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'Alpha' Bets Turn Sour --- Pennsylvania Pension Now Faces Billions in Losses

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The stock-market downturn could force the Pennsylvania state employees' pension fund to make cash payments of \$2.5 billion or more to trading partners on Wall Street.

The potential hit to the \$27 billion pension fund is the result of an exotic strategy used to help finance \$9.2 billion in hedge-fund investments. Those bets helped the pension fund beat the market when stocks were rising, but backfired when the market sank.

Use of the aggressive strategy, called "portable alpha," has been cut in half, with officials of the Pennsylvania State Employees Retirement System acknowledging that the pension fund's exposure was "too large."

Since stocks began falling, the fund has had to pay out \$1.5 billion. Based on current market values of derivatives still outstanding, Pennsylvania could owe another \$1 billion, a fund spokesman says. With the pension fund down about 14% in the first nine months of 2008, it is possible that the state will have to quadruple its annual contribution to roughly \$1 billion in 2012, according to people familiar with the situation.

The blowup is yet another example of the wide-ranging damage caused by sophisticated investment strategies peddled to **pension funds** and other institutional investors when the stock market was soaring.

An estimated \$75 billion or more has been invested using portable alpha. Other **pension funds** that used the strategy include the San Diego County Employees Retirement Association, with \$8.1 billion in total assets, and funds in Kansas, Massachusetts and South Carolina.

Sean Mathis, a partner at business-valuation firm Mathis & Co., believes some **pension funds** were pulled into portable alpha programs without fully realizing the risk. "When all the hand-waving is done, what investors ended up with is a highly leveraged bet on the market and a slug of money in **hedge funds**," he said.

Barring a turnaround, **pension funds** and other devotees of portable alpha "may find out that all they've done is paid a lot of fees and maybe lost a lot of money to boot," Mr. Mathis adds.

The idea behind portable alpha is that it's easy to match the market. If you do it using derivatives like futures, you can tie up less cash and get the same return you would using an index fund. Then you can use the rest of your cash to beat the market. The strategy gets its name from the ability to generate alpha, or above-market returns. As long as the returns on the remainder of your cash beat the futures' cost, you outperform the market. Typically, investors turned to **hedge funds** that are supposed to beat the market in good times and bad to invest that cash.

Last year, Pennsylvania pension-fund officials said the strategy would pay off as long as returns on the hedge-fund investments topped the interest rate owed on the investments. That is what happened when the market was rising. From 2003 to 2006, the pension fund's U.S. stock assets beat the market by an annual average of 6.2 percentage points.

But this year, the portable alpha portion of their portfolio, worth about \$6.4 billion at the start of the year, is trailing the market by an estimated 15 percentage points, indicating that with U.S. and world markets down by 41%, they have lost more than 55% of their value. Fund officials say that, even with that setback, the strategy has generated \$500 million in cumulative above-market returns.

Pennsylvania's portable-alpha strategy was put into place by the fund's former chief investment officer, Peter

Gilbert, who built the program over a decade but stepped down in mid-2007 to become chief of the Lehigh University endowment. A Lehigh spokesman said Mr. Gilbert declined to comment.

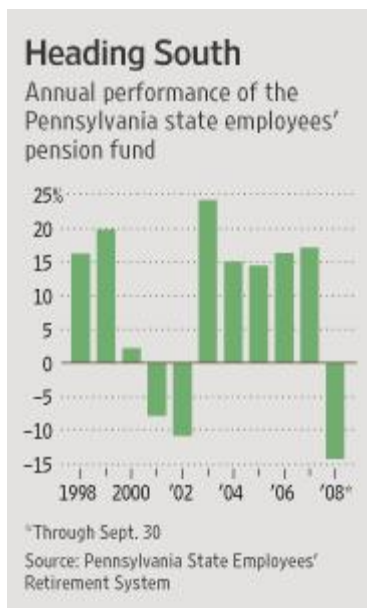
Pennsylvania invested more in **hedge funds** than any other state pension fund. Those **hedge funds** returned 2.8% for the year ended in June, but their performance turned negative in the third quarter and has remained so thus far in the fourth quarter, according to a spokesman for the pension fund.

Pennsylvania spokesman Robert Gentzel says the pension fund has had to sell liquid assets to make cash payouts on swaps it used to implement the strategy, but that such sales weren't unexpected. Assets had been set aside as collateral for the swaps, he adds. Portable alpha was pioneered in the mid- to late 1980s at Pacific Investment Management Co., led by famed bond manager William Gross, and by corporate pension-fund manager Marvin Damsma at Amoco Oil Co., according to the book "Capital Ideas Evolving" by Peter Bernstein.

A Pimco stock mutual fund using portable alpha has trailed the market by more than 10 percentage points this year. A spokesman for Pimco, a unit of German insurer Allianz SE, which has \$1.5 billion in mutual funds using the strategy and another \$30 billion for institutional investors, declined to comment.

Other bond managers with funds that used portable alpha to boost returns also have suffered. Among them is the Western Asset Management unit of Legg Mason Inc. Assets in the unit's \$5 billion U.S. Index Plus accounts were invested mostly in **mortgage**, asset-backed and corporate securities, which have been clobbered amid the market's meltdown.

"I think this particular strategy is going to be pretty widely discussed, debated and re-evaluated," says Jim Hirschmann, chief executive of Western Asset Management.



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