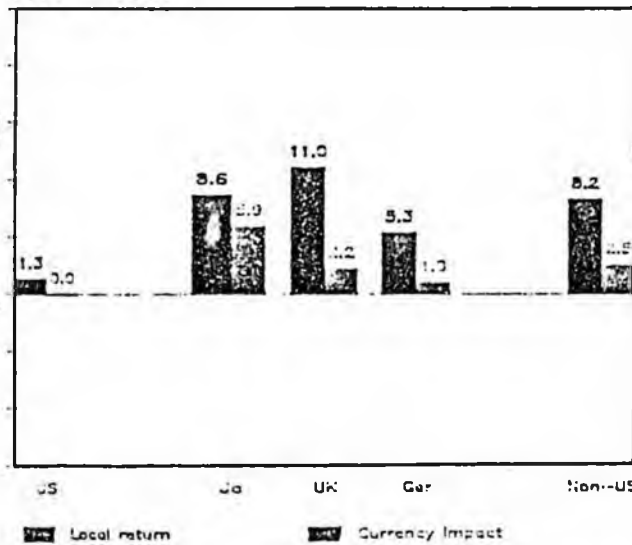
1972 - 1986



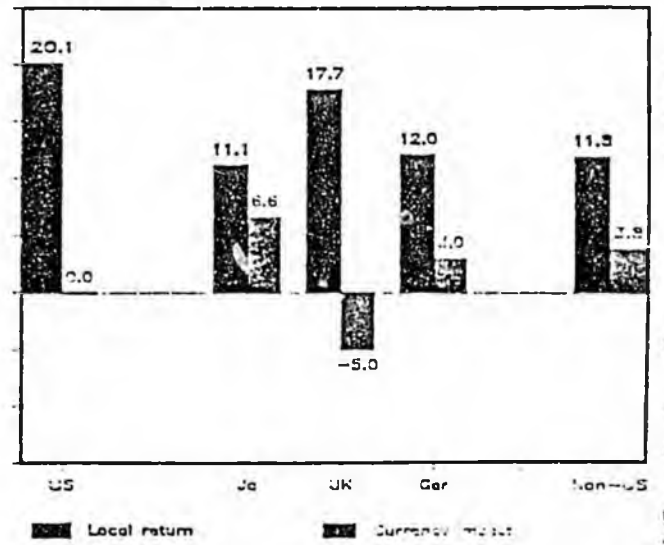
1972 - 1976



1977 - 1981



1982 - 1986



Local return

Currency Impact

Local return

Currency Impact

# International Diversification by United States Pension Funds

The investment portfolios of United States pension funds, which have been the largest single source of funds for this country's capital markets, are currently undergoing profound changes. One of these is the diversification into foreign securities in order to reduce the risk of variability of return as well as to raise the level of return. While the absolute amount going abroad is still rather small, the percentage is gradually increasing. Considering the extremely rapid rate at which the pension funds are growing, this diversification could be regarded as capable of having important domestic and international implications.

Many tens of billions of dollars are being invested by the pension funds each year. The greater part is from private pension plans, primarily those sponsored by corporations. Private pension fund assets totaled \$450 billion at the end of 1980, having grown by more than 100 percent in just five years (table). A sharp improvement in the market value of equities contributed to an unusually large rise last year. But even in the absence of this development there would have been a very substantial increase. An explosion of investable resources will most probably continue throughout the decade. This will happen even after allowing for inflation. A study prepared for the Department of Labor

two years ago estimated that, measured in constant (1975) dollars, the assets of private pension funds will have more than doubled between 1975 and 1985 and will have increased by another 90 percent by 1995.<sup>1</sup>

Close to 40 percent of the private pension fund assets at the end of 1980 was managed by the insurance companies. The remainder, over 60 percent, was handled by banks and adviser/managers. It is estimated that, of the total \$450 billion, roughly \$9-10 billion was invested in foreign assets. More than half of these foreign assets represented pension fund monies invested by the insurance companies, mainly in debt instruments and largely in Canadian assets, although the holdings included fixed-income securities, mostly dollar denominated, of a number of non-Canadian governments. The foreign investments by the other managers were much more diversified. Geographically, they encompassed assets in about twenty countries, predominantly in Europe and Japan, and smaller amounts in countries elsewhere. Less than one third comprised fixed-income securities (including international agency and other securities denominated in United States dollars, as well as foreign currency securities); more than two thirds consisted of equities.

In preparing this study the author had the benefit of many interviews with pension plan executives and officials of various types of inter-mediating financial institutions. They generally requested anonymity with regard to information provided concerning amounts, approaches, techniques, and views, but the author wishes to express her appreciation to all of them. She is also grateful for assistance received from staff members of the Department of Labor and the Securities and Exchange Commission.

<sup>1</sup> ICF Incorporated, *A Private Pension Forecasting Model* (October 1979). The forecast for 1985, in constant 1975 dollars, is approximately \$475 billion and for 1995, almost \$900 billion. The forecasts are based on a number of assumptions, including labor force demographics, economic growth rates, and price developments. As is always the possibility with long-range forecasts, some of the assumptions might turn out to be quite a bit off the mark, as the authors themselves caution.

While state and local government retirement funds total less than half as much as private pension funds, they also constitute a huge pool of investment monies. At the end of 1980 they totaled slightly over \$200 billion, having not quite doubled since 1975 (table). These funds operate for the most part under rather rigid investment constraints, but modifications are being slowly introduced. Two states already have started diversifying into foreign assets, and others may eventually follow. Still, it will be many years before state and local funds could conceivably account for a significant volume of foreign investments.

Although there can be little question that, short of some cataclysmic event, private pension funds will be increasing their foreign investments during the rest of the eighties, one can only hypothesize about the pace of the outflows. A good ball-park guess might be that the share of foreign assets in total private pension fund portfolios will rise during the decade at an annual average of about ½ percentage point from the approximately 2 percent they were at the end of 1980. The dollar outflows implied by this assumption would be substantial, but they would not be so large as to have harmful effects on either domestic financial markets or the value of the dollar in foreign exchange markets.

This article examines in further detail (1) the motivations of pension plan sponsors for diversifying into foreign assets, (2) the considerations that in past years restrained the outflow, (3) the activities of financial intermediaries that have sought a role in carrying out the pension funds' international transactions, (4) the manner and quantity in which funds are being

placed abroad, and (5) the possible implications for the United States balance of payments and financial markets.

#### Motivations for international diversification

Two goals are sought by pension plan officials who decide to broaden their portfolios to include foreign assets. The first is a reduction of the risk associated with variability of investment return. The second is an improvement in the level of return. In the private sector, failure to improve return necessitates larger corporate contributions to meet actuarial funding requirements; in the public sector, failure to improve return implies that, as pension commitments rise, larger tax appropriations are required.

Not surprisingly, the pioneers in foreign asset diversification were primarily pension funds sponsored by large corporations whose officials were already familiar to some degree with foreign economies. However, many sponsors of smaller private funds are now also involved in such diversification. Most recently, some officials responsible for public employee pension funds have begun to shed their diffidence concerning foreign asset diversification. The states of Alaska and Vermont have been leaders in passing the required laws and purchasing foreign assets, and there may be other states considering enabling legislation. However, the great majority of states still have laws that prohibit public pension funds from making foreign investments other than in Canada. Public pension funds governed by New York State law are prohibited from investing even in Canadian corporate equities, although the

#### Assets of Private and Public Pension Funds

In billions of dollars; year-end values\*

Year	Private noninsured pens. on funds	Private insured pension funds†	Total private‡	State and local government retirement funds
1974 .....	115.5	60.8	176.3	88.0
1975 .....	146.8	72.2	219.0	104.8
1976 .....	171.9	89.0	260.9	120.6
1977 .....	178.5	101.5	280.0	132.6
1978 .....	198.6	119.1	317.7	153.0
1979 .....	222.4	139.2	361.6	170.1
1980 .....	286.1	164.6	450.7	202.7

\* Figures reflect equities at market value and other assets at book value.

† Includes noninsured "separate account" pension funds at the life insurance companies.

‡ Includes pension funds and deferred profit-sharing funds of corporations, unions, multiemployer groups, and nonprofit organizations.

Source: United States Securities and Exchange Commission.

may invest in foreign debt that is denominated in United States dollars—*i.e.*, in Eurodollar debt rated A or better or in what are called Yankee bonds (bonds issued in the United States by foreign entities). Nonetheless, there is a growing tendency to loosen the very rigid restraints that still limit most public pension fund investment activities.

A number of institutional changes in pension fund practices over the past decade that have dramatically increased pension costs have added to the incentives to seek new avenues for improving investment returns. These changes include (1) heavier weighting of later, higher earning years in calculating pension benefits, and (2) steps to adjust both workers' and retirees' incomes to compensate for increases in the cost of living. Pension fund officers have consequently come to regard pension plan liabilities increasingly as a purchasing power liability rather than as a fixed-dollar liability and thereby have been additionally stimulated to look for higher returns than those from the more traditional investments.

Enactment in September 1974 of national legislation popularly referred to as ERISA (Employee Retirement Income Security Act), which governs virtually all privately sponsored employee benefit plans, added to the interest in diversification. Previously, pension fund and other fiduciaries had been required by individual state laws to handle funds as "a prudent man" would. In addition, a number of states provided detailed guidelines regarding permissible and prohibited investments, although these were not applicable when a trust agreement governing the creation and administration of an employee benefit trust gave the trustee full investment discretion. ERISA replaced the states' comparatively simple and sometimes restrictive rules with a directive that added considerable complexity to the prudent man rule. Pension fund fiduciaries must now make investment decisions "with the care, skill, prudence and diligence . . . that a prudent man . . . far wiser with such matters would use". Moreover, their prescribed duties include "diversifying the investments within portfolios so as to minimize the risk of large losses". Consequently, the national rule is not only more demanding than most of the earlier state laws but in effect insists on diversification. It has thus opened the door to investments in certain types of assets that pension fund officers had previously regarded as impermissible.

Already in the sixties, the spreading knowledge of modern portfolio theory principles had led to wide diversification of portfolios among domestic firms and industries to reduce the risk of variability of return. Increasing numbers of fiduciaries are now becoming convinced that diversification beyond United States

markets would further reduce this risk. United States securities markets no longer dominate the world scene to the extent that they did: capitalization in equities markets outside the United States comprises approximately one half of the world total, and foreign bonds more than one half the outstanding total. Moreover, many foreign industrial firms have a very respectable capitalization. In addition, foreign business and interest rate cycles have generally not coincided with those in the United States. Although the world has grown more interdependent over time, this has been an erratic development and the correlations between the United States equities markets on the one side and foreign markets on the other, remain considerably lower than the correlations of most United States industry groups with the total United States market. For this reason, sufficiently broad diversification across national boundaries is likely, over a period of time, to dampen the variability of total return. Many pension fund officials have therefore concluded that there are numerous prudent investment possibilities abroad and that these permit investments to be made that can be expected to help achieve the ERISA-mandated goal of minimization of risk.

Many pension fund executives also think international portfolio diversification provides opportunities for increasing the absolute rate of return for any given degree of risk. A large number of the most rapidly growing firms are situated outside the United States: reflecting fast expanding overseas markets and abundant overseas supplies of industrial raw materials and of labor at various skill levels. Moreover, while opinions differ, some managers believe many foreign securities markets are less "efficient" than United States markets, resulting in more opportunities for finding undervalued securities. There is, in addition, the possibility of boosting returns by moving funds around to take advantage of the different cyclical stages characterizing business conditions, equities markets, fixed income markets, and exchange rates in the various countries. Interest was also spurred by negative attitudes toward domestic investment. The lag in United States government and industry policies in adjusting to the steep rise in energy prices, and the delay of certain United States industries in responding to foreign innovations, enabled numerous enterprises abroad to become very competitive and profitable while United States firms lost markets and ran into financial difficulties. Many pension fund executives have also been displeased with the performance of managers of domestic portfolio investments. Given such considerations, a growing number of pension fund officials have come to feel they might gain a higher return by investing part of their funds abroad.

dations. At the same time, steps have been taken by groups abroad to produce information that would be more comparable and comprehensive. Federations of financial analysts have been set up within the past two or three years in France, Germany, and the United Kingdom with the explicit intention of trying to develop reporting standards that would be similar for all European business firms. How quickly this goal will be achieved remains to be seen.

#### *The liquidity issue*

Many pension fund sponsors have been concerned that foreign securities markets were not sufficiently liquid. Compared with the United States market, some markets do indeed have only a few stocks that are very actively traded. In Europe and Japan together, there may be only about one hundred issues that are extremely liquid. However, there are many stocks in which the trading is about on a par with trading in the United States in "special situation" stocks. On an overall basis, a number of markets are at least as liquid as the United States market, and in some countries, including markets as different in size as Japan and Hong Kong, the annual turnover rates, measured as a percentage of capitalization, are even higher.

Intermediaries who take a positive view toward the liquidity of foreign markets sometimes stress that, in the absence of broad and deep markets, it is intimate knowledge of the participants in the markets that is most important. Transactions can be successful if one knows who the stockholders are and works through appropriate channels.

#### *The question of costs*

Higher transaction costs have disturbed some sponsors. It has been estimated that turnover costs for a "round trip" in the market—*i.e.*, a purchase and a sale—would generally amount to about 8 percent in Europe and 6 percent in Japan, including the brokerage fees or commissions, the spreads quoted by market makers, and the government "stamp taxes" or "transaction fees". These figures contrast sharply with the 1 or 2 percent prevalent in the United States. Management fees and custodial fees are also higher abroad. Some United States managers comment that, because of the various higher costs, they have to be particularly careful in revamping a foreign portfolio. Others observe, however, that on a net return basis the higher foreign costs are not very significant, inasmuch as the yields from foreign market investments may be many percentage points greater than those from comparable-risk United States investments.

Some of the larger intermediaries deny that transaction costs are necessarily higher overseas. Unlike

the current situation in the United States, most foreign markets are still on fixed-rate schedules and one cannot negotiate commissions on a trade-by-trade basis but discounts can be obtained in certain countries. In Japan, for instance, where rates are fixed by the Ministry of Finance, a bank or other financial institution can receive up to a 20 percent discount from the fee normally charged by a securities broker. Similarly in Germany—where, as in other countries on the Continent, the brokers are usually banks—discounts of up to 25 percent can be obtained by banks, insurance companies, or other large institutions. In Australia, one can get a discount whenever there are big blocks of shares around.

Foreign withholding taxes on interest and dividend payments are, however, a cost that presents a particularly thorny question to pension fund officers. Since pension fund investments are not subject to income taxes in the United States, pension plan sponsors often do not regard it appropriate to pay withholding taxes abroad. Although not every market that is popular with United States investors imposes withholding taxes—Hong Kong and Singapore are such exceptions—bilateral tax treaties between the United States and many countries in Europe, as well as with Australia, Canada, and Japan, for example, do contain provisions for withholding taxes. The percentages vary from country to country, but are generally less for interest payments than for dividends.<sup>3</sup>

#### *Exchange rate and capital transfer problems*

The risk of unfavorable exchange rate development is another reason some pension plan executives have been wary of international diversification. It would appear, however, that most of those who have overcome their hesitation feel they do not have to worry about short-term currency fluctuations since current liabilities constitute only a minor part of their total pension fund liabilities. Hence, they would never be obliged to liquidate the (relatively small) foreign portion of the

<sup>3</sup> Under the tax treaties, withholding taxes on dividends are usually 15 percent. In some countries, the gross tax initially withheld is higher than 15 percent, and the United States investor has to reclaim the excess. In a few countries (including Austria and Canada), the net tax is less than 15 percent. As for interest income, the United States model tax treaty calls for no withholding tax, but some countries are unwilling to go along with this. Germany, the United Kingdom, and the Netherlands do, but Belgium and Canada, for example, have a withholding tax of 15 percent, France and Japan 10 percent, and Switzerland 5 percent. There is usually no withholding tax on capital gains. A new model tax treaty has been drafted by the United States Treasury Department, but it will probably not affect tax rates for institutional investors. Some countries, it should be noted, provide the possibility of exemption from withholding taxes for certain categories of investors.

pension fund assets on short notice, when currency movements might make such a step undesirable. Regarding the medium and long term, some pension fund managers believe it is possible to forecast the direction in which a currency will move largely on the basis of fundamental economic considerations such as likely inflationary developments, the probable rate of real growth, and expectations regarding the foreign trade or current account balance. Others take the "neutral" position of making no currency assumptions since they believe (1) it is impossible to predict what the currency developments are likely to be, and (2) other factors are more important in the choice of foreign investments. In some cases, foreign currency-denominated investments are being hedged.

Another type of conversion risk is the erection of government barriers to the withdrawal at will by foreign investors of earnings or liquidation proceeds. Many of the nonindustrial countries already have regulations that impose certain explicit limits on withdrawal. Others provide for *ad hoc* administrative decisions by some government agency. Of 140 member countries of the International Monetary Fund (IMF) covered in a 1980 Fund report, only thirty-three had no restrictions of any kind on capital payments.<sup>4</sup> Of these, sixteen were either industrial or oil-exporting countries.

Although a country might not have restrictions on capital payments, it might have, or choose to impose, restraints on foreign capital inflows. A number of countries that hold strong attractions for foreign investors limit such investments through either legal or regulatory barriers. During the past year, however, there has been some small evidence, with actions by Mexico as one example, of a possible tendency to ease these restraints, partly in the belief that economic progress could be furthered more rapidly if foreign private capital were allowed to make more of a contribution.

#### The intermediaries for pension fund diversification

As pension plan sponsors began to display a growing interest in foreign portfolio investments, partly in response to suggestions by a few outside advisers, financial intermediaries of various kinds strove to position themselves to compete in this new field. These included the traditional managers of pension funds, namely, commercial banks and insurance companies, as well as the other types of investment managers that had acquired a significant share of the

pension fund business beginning in the 1960s. Others sought to gain entry by showing that, unlike most United States pension fund advisers and managers who had had little experience with foreign markets and therefore were unable to produce relevant track records, they, on the contrary, had the requisite knowledge and experience. Still others found a niche for themselves by establishing services that were ancillary to the international investment management function itself.

#### The banks

Bank trust departments are still the principal managers of pension plan funds—and now also of a large portion of the internationally invested assets. Even the larger banks that have become active in foreign asset management had initially to intensify their knowledge in certain relevant areas, while others had to work from a much lower base to acquire expertise on foreign economies and companies, foreign securities markets and currency markets, and the relevant networks of foreign intermediaries. A few put securities analysts and investment managers on the scene in existing foreign branches. Others have gathered information on foreign firms and monitored economic developments in part through extensive visits abroad. Over time, some of the banks have established new foreign affiliates of various kinds, with one purpose being to handle the foreign investing or, as a minimum, the associated foreign research activity for the banks' United States clients. Where these foreign offices are managing the investments, they deal with foreign brokers. These are usually London or other European brokers if the manager is operating out of London or some other European city, and Japanese brokers if the manager is operating out of Tokyo or Hong Kong in connection with Asian and Australian investments. A number of banks are also providing global master custodianship services (box).

The banks have been using commingled funds especially established for foreign investments as the principal vehicle for investing those portions of clients' pension funds that have been designated for investment abroad, although a few banks also manage foreign assets for pension funds through separate accounts. In addition, some relatively small amounts are invested in foreign securities for pension fund clients who have not explicitly allocated a portion for foreign investment. This occurs when some other type of commingled fund to which some of a client's assets have been allocated (whether it be a diversified common trust fund, for example, or a growth fund or some other specialized fund) includes securities of foreign firms that fit within the framework of that particular

<sup>4</sup> International Monetary Fund, *Annual Report on Exchange Arrangements and Exchange Restrictions* (1980). For two additional countries, the IMF was unable to determine the situation.

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## Custodial Services for Pension Funds' Foreign Investments

Under ERISA's rules concerning fiduciary responsibility, the so-called indicia (evidence) of ownership of foreign assets held for employee benefit plans must be maintained in locations subject to the jurisdiction of United States district courts, except as might be otherwise authorized by the Secretary of Labor by regulation. Prior to 1977 there were many questions concerning the effect of this rule on holding indicia abroad. In that year, however, the Department of Labor, which is the agency with primary jurisdiction over employee benefit plan fiduciary responsibility, issued a regulation specifying that indicia could be held abroad if the related assets were under the management and control of a United States bank, insurance company, or investment adviser/manager registered with the Securities and Exchange Commission, providing these met certain given criteria. Otherwise, the indicia could be held abroad only if in the physical possession of a United States bank or an SEC-registered broker or dealer, or if in the custody of an entity designated by the SEC as a "satisfactory control location".

Many United States banks were not happy with the 1977 ruling since only brokers and dealers, but not banks, may appear before the SEC. Thus, for foreign locations where a bank did not have a branch that could render custodial services, the bank had to have a broker or dealer intercede with the SEC for approval of a foreign custodial agent, or else had to utilize the services of a branch of a competitor United States bank. In response to appeals from banks and the American Bankers Association, the requirements were eased effective March 30 of this year to permit United States banks to keep the indicia in the custody of a foreign bank or other specified types of foreign entities as long as the custodian is supervised or regulated by a government agency or regulatory authority in the host country.

Several United States banks are now also providing

so-called global master custodianship services that further facilitate the handling of foreign investments for any given pension plan sponsor. These services are provided regardless of who the managers are. Chase Manhattan Bank is the major global master custodian for United States-based sponsors, having started this activity in the early seventies before enactment of ERISA. It has relied upon its foreign branches as sub-custodians in most of the countries where it has branches and has used foreign banks in the same capacity in other countries. Citibank also has provided such services for a number of years. In the past few years there have been several additional United States entrants into the field. Some of these actually rely heavily upon another large domestic or foreign bank and its network of branches or correspondents for the custodial services required in the many locations where large corporate plan sponsors may have foreign investments. A particularly interesting recent entrant is the Mitsubishi Bank of California. Many of the clients for its global master custodianship services are regional banks that are master trustees for pension plans with rather small amounts invested overseas. To provide its global custodianship services, the Mitsubishi Bank makes use of the worldwide facilities of the Mitsubishi Bank of Japan and the latter's various financial affiliates.

The global master custodianship services offered are more comprehensive at some banks than at others, but among those generally available are safekeeping of the indicia, collection of dividends and interest, currency translation, and centralized reporting of all investments and income. Thus, no matter in how many countries the funds of a pension plan are invested, and no matter how many managers are handling portions of that plan's funds, overall responsibility for the custodial, bookkeeping, and accounting operations can be placed in the hands of a single overseer.

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fund. At the end of 1980, international commingled funds amounted to 2 percent of all employee benefit commingled funds set up by banks and approximately 1/2 percent of the aggregate employee benefit funds managed by them as either trustee or investment managing agent.<sup>3</sup>

<sup>3</sup> Federal Financial Institution Examinations Council, *Trust Assets of Banks and Trust Companies—1980*. These data are compiled by the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency.

The Morgan Guaranty Trust Company pioneered in establishing an international commingled fund for ERISA accounts. It informed all ERISA clients in 1974 that, unless the client opted otherwise, a modest proportion of their pension fund reserves would be invested in foreign equities, to be built up at about 1 percent a year to around 5 percent by 1978.<sup>4</sup> Subse-

<sup>4</sup> Only a few clients rejected Morgan's plan, and this "strong" approach is known to have been followed by three more banks. Other banks propose foreign commingled fund investing to their clients on an "invitation" basis.

quently, the maximum allocation was raised to 10 percent, and Morgan now has one equity fund and two bond funds holding most of the assets purchased with ERISA reserves designated for foreign investments—about 6-7 percent of the total discretionary employee benefit funds under its management. Citibank, which set up its first international fund for ERISA clients in 1978, does all the foreign investing of allocated reserves through commingled funds. Currently, its international equity and bond funds total close to 3 percent of its aggregate discretionary employee benefit funds, and it is recommending to most clients that they increase their international allocation to 10 percent over the next few years.

Since the mid-1970s a number of other banks have also established international commingled funds. The smallest is the Girard Bank, which has only about \$800 million of total employee benefit funds under management but nonetheless introduced an international pooled fund this May. In contrast, some banks that are among the largest holders of ERISA funds hesitated for quite some time before deciding to offer international investment services to such clients. Now they are ready to join the competition. Bankers Trust has reorganized a commingled fund that had been relatively dormant for fifteen years and is currently talking to clients about the desirability of foreign diversification. Chase Manhattan Bank has two international commingled funds starting operations, and plans to ask all of its ERISA accounts to put in 2-3 percent of their reserves. And the Bank of America has just established a commingled fund with three divisions, for investments in equities, fixed-income securities, and/or international cash. This apparently is the first international fund with a separate cash division; it will enable a pension plan sponsor to make a specific allocation for investment in highly liquid foreign assets.

At all but the very largest banks, the complexities and costs of handling foreign investments generally rule out separate accounts as opposed to commingled funds. At any institution where an account is handled separately, the client is not only charged a higher fee but is generally required to undertake a minimum foreign investment of several million dollars. The main reason for this latter rule is that prudent minimization of risk is regarded as necessitating diversification into securities in at least five different countries.

#### *The life insurance companies*

Life insurance companies rank second to banks in the volume of pension funds managed. At the end of 1980, pension fund assets accounted for 35 percent of the companies' total assets. These pension funds are handled either as part of each insurance company's

"general account", where the funds are mingled with life insurance and health insurance funds, or individually as "separate accounts". Most states impose severe restrictions on general account investments, including rigorous restraints on foreign investments. New York State, for example, limits portfolio investments outside the United States to stipulated percentages of an insurance company's assets, namely, 10 percent for Canadian securities and 1 percent for all other foreign securities.<sup>7</sup> The rules of New York State are important even for insurance companies based in other states since they must be in "substantial compliance" with New York regulations if they wish to do any insurance business in this state. About half the states are even more restrictive than New York. Neighboring New Jersey, however, is among the less restrictive states. That state imposes no limit on investment in Canada, deemed not to be a foreign country for investment purposes, and permits investments in other foreign securities of up to 2 percent of assets, although investments in any one foreign country are not to exceed 1 percent. Ten states have no statutes at all regarding foreign investments.<sup>8</sup>

In many states the life insurance companies have some extra leeway for general account foreign investments by way of a catch-all investment clause, referred to in the industry as the "basket" clause, which permits a small percentage of total assets to be held in almost any way an insurance company sees fit. In New York State this "basket" amounts to 4 percent; in New Jersey it is 5 percent. Most companies prefer to utilize this leeway for domestic investments, but a few may be making use of part of it to add to foreign investment beyond the limits otherwise permitted.

"Separate accounts" were introduced in the early 1960s, when strong competition for pension fund business began to emerge from new sources, and sponsors were manifesting discontent with the returns from their traditional investments with the life insurance companies. The separate accounts have no restrictions regarding foreign or any other types of investment although ERISA "prudent man" responsibilities hold for the management of these accounts as for other accounts.

<sup>7</sup> The life insurance company's assets that are used as the base for determining the indicated amounts are actually the company's "admitted assets", a term denoting assets that are in good standing. The above-mentioned permitted foreign investments are in addition to investments in any foreign country where the company is authorized to do business. The latter investments are not to exceed one and one-half times the company's reserves and other obligations in that country, or the amount it is required by law to invest in the country, whichever is greater.

<sup>8</sup> The author is indebted to the American Council of Life Insurance for information on the various state laws.

One insurance company—The Prudential Insurance Company of America, the largest United States life insurance company—moved more quickly than others in diversifying into foreign assets. As early as 1976 it established a commingled fund for pension and profit-sharing funds called PRIVEST, whose assets were to consist primarily of private (*i.e.* direct) placements, traditionally an important part of life insurance investments. One of the initial guidelines specified that up to 10 percent of the portfolio could be allocated to Canadian investments and up to 5 percent to other foreign investments. This year, in another move, Prudential embarked on two pilot programs of \$50 million in foreign bonds and \$25 million in foreign equities to test and develop its acquisition, trading, and other operations in the foreign securities markets. The company expects that by the beginning of 1982 it will be able to offer a pooled fund for foreign bonds and one for foreign equities to any pension plan sponsor wishing to diversify internationally. It also anticipates establishing an internal unit to handle foreign currency-denominated investments for its general account; such investments would, however, be constrained in size by state regulations regarding foreign investments.

Aetna Life Insurance Company has chosen a different path. In June it combined with Warburg Investment Management International, an SEC-registered British firm that already was managing a sizable volume of ERISA funds, to form a jointly owned United States subsidiary, Aetna Warburg Investment Management International. Aetna is responsible for the marketing operations and Warburg, operating out of London, for the investment and administrative activities. In this undertaking, clients' funds are being handled in separate accounts.

Other life insurance companies are already thinking of following suit via one channel or another that would enable them to provide foreign investment facilities to employee benefit funds. One is actively studying the alternative routes for entering the foreign portfolio investment area, with the expectation that a decision will be made within the coming year. Another is contemplating the introduction of foreign investment services when it considers exchange rate conditions more opportune. In at least one state where the regulations regarding foreign investments are even more restrictive than in New York, steps are being taken to try to get these changed, which would open the way for insurance companies to offer pension funds foreign investment opportunities.

Some insurance companies have been especially interested in foreign investment in Mexico. In 1979 the life insurance industry attempted to gain passage by the New York State Legislature of a bill allowing

the companies to invest up to 10 percent of the general account funds in Mexican securities—can be done with Canadian securities. When this effort failed, the approach was shifted to obtaining legislative changes: (1) an increase in the general ceiling on foreign asset investments from the present 1 percent to 2 percent; and (2) permission for an additional 1 percent of total assets to be placed in Mexican investments. These changes came very close to passage in 1980, and their sponsors are fairly hopeful of actual passage this time around.

#### *Investment advisers and other intermediaries*

The third group of portfolio managers, those called investment advisers by the SEC, play a particularly important role in handling pension fund assets of the larger United States corporations. They are avid contenders for the new foreign investment business. There were only a very few such managers 10 years ago, but a total of about forty today.<sup>9</sup> Current competitors include foreign as well as United States firms and also United States subsidiaries set up by foreign firms or jointly by United States and foreign firms. The recent development in this country of mergers resulting in large financial conglomerates that encompass a wide range of financial operations makes for an increasingly varied picture.

Those managers of ERISA-subject pension funds that are not United States banks or insurance companies must be registered with the SEC. While a number of foreign-based managers are registered, many do not wish to make known all the information that SEC registration requires. They avoid this by setting up special subsidiaries, usually in the United States, to deal with ERISA clients. Apparently the majority of these subsidiaries are, at most, contact points with United States clients. The actual foreign investment activity and relevant research is generally undertaken from an office located in a foreign market center.

In general, firms of foreign origin are able to display a longtime knowledge of, and experience in, foreign securities markets that puts them, in the opinion of some pension plan executives, a big step ahead of domestic managers, even those that have opened foreign offices. A number of the foreign firms have been active for many decades rather than for just a few years—although in most cases their foreign investment operations until rather recently did not include Asia and other areas outside Europe that are now attracting considerable attention from international investors. United States managers, on the other hand, are often considered to have an advantage because of their fa-

<sup>9</sup> For a listing, see *Pensions and Investment Age*, "International Profiles" (April 27, 1981).

quently greater familiarity with sophisticated investment tools, including modern portfolio theory and advanced statistical techniques. Moreover, for many sponsors, the ability of a management firm to show it has a well-structured decision-making process is of greater importance than the nationality or location of the firm.

Some domestic firms seek to acquire the familiarity with foreign markets and foreign securities necessary for managing foreign investments by placing staff abroad. Others rely upon the availability of increasing amounts of published information from around the world and facilities for instant global communication. Neither tactic, however, provides the track record sponsors often want to see. Hence, another approach has been to team up with an experienced foreign money manager to form a United States subsidiary. There are now a number of such joint ventures. Whatever the setup, where there are both foreign and domestic offices, the United States-based representatives generally act primarily as contact persons while the overseas personnel are the ones most directly involved in the substantive issues of portfolio diversification. As is the case with the foreign firms, overseas offices deal with foreign brokers. Although a few United States brokerage firms have established new offices abroad during the past two years, the business of these branches is more in the retail end and with foreign institutions that wish to invest in the United States rather than with United States institutional investors who are putting money into foreign assets.

A handful of firms have found a very special niche for themselves in providing advice to pension plan sponsors regarding international portfolio managers and other matters relevant to foreign diversification. Most expanded into the international field after experience of a similar kind in the domestic area. Intersec Research Corporation, however, was established in 1975 as a new firm; the first United States counselor in the international area, it also advises portfolio managers. Among the services generally rendered by these counselors are: assessment of a pension plan's objectives and needs and the appropriateness of foreign investment for that plan, analysis of the foreign investment "style" or "philosophy" of managers, monitoring the performance of managers, and recommendations regarding retention or discharge of existing managers and/or the choice of new managers.

The foreign investment services offered by the independent managers have paralleled those by banks and insurance companies with regard to handling pension funds as separate accounts or combined with other accounts, although the latter are actually mutual funds. However, in a recent development that is con-

tributing to the ongoing blurring of lines between traditional types of financial institutions, several independent managers, as well as consultants and brokerage firms, have established or taken over state or nationally chartered trust banks. These will enable the firms to set up commingled funds and provide custodial services in exactly the same way banks can.

#### The increase in international diversification

The number of companies that have put some portion of their pension funds into foreign assets has grown dramatically during the past few years. A recent survey of almost eleven hundred of the largest American corporations found that, of those companies interviewed that ranked among the *Fortune* top 100 industrials, the number holding foreign assets had increased from 17 percent in 1977 to 34 percent in 1980; among *Fortune's* second 100, the number had grown from 7 percent to 29 percent. Interest had intensified among firms responsible for funds with assets of over \$250 million, but smaller pension funds had also become much more involved. Fully 11 percent of all the firms surveyed had some portion of their pension fund reserves in foreign assets at the end of 1980, and another 18 percent said they were planning to start investing internationally during 1981 or 1982.<sup>10</sup> Thus by the end of next year almost one third of the surveyed firms may have become international diversifiers.

#### The "style" of investment

Many of the pension plans that are prepared to place a fairly sizable amount abroad apportion the funds among more than one manager, sometimes including different types of intermediaries as well as both United States-based and foreign-based managers. If a sponsor has only one manager, which would be general for smaller investors, this would be a "global" or "international" manager, responsible for investments in many countries all over the globe, either through a commingled fund or otherwise. If there is more than one manager, there might be a global manager, and/or a "regional" manager (or managers) responsible for investments in only a part (or parts) of the world. Sometimes a sponsor may choose "specialist" managers limited to a specific type of investment such as equities or bonds, or characterized by a specific way of approaching the markets such as market "timing". Finally, some of the managers are given permission to invest part of the international allocation, when they consider it desi-

<sup>10</sup> Greenwich Research Associates, *Large Corporate Pensions 1981 Report to Participants*. The approximately 1,100 companies surveyed ranked among the 1,600 biggest firms in the country.

able, in dollar-denominated assets either in the United States or in the Eurodollar market. In other cases, however, the sponsor's guidelines allow dollar-denominated assets to be held only for liquidity purposes.

The sponsor also has a choice of several types of commingled funds. Some are index (passively managed) funds; others are actively managed funds. The index funds are regarded as a way to obtain widely diversified foreign assets for a relatively low management fee. They also have been utilized as a yardstick against which to measure the performance of a plan's other portfolio managers. However, the index funds are much less popular than the other international commingled funds. Among the actively managed commingled funds are a few that are limited as to type of enterprise and number of countries in which they invest, often blue-chip companies in the most advanced industrialized countries. These are sometimes characterized within knowledgeable circles as "closet index funds". Other commingled funds may emphasize growth companies or some particular type (or types) of industry or, at a given time, may even have a majority of assets in only one favored country. Still others, in contrast, choose broad diversification, either by type of firm or industrial sector or national economy, with investments in some cases being made in as many as twelve or more countries. While a few banks and other management firms offer just one international securities fund, a number offer several different funds that vary as to type of security or currency. This provides a sponsor with greater flexibility in allocation choices as well as greater ease of guideline modifications.

Once a decision has been made to diversify internationally, a pension plan sponsor may rely on new cash flows as a source of funds for such investments. At some banks, however, when a client has agreed to allocate a given portion of its reserves to an international fund, the bank simply liquidates a corresponding amount of the client's domestic holdings. Many sponsors have built up foreign investments only when economic and financial conditions seem to favor such moves, but others have kept up their planned outflows regardless of the changing international constellation of interest, exchange, and inflation rates and of capital market conditions. For them, the basic, long-term considerations that led to their original decision to commit part of their funds abroad remain the determining investment motivation. Relatively few pension plans that have invested abroad have engaged in any net reversal of such investments. This positive attitude seems likely to continue. Of the *Fortune* top 100 industrial firms already investing abroad in 1980, over 75 percent have said they expect to increase such investments during 1981-82, and

roughly 60 percent of those that rank among the next 300 firms have expressed the same intention.<sup>11</sup>

#### *The amounts invested*

Currently, relatively few firms have more than 5 percent of their pension fund reserves invested in foreign securities, but the number is rising, and some are shooting for 10 or even 20 percent in the not too distant future.<sup>12</sup> Moreover, as many as one in four of the respondents to a 1980 survey said that they expected to hold between 2 percent and 5 percent at the end of that year in contrast to the one in ten that were holding such amounts twelve months earlier.<sup>13</sup>

One can do no better than make an educated guess regarding the total amount of foreign securities already acquired for employee benefit fund portfolios. The Department of Labor, which obtains an annual financial report from all ERISA-covered employee benefit plans, does not require that foreign investments be reported separately from domestic investments. Thus, only by going through thousands of reports, and identifying all the securities listed, could the foreign investments be sorted out, but this is not being done. Furthermore, reports on purchases and sales of foreign securities filed on United States Treasury forms and used for United States balance-of-payments statistics do not indicate which of these are transactions for pension fund accounts and often do not include transactions for such accounts that are executed by managers from overseas offices or even by United States-based managers who transmit their transaction orders directly to foreign brokers. A few pension fund consultants try to keep tabs on the amounts invested but none of these estimates are complete.

Banks managed \$229 billion of employee benefit funds at the end of 1980.<sup>14</sup> Approximately \$1.5 billion of this total was in the international commingled funds. The banks held additional foreign assets for the employee benefit funds either because of international diversification for separate accounts or because of foreign securities the banks purchased for commingled funds that were not international funds.<sup>15</sup> However,

<sup>11</sup> Greenwich Research Associates, *op. cit.*

<sup>12</sup> The two state retirement funds that hold foreign assets have 5 percent as their current allocations, and at least one would not hesitate to go as high as 10 percent.

<sup>13</sup> *Institutional Investor* (April 1980).

<sup>14</sup> Federal Financial Institutions Examination Council, *op. cit.*

<sup>15</sup> Foreign securities purchases for "domestic" commingled accounts often are securities for which American Depositary Receipts are available, and therefore might frequently represent purchases from United States residents rather than new outflows.

these latter types of holdings apparently did not exceed \$1 billion, or \$2 billion at most. This would imply that roughly 1-1½ percent of the employee benefit assets with banks was invested abroad, including investments in Canada and in United States dollar-denominated foreign issues. This compared with an estimated ½ percent a year earlier, when employee benefit funds managed by banks totaled \$205 billion.

Life insurance companies, which had assets totaling \$479 billion at the end of 1980, were responsible for the management of \$165 billion of private pension plan funds: \$33 billion in separate accounts and \$132 billion in the general accounts. Among the insurance companies' total assets, approximately \$20 billion (4 percent) consisted of foreign securities. Debt securities, which always bulk large in life insurance company portfolios, accounted for \$19 billion of the \$20 billion. Most of this comprised Canadian paper (government, government agency, and corporate) and some small amount of international agency bonds, but there were also bonds of the governments of Mexico, Japan, France, Sweden, Israel, and some other countries, as well as debt of non-Canadian corporations.<sup>16</sup> Foreign-issued stock probably amounted to no more than \$1 billion. Almost all the foreign investments were for the life insurance companies' general accounts, and only a very small part for the separate accounts. Since roughly 30 percent of the total general accounts consisted of pension fund monies, pension funds might be regarded as the source of approximately \$6 billion of the foreign asset investments (compared with about \$5 billion the previous year), even though the pension funds did not have the responsibility for stipulating how their funds were to be invested.

While intermediaries outside the insurance and banking communities have significant amounts of pension fund reserves under management, again only estimates are available concerning the foreign securities investments they managed at the end of 1980. One compilation suggests the total was almost \$1 billion, up approximately \$200 million from 1979.<sup>17</sup>

In summary, the foregoing estimates suggest that at the end of 1980 roughly \$9-10 billion, approximately 2 percent, of private pension fund assets was held in foreign securities through all management intermediaries, including the portion of insurance company general account foreign investments allocable to pension funds. The additional foreign assets managed internally by private corporations at that time apparently totaled less than \$100 million. However, some large

sponsors who now have their own staffs managing domestically invested pension funds anticipate they will be able to undertake internal management of at least part of their foreign investments in another five years or so, after the staff has gained more knowledge about foreign markets and foreign securities.

As pension funds continue to increase throughout the 1980s, a net outflow would have to occur each year just to maintain an unchanged foreign investment percentage—unless the market value of the existing foreign holdings took a sudden jump. Any growth of the portion allocated to foreign assets would expand the flow further, although it is likely that the annual increase in total allocations will slacken after a number of years. Part of the rise that must be expected during the eighties will undoubtedly reflect the very recent change in attitude of a number of big banks and life insurance companies that have decided to compete in providing new foreign asset investment opportunities for ERISA clients. The same is true concerning the entrance of independent managers, brokers, and consultants into the business of trust banking. With an increasingly active and diversified group of intermediaries available as foreign asset managers and custodians, it seems likely that additional pension plan sponsors will be attracted to international diversification.

Assuming that foreign diversification grows over the rest of the decade at a rate that raises the share of foreign assets in total private pension fund portfolio by an annual average of about ½ percentage point, by 1990 foreign assets would comprise roughly 7 percent of total private pension funds, with many large funds reaching well beyond 10 percent. On the basis of the forecasts of pension fund reserves made by ICF, 7 percent in foreign asset holdings in 1990 would amount to approximately \$120 billion (in current, *i.e.* inflated, dollars).<sup>18</sup> This would imply that during each of the next few years the outflow would remain below \$10 billion and would rise above that level only some time in the middle of the decade. The amounts would be larger if a significant number of state and local pension plans were to start investing abroad.

#### Implications for United States markets

What might be the implications for the United States balance of payments and financial markets as pension funds increasingly diversify into foreign assets? The foregoing estimates suggest that during the first half of the decade net outflows might expand from the approximately \$2¼ billion of last year to something like

<sup>16</sup> American Council of Life Insurance, 1981 *Life Insurance Fact Book*.

<sup>17</sup> Information from Intersec Research Corporation.

<sup>18</sup> The ICF "cyclolong" model on which this figure is based assumed the consumer price index would show a rise of 7 percent in 1986 and 6.5 percent in 1990. The ICF estimate of total private pension plan assets in 1990 came to approximately \$1.7 trillion (ICF, *op. cit.*).

of \$10 billion by the mid-1980s.<sup>19</sup> These are not particularly large sums when compared with other types of capital outflows. For example, during the last five years, United States banks increased their dollar claims on foreigners (excluding claims on their own foreign branches) by an annual average of almost \$18 billion. And new direct foreign investments by United States residents amounted to an annual average of over \$4 billion. Inclusion of reinvested earnings would increase this figure to \$16 billion.<sup>20</sup>

A growing international orientation by United States pension funds will presumably affect to some extent the location of their short-term liquid reserves, the volume of which can fluctuate considerably. For example, since 1978, "cash and deposits" of private noninsured pension funds have accounted for 4 percent of total assets after having constituted only 2 percent for many years, and at the end of 1980 such liquid assets amounted to \$9.3 billion.<sup>21</sup> This undoubtedly reflected the diversion of funds from long-term investments in 1978, due to the drop in bond and stock market prices and the surge in short-term interest rates. Thereafter, liquid reserves were kept at high levels presumably because of uncertainty about the outlook for capital market developments and the continuing attraction of short-term rates. In the future, at similar junctures, when short-term rates abroad are also attractive, pension fund managers may pay increased attention to the alternative foreign liquid investment possibilities (as perhaps indicated by the establishment of an international cash division in the Bank of America's new international commingled fund). A persistent trend toward greater international diversification of *short-term* investments would introduce the possibility that the management of such investments would contribute to exchange market volatility. However, these flows would be just one stream in a multitude of many fluctuating sources of supply and demand in the huge short-term financial markets.

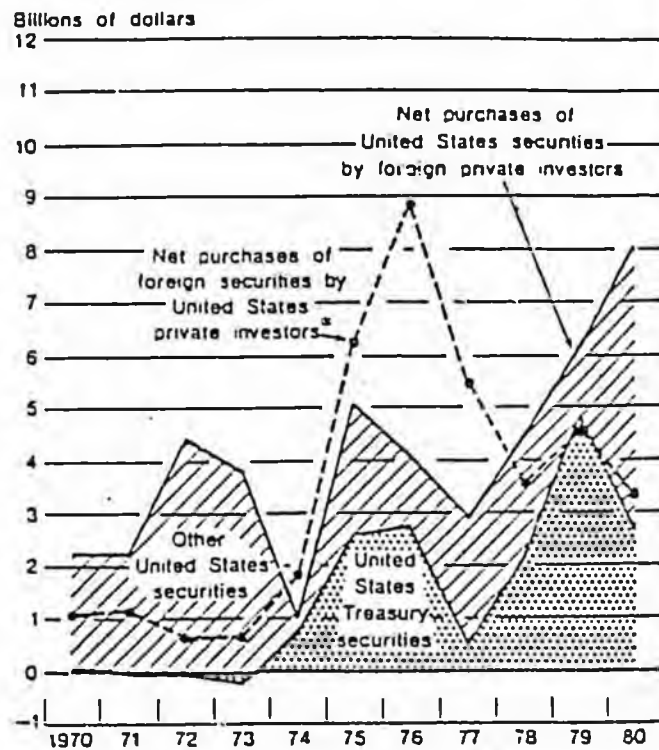
At the same time that United States investors have begun to look abroad, the incentive to diversify and the breadth and depth of United States capital markets have led additional numbers of foreign investors to look to the United States. Indeed, throughout the past

<sup>19</sup> It is to be noted that, even when foreign fixed-income investments are United States dollar denominated, as the bulk of the insurance company investments have been, the borrowers generally convert the funds into foreign currencies, resulting in flows through the exchange markets.

<sup>20</sup> Board of Governors of the Federal Reserve System, *Federal Reserve Bulletin*, and the United States Department of Commerce, *Survey of Current Business*.

<sup>21</sup> United States Securities and Exchange Commission, *SEC Monthly Statistical Review* (May 1981).

### Net Foreign Securities Purchases by Private Investors



\* No data available on components of net purchases by United States private investors.

Source: United States Department of Commerce, Bureau of Economic Analysis, *Survey of Current Business*, June 1981.

decade, except for a bulge in outflows during the year 1974 through 1977 resulting from the elimination of the interest equalization tax and the reemergence of the Yankee bond market, foreign private inflows into the United States securities markets were considerably greater than outflows into foreign securities markets by all private United States investors—pension funds, foundations and other institutions, businesses, and individuals (chart).<sup>22</sup> Thus, any diversion to foreign markets of pension fund resources that might otherwise have been invested in domestic capital markets has in most years been much more than offset in amount by inflow from private foreign residents. In addition, there have been considerable investments in United States private securities by foreign official agencies.

<sup>22</sup> Some pension fund outflows are not recorded in these figures, particularly, as noted above, when managers are operating out of overseas offices and/or foreign brokers are being used.

The clear-cut existence of a two-way flow of funds in an increasingly interdependent world, but one where the United States continues to exert an extraordinarily strong pull on foreign investors—not only into the securities market but also into real estate and direct investments—makes it appear improbable that the rise in investments abroad by United States pension funds (and other institutional investors) will lead to a secular downward pressure on the United States dollar. The current Administration's general attitude concerning the need to encourage investment, and its budget and tax policies, may reinforce foreigners' interest in investing in this country. Moreover, the longer term foreign investment strategies that United States pension plan sponsors have by and large followed, and the relatively low weight most of them give to short-run exchange market conditions, means that the management of these funds is not

likely to be a significant source of instability in exchange markets. Indeed, the presence of more international capital flows that are governed by a longer view could actually be a source of stability.

Thus, the growing international diversification of United States pension fund portfolios seems, from the vantage point of 1981, to be a development that is capable of providing benefits for both pension plan sponsors and pension fund beneficiaries—if the sponsors are sufficiently knowledgeable to make the proper choices concerning guidelines and managers. Moreover, the expanding diversification appears unlikely to have any noticeably adverse effects on the exchange rate for the dollar or any perceptibly negative effect on United States financial markets. The outflows will not be particularly large, compared with other capital outflows, and investments in this country's markets by foreigners will probably continue to be much greater

Edna E. Ehrlic

# International Investing: The Challenges and the Opportunities

Rodger F. Smith

## INTRODUCTION

International investing by American pension funds is a relatively recent phenomenon. In many ways, the institutional part of the business was born in 1974 when Morgan Guaranty Trust launched the first commingled fund for pension funds to invest in international securities.

The birth was controversial in several ways. First, 1974 was the beginning of life with ERISA—a formalization of prudence. This new law created major turmoil among plan sponsors. Second, it came at the end of a two-year period of rapidly declining domestic equity prices, in 1973 and 1974. Third, Morgan Guaranty did not ask its clients for approval. Instead, clients that did not want international exposure were forced to say "no," which was in keeping with Morgan Guaranty's traditional sense of responsibility.

In hindsight, the timing of the move was almost perfect. The bottom of the market was reached very quickly, international performance in the early years was very strong, and the international investment management business as we know it today began to grow in earnest.

We have come a long way in just a decade. Much has been tried—and much more learned by plan sponsors and investment managers alike. The purpose of this seminar on International Equity Investing is to bring this learning together and to seek to channel future thought as the business moves from the rapid growth phase that has characterized it during the past several years into a more mature growth phase.

Before turning to a detailed examination of the business itself, it is useful to step back for a moment and look at the market forces that are driving the business—primarily America's largest pension funds. Pension funds are a trillion dollar business. They are also growing at an underlying rate of 12–15 percent per year. This rate of growth means that pension funds spawn a *new* business totalling nearly \$150 billion each and every year. Truly, the business of managing pension funds is a very large, rapidly growing, and increasingly profitable business for investment management firms.

To put international investing by American pension funds into perspective, four different factors should be examined: first, the *number* of pension funds that invest abroad; second, the *dollars* they invest abroad today, and their intentions to change these investments in the future; third, the *reasons* pension funds invest internationally; and, fourth, the reasons pension funds do *not* invest internationally. This background will serve as a springboard for each of the subsequent speakers who will discuss more specific aspects of international investing.

## INTERNATIONAL INVESTING BY AMERICAN PENSION FUNDS

The number of American pension funds investing internationally has increased significantly in recent years. Each year in the fall, Greenwich Research Associates conducts extensive research on the investment policies and practices used by large corporations in the management of their employee benefit funds. The Greenwich Research Associates universe includes the nation's 1,600 largest companies. These companies range from AT&T down to companies with plan assets as small as \$10 million. In aggregate, their assets total more than \$475 billion; they represent 80 percent of *all* corporate pension assets in America, and they account for the lion's share of the present dollars invested internationally.

### More Plans Getting Involved

As shown in Table 1, the number of companies investing internationally more than doubled from 8 percent in 1979 to 17 percent in 1981. Growth slowed during the following two years with only a 1 percent increase each year to 18 percent in 1982 and to 19 percent this past year. This equates to approximately 250 large corporations that presently invest a portion of their employee benefit funds outside the United States.

Companies with larger plan assets more often invest internationally. Table 1 shows that almost two thirds of the companies with plan assets over

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TABLE 1. How companies investing abroad have been changing

	1979	1980	1981	1982	1983
Plan assets					
Over \$1 billion	26%	40%	59%	60%	63%
\$251-1,000 million	21	25	35	40	31
\$100-250 million	11	14	18	23	22
Under \$100 million	3	6	8	9	6
Total companies	8	13	17	18	19

Source: Greenwich Research Associates.

\$1 billion currently invest abroad. In contrast, approximately one-third of the companies with plan assets of \$250 million to \$1 billion invest abroad; one fifth of the companies with plan assets of \$100 million to \$250 million invest abroad; while only 6 percent of companies with plan assets under \$100 million presently invest internationally. International investing is clearly a large-company phenomenon.

#### Dollar Commitment Is Growing Rapidly

Dollars invested abroad by corporate pension funds have also increased rapidly—and significant further growth is projected during the next three years. As shown in Table 2, pension assets invested internationally more than doubled from \$4 billion in 1982 to almost \$9 billion in 1983. This increase is ahead of last year's expectation of an increase to \$8 billion in 1983. This is particularly interesting in light of the strong U.S. stock market and the strength of the dollar during that period.

Looking ahead, corporate pension funds expect to increase international investments more

TABLE 2. How projected dollars invested abroad have been changing

	1982 Actual	1983 Actual	1986 Projected
Plan assets			
Over \$1 billion	\$2,420*	\$7,118	\$17,346
\$251-1,000 million	1,067	1,285	4,462
\$100-250 million	313	288	775
Under \$100 million	157	71	224
Total companies	\$3,957	\$8,761	\$22,807

\* Dollars in billions.

Source: Greenwich Research Associates.

than two and one-half times to a projected \$23 billion by the end of 1986.

Assets invested internationally are concentrated among the very largest funds. In fact, 85 percent of present assets and 76 percent of projected 1986 assets are concentrated among companies with plan assets over \$1 billion.

What is driving this expected \$14 billion growth in assets invested internationally during the next three years? There are three different factors involved:

- Total pension assets (net contributions plus investment gains) are growing at an underlying rate of 12-15 percent per year. This "normal" growth in pension assets accounts for almost one-third of the projected growth of international assets from \$9 billion in 1983 to \$23 billion in 1986. With pension funds becoming increasingly well funded, a larger percentage of future growth will come from investment gains as opposed to net contributions.
- More companies are making initial commitments to international investing. In fact, 9 percent of the companies included in our 1983 research indicated they plan to *start* investing abroad by the end of 1984. This will bring the total number of companies investing internationally to approximately 375, assuming all these expectations are fulfilled. During the past four years, however, only 55 percent of the intentions to start investing abroad were actually fulfilled. Therefore, companies investing abroad for the first time account for slightly less than one-fifth of the total projected asset growth.
- Plan sponsors that presently invest abroad are increasing the *percent* of assets invested internationally. This increase in asset mix accounts for fully one-half of the projected \$14 billion growth in international assets.

#### But Commitment Remains Low as Percentage of Total Assets

While international assets presently account for less than two percent of *total* employee benefit fund assets, the companies that invest abroad presently invest only slightly less than four percent of their assets internationally. As shown in Table 3, these companies plan to increase interna-

TABLE 3. How percent of total assets invested internationally is changing

Percent invested	1983 Actual	1986 Projected
None	84.0%	71.0%
1	3.0	2.0
2	3.0	2.0
3	3.0	2.0
4	1.0	1.0
5	2.0	6.0
6-10	2.0	4.0
Over 10	0.0	0.0
No answer/uncertain	2.0	12.0
Mean*	3.8	5.6
Median	3.0	5.0

\* Note: Mean and median exclude None.  
Source: Greenwich Research Associates.

tional investments by 180 basis points to nearly six percent by the end of 1986. Interestingly, none of these funds now invest—or plan to invest—more than 10 percent of their total pension assets abroad. Because equity investments are 50 to 60 percent of total assets, international investments could total more than 10 percent of *equity* assets, but not more than 10 percent of *total* assets.

### REASONS TO INVEST ABROAD: THEORY AND EVIDENCE

Corporate pension funds invest abroad for two primary, and complementary, reasons. To increase investment returns and to reduce total portfolio risk.

Initially, a majority of companies favored international investing as a way to reduce total portfolio risk by increasing diversification. As domestic equity markets improved, the pendulum began swinging the other way to the point where, in last year's research, reasons to invest abroad favored increasing returns over reducing risk by a 70 to 30 margin.

#### Return Experience

Empirical research shows that returns earned in international markets have exceeded returns earned domestically over long-time horizons. For the 10 year period 1973-1983, shown in Table 4, the compound annual rate of return for the Capital International EAFE index was 11.1 percent and outperformed the 10.6 percent return

TABLE 4. Time weighted rates of return

	Five years 1978-1983	Ten years 1973-1983
EAFE Index	10.1%	11.1%
S&P 500	17.3	10.6
CPI	8.4	8.2

of the S&P 500 by an average of 50 basis points annually over the entire period.

Relative to inflation, EAFE returns were also superior—outperforming the annual 8.2 percent increase in the Consumer Price Index by 290 basis points annually over the past decade.

During the past five years, however, the picture was different. For the period 1978-1983, the domestic market was strong with the S&P 500 return of 17.3 percent outperforming the 10.1 percent return of the EAFE Index by a whopping 720 basis points. During the same period, the EAFE Index again outperformed the 8.4 percent increase in the Consumer Price Index by an average of 170 basis points.

The long-term case for increased returns from international investing is strong. The past five years have not provided superior returns, but returns have exceeded the increase in consumer prices.

#### Risk Experience

Total portfolio risk has also been reduced by investing in international markets. As shown in Table 5, the standard deviation of the EAFE Index during the ten-year period, 1973-1983, was slightly higher than that of S&P 500—18.4 percent versus 18.2 percent. However, because returns from international markets are not highly correlated, total equity portfolio risk has been reduced by investing abroad. For example, by investing 10 percent of a domestic equity portfolio internationally, total equity portfolio risk was reduced to 17.8 percent—a decline in total equity

TABLE 5. Standard deviation of returns

	Ten years 1973-1983
EAFE Index	18.4%
S&P 500	18.2
S&P/EAFE—90/10	17.8
S&P/EAFE—80/20	17.5

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risk of a little more than two percent. By increasing the international component to 20 percent, total equity portfolio risk was further reduced to 17.5 percent, almost a four percent reduction in risk.

During the past ten years, therefore, domestic investors were rewarded for investing internationally both by increased returns and reduced risk.

### REASONS NOT TO INVEST ABROAD

Corporate pension executives who do not invest abroad cite four reasons as most important in their decisions:

- Senior management reluctance;
- Lack of international experience internally;
- Foreign currency risk; and
- Political risks.

Interestingly, two concerns voiced by investment professionals about putting money abroad

are not shared by plan sponsors. First, is the continued strength of the U.S. dollar. A number of investment organizations want to see the dollar weakened before committing assets abroad. This factor is not holding large corporations back.

A second concern to investment managers, but not to plan sponsors, is the perceived near-term attractiveness of the American stock market.

### CONCLUSION

American pension funds have moved international investing from an emerging growth business into a new, but more mature growth business. More companies are investing abroad, more money is being invested abroad, and plan sponsors are increasing the percentage of assets invested internationally. All of these trends are currently positive, making the challenges facing plan sponsors and investment managers increasingly important—and exciting. With this as background, let's proceed now to look at the specific challenges of managing international portfolios.

# International rates of return

## Equities: Annual returns in local currencies

% pa	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	Ave 75-84
USA	37.3	23.7	-7.3	6.6	18.6	32.6	-5.0	21.6	22.6	6.2	14.8
Japan	19.2	21.4	-3.1	26.0	4.2	9.5	17.3	6.0	25.2	26.4	14.8
UK	152.0	2.2	49.1	8.5	11.4	35.4	13.7	29.2	29.1	31.9	31.7
Canada	18.3	9.2	6.2	30.6	50.6	24.0	-10.7	6.5	33.8	-1.4	15.4
Germany	41.8	-3.9	12.2	9.7	-7.4	4.0	4.9	19.4	44.2	11.2	12.5
Australia	57.5	3.8	6.7	21.2	49.5	45.0	-20.2	-10.7	70.3	-4.8	18.1
Switzerland	46.0	3.2	5.4	-1.4	10.4	2.9	-8.1	14.8	30.4	5.9	10.0
France	46.1	-11.4	0.2	53.9	24.3	10.7	-10.2	14.9	68.0	23.2	19.4
Singapore	70.8	12.7	0.4	34.6	28.7	56.9	15.8	-14.1	32.7	-24.9	17.9
Netherlands	61.8	7.0	7.7	4.7	15.4	27.2	-0.4	24.7	61.0	29.6	22.2
Hong Kong	118.6	30.5	-12.4	23.2	88.6	79.7	-7.0	-36.6	16.8	47.8	26.6

## Bonds: Annual returns in local currencies

% pa	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	Ave 75-84
USA	9.7	16.6	0.1	-0.4	-2.4	-3.2	1.1	43.0	0.3	14.6	7.2
Japan	13.9	10.9	23.9	3.8	-5.9	6.3	13.0	10.3	10.2	12.1	9.6
UK	41.8	12.3	50.1	-3.4	4.5	21.3	1.4	54.5	16.2	7.2	19.0
Canada	1.7	18.3	5.2	0.7	-3.5	1.3	-3.5	44.7	9.3	15.6	8.2
Germany	17.5	15.5	17.7	2.9	-0.7	0.7	4.3	22.9	4.8	15.4	9.8
Australia	4.1	4.9	20.3	16.2	-2.9	-10.2	-5.0	32.9	9.1	14.5	7.7
Switzerland	14.8	16.7	9.6	10.3	-2.6	0.1	0.2	10.6	2.6	3.3	6.4
France	16.1	4.7	9.9	17.0	-4.4	2.6	3.5	19.5	20.6	20.3	10.7
Netherlands	11.5	10.9	7.7	5.2	1.6	2.7	5.4	29.1	7.6	14.7	9.4

## Equities: Annual returns converted into US dollars

% pa	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	Ave 75-84
USA	37	24	-7	7	19	33	-5	22	23	6	15
Japan	18	26	19	55	-16	29	9	-1	27	16	17
UK	117	-14	68	15	21	46	-9	9	16	5	23
Canada	15	10	-2	21	52	22	-10	3	32	-7	12
Germany	30	7	25*	24*	-4*	-10*	-10*	10*	24*	-5*	8*
Australia	49	-10	12	22	44	55	-24	-22	56	-13	13
Switz	41	11	30	21	12	-8	-9	3	20	-11	10
France	45	-20	6	73	29	-2	-29	-3	36	6	10
Singapore	59	14	5	46	29	62	19	-17	32	-27	19
Neth	51	17	17	20	20	13	-14	17	38	12	18
HK	114	41	-11	18	83	74	-16	-45	-3	47	21

\*Excluding German tax credit.

## Bonds: Annual returns converted into US dollars

% pa	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	Ave 75-84
USA	10	17	0	0	-2	-3	1	43	0	15	7
Japan	12	15	52	28	-24	25	4	3	12	3	12
UK	22	-6	69	3	14	30	-19	31	4	-15	11
Canada	-1	19	-3	-7	-2	-1	-3	40	8	9	5
Germany	8	28	53	18	5	-11	-9	16	-9	0	7
Australia	-1	-9	26	17	-7	-4	-9	16	0	5	3
Switz	11	25	35	35	-1	-10	-1	-1	-6	-13	6
France	15	-6	16	32	-1	-9	-18	1	-2	4	2
Neth	4	21	17	21	5	-8	-9	21	-8	-1	6

# THE 10 LARGEST MARKET CAPITALIZATIONS AND THEIR SHARE OF NATIONAL STOCK MARKETS

ANALYSIS

USA			JAPAN			UNITED KINGDOM		
	\$ million	% of total		\$ million	% of total		\$ million	% of total
IBM	77888	4.5	SUMITOMO BANK	14821	2.3	BRITISH PETROLEUM	12340	5.0
EXXON CORP	41381	2.4	DAIICHI KANGYO BANK	14162	2.2	BRITISH TELECOM	10080	4.1
GENERAL ELECTRIC	27040	1.6	TOYOTA MOTOR CORP	13374	2.1	SHELL T & T	9851	4.0
AMERICAN TEL & TEL	21791	1.3	MITSUBISHI BANK	13321	2.0	GENERAL ELECTRIC	6261	2.6
GENERAL MOTORS	21608	1.2	FUJI BANK	13233	2.0	BAT INDUSTRIES	5919	2.4
STANDARD OIL INDIANA	15402	0.9	SANWA BANK	12615	1.9	IMPERIAL CHEMICAL	5838	2.4
DU PONT DE NEMOURS	13299	0.8	MATSUSHITA ELECT IND	10485	1.6	BTR	5428	2.2
ATLANTIC RICHFIELD	12813	0.7	INDUSTRIAL BANK OF JAPAN	9280	1.4	GLAXO HOLDINGS	5419	2.2
CHEVRON	12444	0.7	HITACHI LTD	9047	1.4	MARKS & SPENCER	4408	1.8
MOBIL	12435	0.7	TOKYO ELECTRIC POWER	8701	1.3	BEECHAM GROUP	3239	1.3
<b>TOTAL TOP TEN</b>	<b>256101</b>	<b>14.8</b>	<b>TOTAL TOP TEN</b>	<b>119039</b>	<b>18.2</b>	<b>TOTAL TOP TEN</b>	<b>68783</b>	<b>28.0</b>
<b>TOTAL STOCK MARKET</b>	<b>\$ 1732 billion</b>		<b>TOTAL STOCK MARKET</b>	<b>\$ 651 billion</b>		<b>TOTAL STOCK MARKET</b>	<b>\$ 245 billion</b>	
CANADA			GERMANY			AUSTRALIA		
	\$ million	% of total		\$ million	% of total		\$ million	% of total
BELL CANADA	6815	5.2	SIEMENS	8163	9.1	BROKEN HILL PROPRIETARY	4020	7.6
IMPERIAL OIL	6481	5.0	DAIMLER-BENZ	7369	8.2	CRA	2202	4.2
NORTHERN TELECOM	4030	3.1	ALLIANZ VERSICHERUNG	4449	5.0	WESTPAC	1255	2.4
SEAGRAM CO	3852	3.0	DEUTSCHE BANK	4384	4.9	MIM HOLDINGS	1096	2.1
GULF CANADA	3372	2.6	BAYER	3493	3.9	ANZ GROUP HOLDINGS	1042	2.0
TEXACO CANADA	3227	2.5	KOCHST	3435	3.8	CSR	957	1.8
CANADIAN PAC ENTERPRISES	3226	2.5	BASF	2955	3.3	WESTERN MINING	925	1.8
CANADIAN PAC ITO	3128	2.4	RWE	2252	2.5	NATIONAL AUSTRALIA BANK	824	1.6
ALCAN ALUMINIUM	2494	1.9	MUNCHEMER RUCKVERSICH	2010	2.2	COMALCO	807	1.5
SHELL CANADA	2429	1.9	VEDA	1958	2.2	SANTOS	800	1.5
<b>TOTAL TOP TEN</b>	<b>39054</b>	<b>30.1</b>	<b>TOTAL TOP TEN</b>	<b>40468</b>	<b>45.1</b>	<b>TOTAL TOP TEN</b>	<b>13928</b>	<b>26.5</b>
<b>TOTAL STOCK MARKET</b>	<b>\$ 130 billion</b>		<b>TOTAL STOCK MARKET</b>	<b>\$ 90 billion</b>		<b>TOTAL STOCK MARKET</b>	<b>\$ 53 billion</b>	
FRANCE			SWITZERLAND			NETHERLANDS		
	\$ million	% of total		\$ million	% of total		\$ million	% of total
AQUITAINE (ELF) SNEA	2429	5.0	NESTLE	5381	11.7	ROYAL DUTCH PETROLEUM	15774	43.4
AYIONS DASSAULT BREGUET	1651	3.4	SCHWEIZ BANKGESELL. UBS	4815	10.4	PHILIPS	3428	9.4
AIR LIQUIDE	1639	3.4	CIBA-GEIGY	3608	7.8	UNILEVER	3156	8.7
L'OREAL	1050	2.2	SCHWEIZ BANKVEREIN SBS	3587	7.8	NATIONALE-NEDERLAND	1876	5.2
MOET-HENNESSY	954	2.0	HOFFMANN-LA ROCHE	2481	5.4	AKZO	1252	3.4
BSN-GERVAIS DANONE	919	1.9	SCHWEIZ KREDITANSTALT	2428	5.3	ALGEMENE BANK NEDERLAND	1021	2.8
FRANCAISE DES PETROLES	856	1.8	SANDOZ	1577	3.4	MEIHEKEN	845	2.3
SANOFI	811	1.7	ZURICH VERSICHERUNG	1227	2.7	AMEY	779	2.1
GENERALE DES EAUX	739	1.5	SCHWEIZ RUCKVERSICHERUNG	1065	2.3	AMRO BANK	772	2.1
ESSO	697	1.4	WINTERTHUR	987	2.1	AEGON	770	2.1
<b>TOTAL TOP TEN</b>	<b>11745</b>	<b>24.3</b>	<b>TOTAL TOP TEN</b>	<b>27156</b>	<b>59.9</b>	<b>TOTAL TOP TEN</b>	<b>23673</b>	<b>81.5</b>
<b>TOTAL STOCK MARKET</b>	<b>\$ 46 billion</b>		<b>TOTAL STOCK MARKET</b>	<b>\$ 46 billion</b>		<b>TOTAL STOCK MARKET</b>	<b>\$ 36 billion</b>	
HONG KONG			ITALY			SINGAPORE		
	\$ million	% of total		\$ million	% of total		\$ million	% of total
HONGKONG SHANGHAI BANK	3231	10.4	FIAT	2826	10.5	OCBC OVERSEA CHINESE BK	2000	7.7
HANG SENG BANK	1795	5.6	ASSICURAZIONI GENERALI	2726	10.1	SIME DARBY	798	3.1
HONGKONG LAND	1554	4.8	STET	2045	7.6	DEVELOPMENT BK SINGAPORE	773	3.0
HUTCHISON WHAMPOA	1521	4.7	SIP	1501	5.6	UNITED OVERSEAS BANK	771	3.0
CHINA LIGHT & POWER	1499	4.6	OLIVETTI	1489	5.5	MALAYAN BANKING	702	2.7
HONGKONG TELEPHONE	1301	4.0	SELM	1112	4.1	SINGAPORE PRESS HOLDINGS	676	2.6
HONGKONG ELECTRIC	1295	4.0	MONTEDISON	772	2.9	CONSOLIDATED PLANTATIONS	613	2.3
HONGKONG KOWLOON WHARF	1269	3.9	ALLEANZA ASSICURAZIONI	751	2.8	GENTING	561	2.1
SWIRE PACIFIC	1266	3.9	MEDIOBANCA	713	2.6	STRAITS TRADING	449	1.7
CHEUNG KONG	800	2.5	BANCA COMMERCIALE	698	2.6	KUALA LUMPUR KEPONG	444	1.7
<b>TOTAL TOP TEN</b>	<b>15531</b>	<b>48.0</b>	<b>TOTAL TOP TEN</b>	<b>14633</b>	<b>54.3</b>	<b>TOTAL TOP TEN</b>	<b>7787</b>	<b>29.9</b>
<b>TOTAL STOCK MARKET</b>	<b>\$ 32 billion</b>		<b>TOTAL STOCK MARKET</b>	<b>\$ 27 billion</b>		<b>TOTAL STOCK MARKET</b>	<b>\$ 26 billion</b>	
SWEDEN			SPAIN			BELGIUM		
	\$ million	% of total		\$ million	% of total		\$ million	% of total
VOLVO	1871	9.2	TELEFONICA NACIONAL	2469	17.2	PETROFINA	1670	13.4
ASEA	1253	6.1	HIDROELECTRICA ESPANOLA	856	6.0	INTERCOM	1014	8.1
ERICSSON	1188	5.8	IBERDUERO	725	5.1	EBES	873	7.0
SAAB-SCANIA	917	4.5	BANCO DE SANTANDER	705	4.9	SOCIETE GEN DE BELGIEQUE	596	4.8
ELECTROLUX	909	4.5	BANCO CENTRAL	632	4.4	GROUPE BRUXELLES LAMBERT	523	4.2
PHARMACIA	801	3.9	BANCO ESPANOL DE CREDITO	603	4.2	SOLVAY	513	4.1
ASTRA	710	3.5	BANCO DE BILBAO	428	3.0	UNERG	364	2.9
SCA SVENSKA CELLULOSA	671	3.3	UNION ELECTRICA-FENOSA	415	2.9	SOCIETE GEN DE BANQUE	359	2.9
SKANDINAV. ENSKILDA BANK	642	3.1	FECSA	341	2.4	KREDIETBANK	328	2.6
SKANSKA	614	3.0	BANCO HISPANO AMERICANO	299	2.1	ROYALE BELGE VIE ACC.	301	2.4
<b>TOTAL TOP TEN</b>	<b>9576</b>	<b>46.9</b>	<b>TOTAL TOP TEN</b>	<b>7473</b>	<b>52.2</b>	<b>TOTAL TOP TEN</b>	<b>6541</b>	<b>52.4</b>
<b>TOTAL STOCK MARKET</b>	<b>\$ 20 billion</b>		<b>TOTAL STOCK MARKET</b>	<b>\$ 14 billion</b>		<b>TOTAL STOCK MARKET</b>	<b>\$ 12 billion</b>	

Market capitalization is defined as the total number of shares outstanding times per share price (at 26 April 1985). The 10 largest companies for all countries are selected from the 1600 companies included in CAPITAL INTERNATIONAL PERSPECTIVE. The total market capitalization for each country is an estimate of the aggregate market value of all listed shares, excluding foreign securities and investment trusts. The total market capitalization of the USA refers to the New York Stock Exchange only; that of Japan to First Section only. For industry classification of the above companies, see quarterly issues of CAPITAL INTERNATIONAL PERSPECTIVE.

### 3. INCREASED RETURNS:

The rewards which may be derived from investments in many of the world's fastest growing markets, sectors and stocks. This is shown very clearly by the fact that in only one year since 1977 has the U.S. been among the top five performing markets.

#### TOP PERFORMING MAJOR STOCK MARKETS WORLDWIDE SINCE 1977 (% change vs. prior year — U.S. dollar terms)

Year	1st	2nd	3rd	4th	5th
1977	U.K. +56	Switz. +28	Germany +24	Japan +15	Holland -15
1978	France +68	Japan +52	Sing./Mal. +44	Italy +44	Belgium +29
1979	Norway +177	Hong Kong +80	Canada +50	Australia +42	Sing./Mal. +28
1980	Italy +78	Hong Kong +71	Sing./Mal. +62	Australia +52	U.K. +39
1981	Sweden +36	Denmark +24	Sing./Mal. +18	Japan -15	Spain +11
1982	Sweden +23	U.S.A. +21	Holland +15	Germany -9	U.K. +8
1983	Norway +79	Denmark +63	Australia +53	Sweden +49	Holland +36
1984	Hong Kong +45	Spain +36	Japan +17	Belgium -12	Holland +11
1985	Austria +177	Germany +119	Italy -133	Switz. -107	France -86

Only once since 1977 has the U.S. stock market been among the five best performers in the world.

Source: Capital International, S.A., Geneva. All figures shown in U.S. dollar terms, capital appreciation plus dividends.

### 4. ADDED CURRENCY GAINS:

An investment in an overseas stock market will have exposure to currency changes as well as stock price movements.

If the dollar weakens, the value of a stock in such a market will go up in U.S. dollar terms.

An investment can be made to take advantage of a rise in an overseas stockmarket. If it is anticipated that the U.S. dollar will strengthen, the currency can be hedged to protect against such strengthening.

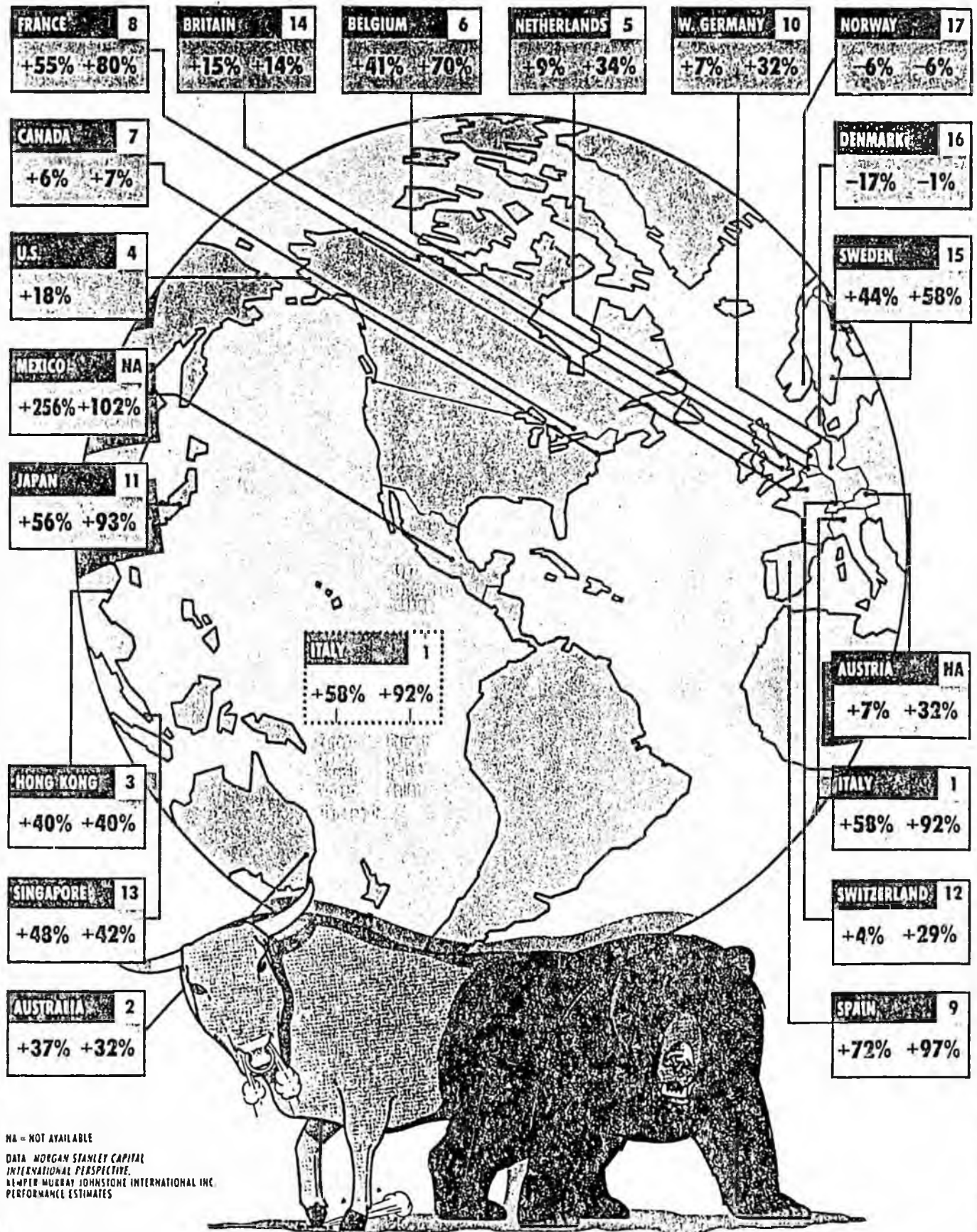
Thus, in one case there is opportunity, and in the other, protection. A very potent and attractive combination.

#### CUMULATIVE PERFORMANCE OF MAJOR STOCK MARKETS 1977-1985 (total return with dividends reinvested)

1st	2nd	3rd	4th	5th
U.K. +417	Japan +370	Italy -353	Holland +316	Germany -290

These figures for cumulative performance 1977-1985 become even more impressive when compared with the U.S. +171% (12th) over the period.

# HOW WORLD STOCK MARKETS DID IN 1986 —AND A FORECAST FOR 1987



NA = NOT AVAILABLE

DATA: MORGAN STANLEY CAPITAL  
INTERNATIONAL PERSPECTIVE.  
ANALYSIS BY MURRAY JOHNSTONE INTERNATIONAL INC.  
PERFORMANCE ESTIMATES

ILLUSTRATION BY ROSEGER GEMMAY